the SEC goes INTERNATIONAL

By Jack T. Ciesielski, CPA, CFA, and
Thomas R. Weirich, CPA

In April 2005, Don Nicolaisen, then chief accountant of the Securities & Exchange Commission (SEC), laid out a "road map to convergence" for the melding of domestic and international accounting standards—specifically, those of the U.S. Financial Accounting Standards Board (FASB) with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Nicolaisen's road map ultimately called for eliminating the IFRS-to-GAAP (Generally Accepted Accounting Principles) reconciliation in SEC filings by the year 2009 or sooner.

The problem facing management accountants is that "sooner" is starting to look a lot like "now."

First, a little background: In August 2007, the Commission issued a Concept Release to help it gauge interest in allowing U.S. registrants to choose between FASB and IASB standards in preparing their financial statements—a more extensive proposal that could eventually put all accounting standards under one roof but create surprising costs and inefficiencies along the way. (For the complete text of the Concept Release, go to www.sec.gov/rules/concept/2007/33-8831.pdf.) On December 21, 2007, the Commission adopted a final ruling: Securities Act Release No. 8879 (SEC Release No. 33-8879), "Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP," with an effective date of March 4, 2008.

More recently, on August 27, 2008, the SEC voted to publish for public comment a new, second, proposed "road map" that could ultimately require large United States companies to use IFRS by 2014. The Commission would decide by 2011 on whether adopting these standards would benefit investors if U.S. companies follow them in their various filings with the SEC.

In the greater global economy, the main benefit to shareholders would be an increase in investment choices. Conversion to U.S.-style reporting, a long-standing barrier to foreign filers, would be removed, and the exchanges would probably be flooded with new registrants. But are more choices always worth the cost? We'll present the highlights of these pronouncements and the potential implications for management accountants.

CAUGHT BETWEEN TWO ACCOUNTING WORLDS

Foreign companies that want to trade their stocks and debt in the U.S. must file financial statements with the SEC, just like domestic companies. Those financial statements might be prepared in terms of U.S. accounting principles, but more likely they're presented in a firm's native accounting format. Lately, that's been IFRS as their acceptance around the world expands. Regardless, if a firm's financial statements aren't presented in U.S. GAAP, the SEC requires reconciliation between as-presented earnings and stockholders' equity and their GAAP-prepared equivalents. That reconciliation requirement has been a fixture of Form 20-F filings, used by foreign companies since 1982, and it has imposed an unpleasant cost on those who wanted to trade their securities in U.S. markets: To be able to prepare the reconciliation, they've had to effectively keep two sets of books.

How useful has the reconciliation been to investors and analysts? It's debatable. For instance, it doesn't permit line-by-line comparisons of foreign issuers to their U.S. counterparts, which automatically limits its usefulness. Because it's part of a 20-F filing, the reconciliation usually isn't available to investors on a particularly timely basis, either: There's a six-month filing deadline for 20-Fs. By comparison, many U.S companies deemed "large accelerated filers" (those with more than $700 million in market float) must file their Form 10-Ks within 60 days of their fiscal year end. To investors never satisfied with enough information, the reconciliation seems like paltry, stale data.

On the other hand, the SEC is charged with protecting investors' interests, and the reconciliation provided two key financial measurements used for valuing firms. Instead of burdening investors with the cost of forcing their own imprecise adjustments onto the foreign financial statements in order to make them comparable to domestic counterparts, the SEC imposed this expense on the firms benefiting from trading their securities in the U.S. While it was an added cost for those foreign filers, it wasn't as great as it would've been if the Commission had required full GAAP financial statements—something that's within its authority. The reconciliation was a cost-effective way of providing something for everyone: bare-bones information for investors at a minimized incremental cost for foreign filers. It was a compromise, guaranteeing that nobody would be completely happy.

QUICKENING THE PACE TO CONVERGENCE

Since the reconciliation was first required more than 25 years ago, much has changed in global markets and in the setting of standards for financial reporting. In 2001, the privately funded IASB was established as the successor organization to the International Accounting Standards Committee (IASC), which had issued 41 International Accounting Standards since its inception in 1973. When the IASB replaced the IASC in 2001, an entire support system patterned after the U.S. standards-setting infrastructure went into place. The IASB is governed by the London-based (and Delaware-incorporated) International Accounting Standards Committee Foundation (IASCF), similar to the FASB and its relationship with the Financial Accounting Foundation (FAF). Interpretations of IASB standards are carried out by an International Financial Reporting Interpretations Committee (IFRIC), whose American counterpart is the FASB's Emerging Issues Task Force (EITF). The IASB is advised by a Standards Advisory Committee—just like the FASB is counseled by the Financial Accounting Standards Advisory Committee.

THE IASB MAY WELL BE SUCCEEDING: MORE THAN 100 COUNTRIES HAVE ADOPTED ITS STANDARDS, WITH MORE HOPPING ON THE BANDWAGON.

The IASB's goal is "to develop, in the public interest, a single set of high-quality, understandable, and international financial reporting standards (IFRS) for general purpose financial statements." The IASB may well be succeeding: More than 100 countries have adopted its standards, with more hopping on the bandwagon. Canada, for example, will phase in IFRS as its accounting language over the next few years, though the transition reportedly could take as long as five. India and Japan have also announced their plans to fully converge their standards with IFRS by 2011. The European Union required its members to adopt reporting in IFRS terms beginning in 2005, greatly increasing the "installed base" of firms publishing financials under the international standards.

The United States isn't ignoring the global movement, by any means. Pursuant to a Memorandum of Understanding known as the "Norwalk Agreement," which was reached in September 2002, the FASB and the IASB have been working toward converging the two sets of standards "as soon as is practicable." Since then, neither body has started a major standards-setting project without a joint effort.

UNDER A WATCHFUL EYE

The SEC has been monitoring the convergence scene keenly over the past few years. In an April 2005 article in the *Northwestern Journal of International Law and Business*, Don Nicolaisen, the SEC's chief accountant at the time, declared: ". . . both the U.S. GAAP and IFRS models have their place in the U.S. capital markets, and that convergence is the enabler that will allow them to coexist. What is essential is that each set of standards be complete, that each produce financial statements of high quality, that each set of standards enjoy wide acceptance and use, that the standards be reasonably comparable to each other and that investors are capable of and comfortable in understanding the nature of differences between the two sets of standards."

It was in this article that Nicolaisen described the "possible road map" to convergence that discards the GAAP reconciliation for IFRS-based financial statements by 2009 or sooner. The Commission has stayed on course since then and now has eliminated the reconciliation for foreign firms that report on a pure IFRS basis—that is, with no exemptions from standards *as published by the IASB*. In reality, some countries claim to have adopted IASB standards but employ their own version of a particular accounting standard. Another important exception is in the European Union: While it requires its member countries to use IFRS in their financial reporting, the EU has carved out an exception that allows firms to elect whether or not to follow the hedge accounting provisions of International Accounting Standard No. 39 (IAS 39), "Financial Instruments: Recognition and Measurement." Out of the thousands of firms that are reporting on an international accounting basis, however, only 29 have opted to use that exception, according to IASB member Thomas Jones, speaking in a panel discussion at the Council of Institutional Investors' 2008 annual meeting. This is because of the complexity of the accounting.

Of course, not all investors are going to be comfortable without the familiar touchstone of GAAP earnings in foreign filings. The majority, however, seemed to express indifference toward the reconciliation during an SEC-sponsored investor roundtable held in March 2007. While it would be surprising to find investors who used the reconciliation information *directly* in their investment analysis and found it helpful, many investors probably used it without even noticing. First, it provided a handy context: If foreign filers were reporting just like anyone else in the U.S., would they look better or worse on the basis of at least two metrics? Second, it provided a proxy for complexity, something that turns off many investors. The sheer number of reconciling items and the magnitude of the differences they create might convince some investors that evaluating foreign investments is outside their range of competence—or that the effort to monitor them might not be worth it. And, lastly, investors used the reconciliation as on-the-job training to learn about IFRS in real-world applications rather than try to parse knowledge from the standards' actual wording or from textbooks. Removing the reconciliation, it was argued, would take

AS LARGE DOMESTIC FIRMS INCREASE THEIR GLOBAL FOOTPRINT, IT BECOMES MORE LIKELY THAT THEY MAY HAVE TO REPORT SUBSIDIARY OPERATIONS ON AN IFRS BASIS TO REGULATORS IN FOREIGN COUNTRIES.

away a source of education, running somewhat counter to the SEC's mission of investor advocacy.

MELDING THE STANDARDS

There's no question that the convergence of the IASB and FASB standards is a good idea: Investors want to put their money where it's going to earn the best return, and they like to have more choices. Different reporting languages describing the same economic events can prevent capital from flowing to where it's best served. Still, eliminating the reconciliation has some drawbacks:

◆ **Most investors will wrestle with understanding IFRS.** Do investors really comprehend the nuances of IFRS enough to compare the financials of different companies using different standards? It's not likely: The level of education about IFRS at the American college level is practically nil, and what little there may be is in the curricula for accounting degrees, not finance degrees.

◆ **Enforcement may be more difficult.** The SEC is depending on the uniform application of IFRS among different countries and is relying on cooperation with other countries' securities regulators to monitor and enforce that application. For new registrants in the U.S., enforcement isn't likely to be quite as direct.

◆ **Many companies are still inexperienced in applying IFRS.** As mentioned earlier, the European Union's members have used IFRS only since the beginning of 2005; many companies have had just two years of experience with the new reporting. In July 2007, the SEC examined filings of IFRS-reporting firms and noted problems in the application of the standards in the areas of cash-flow statements, accounting treatments for common control mergers, recapitalizations, reorganizations, acquisitions of minority interests, and similar transactions. (For more details, see "Staff Observations in the Review of IFRS Financial Statements" at www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm.)

◆ **IASB will be elevated to standards-setter status.** With the elimination of the reconciliation, the SEC effectively recognizes the IASB as a standards setter. Its standards would have the same stature as the FASB's, yet the IASB's independence isn't the same. That's because EU politics have played a role in past IASB standards and could do so again—another risk to achieving truly converged accounting standards between the U.S. and the international community.

BEYOND CONVERGENCE

Suppose U.S. firms in a particular industry face competition from foreign companies that report on an IFRS basis and are consistently more profitable because of the differences in the two sets of standards. Without the reconciliation, how would investors make a fair comparison? They really couldn't, so, if there isn't any reconciliation, U.S. firms are at a disadvantage in the capital markets. Yet allowing them to move their accounting to IFRS for their SEC filings provides relief and effectively levels the playing field. That's a scenario that could become more common: As the Commission points out in its Concept Release, the continuing acceptance of IFRS around the world could lead to more comparisons between U.S. firms and IFRS-adopting firms, and the comparisons could be especially pointed if those foreign companies elect to trade their securities in the U.S. Furthermore, as large domestic firms increase their global footprint, it becomes more likely that they may have to report subsidiary operations on an IFRS basis to regulators in foreign countries. These companies thus might have to adopt IFRS reporting whether they want to or not.

The Concept Release is an exploratory document, less of a concrete rule (like dropping the reconciliation) than it is the Commission's attempt to gather information and advice on the ramifications of offering American firms the choice of reporting in IFRS. Here are some of the key issues:

◆ **Free choice:** First of all, do investors and financial statement preparers believe that there should be a choice?

◆ **Capital bias:** Does such a choice give some firms an advantage over others? For instance, large multinational firms might find it cost effective to switch to IFRS, but small domestic companies with limited resources may not be able to make the transition. If a firm saves substantial sums of money by using IFRS, will that put others at a disadvantage?

◆ **Capital formation:** If the option isn't granted, what happens to capital markets in the U.S. as IFRS adoption gains steam overseas? Will U.S. companies list their securities elsewhere?

◆ **Investor usefulness:** Will investors be able to understand and use U.S. firms' financial statements prepared on an international reporting basis?

◆ **Barriers to switching:** Would there be contractual barriers for U.S. firms in switching to IFRS? For example, many covenants and agreements may be contingent on figures being reported on a U.S. GAAP basis.

◆ **Convergence efforts:** What would be the effect on the FASB and standards setting in the U.S.? How much would the convergence of U.S. and international standards matter? If the FASB and the IASB were unable to unite certain standards, what should the SEC do?

◆ **Confidence in the process:** Do investors and financial statement preparers have confidence in the process that has produced IFRS? If so, are they certain that it will continue to be robust? If they're secure in the process and the standards, should it matter to them if the SEC officially recognizes the principles? Does it matter to investors that the SEC has no direct oversight over the IASB, which is quite unlike its relationship with the FASB?

◆ **Experience gathering:** Currently, International Financial Reporting Standards aren't part of many college accounting curricula; in fact, they're not tested in the Uniform CPA Examination or the Certified Management Accountant (CMA®) exam. What barriers and incentives exist for changing the content of the CPA or the CMA exams? What will it take to get experienced professionals to adapt to a world that would embrace IFRS more fully and for getting colleges and universities to do the same? If accountants in the U.S. are unfamiliar with international standards, then most investors are likely even further behind. Should the SEC take it upon itself to help educate investors? If so, how?

◆ **Practice issues:** What actual differences between the two sets of standards would pose problems for financial statement preparers and their auditors in converting to IFRS? Do such differences matter in giving U.S. preparers the choice of a basis? What costs would be involved in a conversion, and what benefits would justify the costs?

◆ **Auditing and regulation:** Would auditing firms be willing to audit IFRS-based financial statements? Would the relative "balance of power" within the public accounting hierarchy be affected by giving companies the choice? Would the audit quality of IFRS-based U.S. financial statements be satisfactory? Is the ability to share information among international securities regulators sufficiently developed to ensure that IFRS will be applied properly?

◆ **Transition and timing:** Who within each company should decide to make the switch—management, the board of directors, or shareholders? When would investors and auditors be ready for an accounting system that allows a choice? Should the SEC establish a timetable for giving an IFRS-based option to U.S. firms? Should the choice be available only for a limited time? Should companies be allowed to switch back to U.S. GAAP?

IMPLICATIONS FOR MANAGEMENT ACCOUNTANTS

There's no doubt in the corporate world that IFRS represent a major step toward creating greater transparency and comparability between companies around the world. But, unfortunately, the link between traditional U.S. GAAP and management accounting has been somewhat overlooked. These linkages reflect practices that have developed over time in companies, specifically in the corporate accounting areas, to aid management in decision making and controlling activities. Now, with the potential adoption of IFRS, these linkages face the danger of breaking. The result will be the need to develop new best practices in these areas—for instance, new analytical/management accounting concepts that are based on IFRS. Companies will need to standardize their practices in order to create a common internal global management accounting language for decision making and performance management.

As you can see from this discussion, there are still many issues and questions that need to be addressed by all parties, including management accountants. But one thing's for certain: With the world seemingly becoming smaller by the day, and more and more organizations reaching out beyond their borders, now's clearly the time to start developing a strong set of "International Management Accounting Standards." ■

Jack T. Ciesielski, CPA, CFA, is president of R.G. Associates, Inc., an investment research and capital management firm. You may contact Jack at (410) 783-0672 or jciesielski@accountingobserver.com.

Thomas R. Weirich, CPA, Ph.D., is a professor of accounting at Central Michigan University. You can reach him at (989) 774-3314 or weiri1tr@cmich.edu.