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SEC Seeks Input on Allowing Domestic Companies to Use IFRS

The SEC issued a Concept Release to obtain comments on whether it should consider permitting domestic companies registered with the SEC to file financial statements that comply with international financial reporting standards as published by the IASB, rather than U.S. GAAP.¹ The potential change could have broad ramifications for preparers, auditors, users, regulators, colleges and universities, and other interested parties. Comments on the release are due by November 13, 2007.

The Concept Release is consistent with the SEC's interest in promoting the global convergence of financial reporting and follows the SEC's July rule proposal to eliminate the reconciliation requirement to U.S. GAAP for foreign private issuers preparing financial statements in accordance with IFRS as published by the IASB. The July rule proposal would give foreign private issuers a choice between presenting financial statements in accordance with either IFRS or U.S. GAAP, a choice currently unavailable to domestic companies.² The question of allowing domestic companies to use IFRS has also been brought in focus by the increased use of IFRS outside the U.S. IFRS is currently required or permitted for preparing and presenting financial statements in approximately 100 countries. The number of U.S. filings based on IFRS by foreign private issuers increased from just a few in 2005 to over 100 in 2006.³

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¹ SEC Release No. 33-8831, Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards, August 7, 2007, available at www.sec.gov.

² SEC Release No. 33-8818, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, July 2, 2007, available at www.sec.gov.

³ Speech by SEC Commissioner Roel C. Campos, Remarks at the Open Meeting: Concept Release on Allowing U.S. Issuers to use IFRS, July 25, 2007, available at www.sec.gov.

Key Issues

The Concept Release identifies issues that need to be considered in deciding whether to give domestic companies a choice of filing financial statements that comply with IFRS or with U.S. GAAP. Highlights from the release's questions are given below:

- Should the SEC allow domestic companies to choose to file financial statements in accordance with IFRS? Are there issues unique to investment companies that should be considered?
- Is SEC oversight of the IASB sufficient and does the IASB follow appropriate due-process procedures in setting standards?
- How do differences between IFRS and U.S. GAAP bear on whether domestic companies should be permitted to apply IFRS?
- What would be the effect on U.S. capital markets if some domestic companies reported in accordance with IFRS and others in accordance with U.S. GAAP? Would permitting domestic companies to apply IFRS increase or decrease financial-statement comparability for users?
- To what degree would investors and other market participants be able to understand and use financial statements prepared in accordance with IFRS?
- Would domestic companies who chose to file IFRS financial statements need to monitor foreign regulators' interpretations of IFRS in addition to any SEC interpretations? How would regulatory oversight need to change to promote consistent regulatory interpretations of IFRS on a global basis?
- How would permitting domestic companies to file using IFRS affect the process of converging U.S. GAAP and IFRS? What should be the roles of the FASB and IASB in the near and long term? Would there continue to be a need for two standard-setting bodies if IFRS becomes more widely used and accepted in the U.S.?
- What incentives and disincentives would determine whether colleges and universities develop needed educational programs?

Related Issues. Respondents to the SEC release may also wish to consider these questions about the potential effects of an SEC decision to give domestic companies permission to file financial statements using IFRS:

- Do IFRS financial statements provide information that is as decision-useful to investors as do U.S. GAAP financial statements? Can IFRS financial statements be prepared at the same or lower cost?
- Should IFRS be mandated and, if so, over what period of time should companies be permitted to transition to IFRS?
- Would it be best to delay the permission for domestic companies to file financial statements using IFRS until selected joint FASB-IASB projects, such as the one on financial-statement presentation, are completed?

Permitting domestic companies to file IFRS financial statements would likely result in a significant undertaking, requiring efforts from preparers, auditors, regulators, users, and other interested parties. However, many foreign private issuers and companies listed

in the EU, Australia, and other jurisdictions have adopted IFRS in the last few years despite difficulties similar to those domestic companies would face in adopting IFRS.

Potential Impact on Convergence

Convergence between U.S. GAAP and IFRS has for several years been one of the standard-setting priorities of the FASB and IASB,⁴ and the SEC staff identified convergence efforts as one of the factors to be considered in deciding whether to propose eliminating the reconciliation requirement for foreign private issuers.⁵ The Concept Release asks whether permitting domestic companies to file IFRS financial statements would reduce incentives for the FASB, IASB, or both to continue their convergence efforts and whether market participants would still have an incentive to support convergence efforts.

The risk to convergence efforts from giving domestic companies a choice would be influenced by the number of domestic companies that adopt IFRS. Assuming a decision to permit domestic companies to file using IFRS, widespread adoption of IFRS could diminish incentives for convergence. It is less clear, however, what effect a more limited movement by domestic companies to adopt IFRS would have on standard setters' incentives. Whether or not domestic companies are allowed to choose between U.S. GAAP and IFRS, the proposed elimination of the U.S. GAAP reconciliation for foreign private issuers that file with the SEC using IFRS could, by itself, diminish momentum to converge the two sets of accounting standards.

⁴ The Norwalk Agreement, Memorandum of Understanding between the FASB and the IASB, October 29, 2002; and A Roadmap for Convergence between IFRSs and U.S. GAAP—2006-2008, Memorandum of Understanding between the FASB and the IASB, February 27, 2006; both available at www.fasb.org.

⁵ Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, A Securities Regulator Looks At Convergence, April 2005, available at www.sec.gov.

Potential Benefits

Companies responding to the release are likely to analyze how they would be affected by an SEC decision to permit domestic companies to file financial statements in IFRS. The types of potential benefits depend greatly on individual circumstances, but are likely to fall into the following categories.

Foreign Subsidiaries. U.S. multinational companies may have obligations or opportunities to file local statutory IFRS financial statements for their foreign subsidiaries. These statutory financial statements historically have been prepared using the foreign country's GAAP, requiring the companies to maintain two sets of records in each country with a statutory requirement: one for local statutory reporting and one based on U.S. GAAP for the consolidation information. Many of these countries may now accept statutory reports prepared in accordance with IFRS. Domestic companies with significant foreign operations may wish to consider whether and to what degree permission to file IFRS consolidated financial statements in the U.S. could simplify their accounting processes and reduce their costs by enabling them to use IFRS for both U.S. and foreign-country statutory reporting.

Comparability. Domestic companies that operate in industries with foreign competitors reporting financial information in accordance with IFRS may be able to improve the comparability of financial information with their peers if they are permitted to file IFRS financial statements with the SEC. The more significant the differences between

U.S. GAAP and IFRS reporting within the industry, the more clear the benefit in comparability. Some users may attempt to adjust for differences between U.S. GAAP and IFRS financial information.⁶ However, it is often impossible to accurately quantify the differences between U.S. GAAP and IFRS without detailed information that is not available outside of the company, and it may be time-consuming for management to explain the differences to the investment community. Allowing such companies to file IFRS financial statements may therefore enhance comparability.

Differences Between IFRS and U.S. GAAP. Companies evaluating the potential effect of permission to file financial statements in either U.S. GAAP or IFRS may conclude that conceptual and application differences between the two sets of standards would enable improvements in the quality of their presentations. U.S. GAAP and IFRS differ significantly, for example, on consolidation, de-recognition, classifying financial instruments as debt or equity, revaluations of investment property and long-lived nonfinancial assets, and impairments and impairment reversals. Even in areas where the standards are similar, application differences exist. Both U.S. GAAP and IFRS have a "fair value option" for financial instruments, but its scope is more limited under IFRS, which permits its use only if certain criteria are met. U.S. GAAP permits management a free choice upon initial recognition. Identifying and quantifying the relevant differences between U.S. GAAP and IFRS is a significant undertaking, but the task would be criti-

cal if a domestic company faced a choice of using IFRS or U.S. GAAP in filings with the SEC. Companies would have to decide which set of standards offered the most decision-useful communication to its investors, creditors, and other users of the financial statements.

Potential Costs

One of the most obvious potential costs from permitting domestic companies to file IFRS financial statements with the SEC is for training a company's accountants, internal auditors, and other personnel. Investors, creditors, external auditors, and regulators would incur costs to prepare themselves to understand IFRS financial reporting well enough to perform their responsibilities. Companies that chose to apply IFRS could also incur costs to meet non-SEC requirements to provide U.S. GAAP information, such as financial-covenant and state-regulatory requirements, and would incur costs for changes in information systems and related controls. Information on potential costs is likely to play an important role in SEC deliberations.

Training. The effort to train corporate accountants sufficiently to enable the preparation of reliable IFRS financial statements could be significant. The knowledge gained learning to apply U.S. GAAP would be a solid foundation for learning IFRS, but it would still take time to raise individuals' IFRS knowledge to the level of their U.S. GAAP knowledge. The company's auditors and other external advisors, such as actuaries and valuation professionals, would need to make a similar investment.

⁶ SEC Staff Roundtable on International Financial Reporting Standards "Roadmap," March 6, 2007. The agenda, list of panel participants, archived webcast, and transcript are available at www.sec.gov/spotlight/ifrsroadmap.htm.

Companies responding to the Concept Release may wish to consider the experience of EU countries, which adopted IFRS over a five-year period that included educating all relevant constituents on the new standards of financial reporting.

Contractual and Legal Requirements. A company's non-SEC requirements to provide U.S. GAAP financial statements could make it less cost-effective for them to file IFRS financial statements with the SEC, because they would have to retain both accounting and reporting capabilities and incur the costs to prepare both types of reports. For example, debt covenants and certain regulatory filings may require companies to provide U.S. GAAP financial statements or maintain financial metrics calculated using U.S. GAAP. Some companies could find the prospect of renegotiating these kinds of financial-reporting obligations an obstacle to adopting IFRS.

Systems and Controls. Domestic companies given the choice of filing financial statements in IFRS would need to consider necessary changes to systems designed to capture and produce U.S. GAAP information. For example, separating multiple-element revenue arrangements into the units of account may differ under U.S. GAAP and IFRS, requiring sys-

tem modifications to capture and report the information required by IFRS. Compliance with initial adoption requirements would entail developing the data for prior years as part of the process of converting to IFRS.⁷ Similarly, internal-control processes designed to promote compliance with U.S. GAAP would need to be adapted for compliance with IFRS, documented, and tested by management and auditors as required by Section 404 of the Sarbanes-Oxley Act.

Interpreting IFRS

Respondents to the Concept Release should take into account that IFRS is a less mature body of literature and its ongoing development and interpretation would affect its application. There are far fewer interpretations of IFRS than of U.S. GAAP and far fewer established practices. The standards contain little industry-specific guidance. A domestic company that adopted IFRS, assuming it were permitted, may initially be inclined to interpret IFRS using the U.S. GAAP background with which it is familiar. That would sometimes be appropriate, but may not yield acceptable interpretations in all situations.

The SEC has been training its staff in IFRS in order to enable them to review the finan-

cial statements of foreign private issuers. As a result of those reviews, and as more foreign private issuers adopt IFRS, the SEC may develop its own interpretations of IFRS. Other securities regulators around the world are similarly reviewing the application of IFRS in their national markets and may develop their own interpretations. While securities regulators around the world generally agree that a consistent global application of IFRS is desirable, different regulatory interpretations could arise.

The SEC is examining the mutual-recognition approach, under which national regulators accept the regulation of other national regulators within their respective jurisdictions. This is consistent with the U.S. Treasury's capital markets competitiveness action plan announced early this summer. The plan includes considering mutual recognition for regulatory systems outside the U.S. that compare satisfactorily to related U.S. regulation.⁸ Progress on mutual recognition will be an important consideration for domestic companies that have regulatory filings in foreign markets that permit or require the use of IFRS.

The Concept Release notes that an IFRS option would be integrated with the SEC's existing rules, regulations, and interpretations. The SEC considered this question in its 2007 rule proposal to accept IFRS financial statements prepared by foreign private issuers without reconciliations to U.S. GAAP and proposed that the requirements in Regulation S-X generally would be applicable to foreign

IFRS and U.S. GAAP Compared

Those who wish to learn more about how IASB standards differ from U.S. GAAP may refer to KPMG's publication *IFRS compared to U.S. GAAP*, July 2007. It presents significant differences between the two sets of standards. An overview version is available free for download at <http://kpmg.com/IFRS.htm>, and the full text may be ordered at the same location.

⁷ IFRS 1, First-Time Adoption of International Financial Reporting Standards, June 2003.

⁸ Press release HP-408, Paulson Announces First Stage of Capital Markets Action Plan, May 17, 2007, and Press release HP-476, Paulson Announces Next Steps to Bolster U.S. Capital Markets' Global Competitiveness, June 27, 2007, both available at www.ustreas.gov.



private issuers using IFRS. This will likely require modifying portions of Regulation S-X, such as the sections addressing the form and content of financial statements. Much of the accounting guidance contained in Staff Accounting Bulletins and other guidance issued by the SEC may need to be adapted to IFRS.



The SEC's Concept Release marks a turning point in financial reporting that came sooner than many expected. We expect the release to draw strong reactions from participants in the U.S. capital markets and international attention as well. For the reasons cited above, responding to the Concept Release will be demanding, but the potential consequences suggest that members of the financial-reporting community should provide their thoughts to the SEC.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the text of any of the cited documents or any other applicable or potential accounting literature or SEC regulations. When complying with GAAP or filing requirements, companies should consult the text of the applicable documents that set out requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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