INDUSTRY NEWS

SEC Roundtable Compares Performance of U.S. GAAP and IFRS during Subprime Crisis

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This is a summary of a forum discussion. No rules have been proposed or finalized.

August 4, 2008 — The Securities and Exchange Commission (SEC) hosted a roundtable comparing the performance of U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) during the recent market turmoil caused by the subprime mortgage crisis. According to SEC Chairman Cox, the SEC held the roundtable to understand how IFRS and U.S. GAAP "performed in the cauldron of the recent market turmoil." The roundtable consisted of two panels – the first aimed at evaluating financial reporting in the financial services industry sector and the second targeting other industries. In summarizing the session, Chairman Cox noted that the participants generally agreed that IFRS worked well in the subprime crisis. The participants continued to support the movement towards the adoption of IFRS by U.S. issuers.

Panelists included investors, issuers, auditors and others experienced in evaluating company financial statements prepared in accordance with IFRS or U.S. GAAP.

BACKGROUND

Last August, the SEC issued a Concept Release soliciting input on whether U.S. issuers should be permitted to prepare financial statements using IFRS as published by IASB. Based on the comments received, discussion during recent roundtables and pressure on U.S. market regulators, it is likely U.S. issuers will be able to use either IFRS or U.S. GAAP for public reporting purposes in the United States, with potential mandatory application to follow.

KEY POINTS

The discussion began with a review of on- and off-balance sheet financing. Charlotte Jones, Global Head of Accounting Policy Group at Deutsche Bank, noted that Deutsche Bank consolidated over 200 Qualified Special Purpose Entities when it transitioned from U.S. GAAP to IFRS. Jones described the effort as one that requires "more work, but on balance gives a more realistic answer to what is going on." As several panelists noted, IFRS has two basic models for consolidation – a control model under *International Accounting Standards (IAS) 27*, *Consolidated and Separate Financial Statements*, and a

risks/rewards model under *Summaries of Interpretation (SIC) 12, Consolidation – Special Purpose Entities*. The key is distinguishing between the two. In some instances, focusing on the qualitative factors included in *SIC 12* can lead companies to a conclusion similar to that found in *Financial Interpretation Number (FIN) 46R*, *Consolidation of Variable Interest Entities*. As Trevor Harris of Morgan Stanley noted, it is "very easy to slip back into modes where you want bright-line rules."

The discussion moved to a review of fair value measure and disclosure concepts. In general, the investors on the panel felt that current disclosures are working. As Trevor Harris pointed out, disclosures in U.S. GAAP regarding, "level one, level two, and level three have been helpful."

In addition, Paul Boyle of the Financial Reporting Council (FRC) in the U.K. felt that U.K investors found IFRS to be an acceptable model. He identified that any loss of confidence in current financial markets is not due to accounting standards. The lack of confidence comes from investors not liking what they are seeing in the numbers, which is "being *revealed* by the numbers, not concealed," he added. In other words, the disclosure requirements in both U.S. GAAP and IFRS have improved the information provided to investors, enabling them to better evaluate financial institutions' performance.

IFRS 7, Financial Instruments: Disclosure, became effective for annual periods beginning on or after January 1, 2007. This forced companies to rethink their disclosures. For example, Deutsche Bank reevaluated how its disclosure information was compiled and moved selected information out of the Management Discussion and Analysis (MD&A) section of its report into footnotes as required by *IFRS 7*. As Paul Boyle of the FRC noted, this is increasing the complexity for investors.

Those concerns aside, panelists generally supported the new fair value disclosures required under *FAS 157*, noting that some were voluntarily appearing in IFRS filings. In addition, SEC staff admitted they looked to *IFRS 7* for guidance that was recently released in a letter to financial institution CFOs encouraging better disclosure in their MD&A sections. While the process may not be complete, both FASB and the IASB are making strides to improve the information provided to investors.

This led to general agreement that a disclosure framework project, which has been discussed by both standard setters, was key to improving both sets of GAAP and the information provided to investors. In addition to the disclosure framework, several panelists noted that enhanced disclosure should be supported by enhanced tools to locate and analyze that data. Ron Graziano from Credit Suisse said that more data points are good "especially when you have an architecture like XBRL."

In discussing the use of fair value for entities outside of financial services, panelists identified situations where the mixed-attribute model of financial reporting led to mismatches of information. For example, Roger Harrington, VP of Group Accounts for BP, noted that BP holds inventory at cost and related derivatives at fair market value under *IAS 39, Financial Instruments: Recognition and Measurement*. He added that BP did not select hedge accounting since that would have required too much effort.

SEC Commissioner Luis Aguilar asked Paul Boyle about the "big bang" transition to IFRS in the U.K. Mr. Boyle said the U.K. did not do a lot of planning for the transition and

was “lucky to get away with it.” He also felt there was a much bigger drive in the European Union to move to a single standard from the 25 different sets of national GAAP that existed prior to 2005 versus the situation in the United States where only two sets of GAAP exist (IFRS and U.S.). SEC Commissioner Elisse Walter added that IFRS is more mature in 2008 than it was when the EU adopted in 2005, hinting that it is now a stronger platform for U.S. companies than it was for the Europeans.

In considering the transition, Mr. Boyle noted that the major downside of a big bang transition is that the price of IFRS expertise will likely rise. He recommended that the SEC allow companies the option to elect IFRS, allowing each company to decide when the balance of benefits and costs indicates it is time to make the transition.

The future direction of IFRS in the U.S. market seems to be reaching a key juncture. John White, Director of the SEC’s Division of Corporation Finance, identified three consistent themes surrounding the SEC’s efforts around IFRS. First, the goal is for all major financial markets to adopt a single set of high-quality financial standards. Second, both U.S. GAAP and IFRS meet the criteria for a set of high-quality financial standards with global momentum favoring IFRS. Third, a transition to IFRS for the U.S. will be challenging, and stakeholders are looking for a road map that outlines the transition and contains a mandatory adoption date. The roundtable participants confirmed they shared this view.

Prior to any transition, it was agreed that the International Accounting Standards Board (IASB) should address specific weaknesses. These areas include adding guidance regarding revenue recognition, incorporating fair value disclosure guidance from FAS 157 into international standards, providing more comprehensive guidance on consolidation policies and clarifying derecognition in relation to securitization accounting.

The U.S. is clearly on course to adopt IFRS. The questions are who will be allowed the option to adopt IFRS and when will all public filers be required to use international standards.

Bob Laux stated that Microsoft has begun an impact assessment to determine if it would opt for IFRS if given the choice. He is considering transparency and trying to take a clean sheet approach in communicating the economics of Microsoft. This is particularly true in the area of revenue recognition. The Microsoft team discovered early in this process that it will have to develop controls of its own to communicate to business units how to apply the more principles-based international standards regarding revenue recognition. This is in contrast to the current state under U.S. standards where the company can reference specific paragraphs in specific standards to provide clear guidance in internal policies and procedure.

Chairman Cox summarized by noting that many panelists view a transition to IFRS as an opportunity for issuers to take a fresh look at their financial reporting.

IMPACT TO BUSINESSES

An “either-or” decision to adopt IFRS as soon as permitted or as late as required is a false dichotomy. The transition can be viewed as a set of staged activities that position a company to take advantage of favorable financial effects sooner, or minimize negative

financial impacts later. This enables companies to match financial reporting and financial market benefits to their readiness to implement.

Beginning an orderly approach to the transition now allows companies to take advantage of the time available to implement IFRS and avoid a Sarbanes-Oxley (SOX)-like fire drill. Most accelerated filers completed their year-one SOX efforts with a “just do it” mentality that left companies cleaning up messes and streamlining processes in ensuing years. The current timeline allows companies to begin the journey to IFRS in a different fashion — allowing them to control the timelines, resources and decision-making and avoid the “under-the-gun” approach that made SOX such a negative experience. This flexibility is clearly a benefit of the SEC’s optional adoption period under consideration.

Companies should begin with a series of assessments — impact to financial statements, organizational readiness, policy consistency, etc., — and based on that information devise a plan to train staff, develop and implement global policies, procedures and processes, and convert specific entities before making a final transition to IFRS. Companies can initiate a significant portion of the effort now by investing in streamlining processes that lay the groundwork for the ultimate transition to IFRS. The key is to begin readiness activities now and convert once your company is prepared and it makes financial sense.

Specific industry accounting issues and cost saving opportunities under a single set of reporting standards will be the likely drivers influencing companies to choose to file under IFRS during the optional period. As discussed during the roundtable, companies will have to apply fair value accounting, hedge accounting and revenue recognition in their industry. They will need to understand how investors view their company in light of these accounting issues and whether they view early adoption of IFRS as a competitive advantage.

As companies initiate their analysis of the effects of IFRS, it’s important to consider not only what the balances will look like, but also how IFRS affects the infrastructure used to obtain those balances. IFRS, and any optional timeline for implementation, provides finance functions with a reason to re-examine and simplify accounting polices, processes and technologies across the enterprise. Forward-looking companies can leverage IFRS to build a truly efficient and flexible accounting infrastructure, streamlining costs, leveraging global strengths and enhancing enterprisewide decision-making.

Now is the time to begin working with the audit committee, financial management and other stakeholders to begin preparations for this transition.

HOW JEFFERSON WELLS CAN HELP

Jefferson Wells is a global provider of comprehensive financial reporting and technical accounting services including research, documentation, ongoing SEC reporting compliance and knowledge transfer. Jefferson Wells provides clients with the skills required to assess and implement IFRS — including technical accounting, project management, policy and procedure review and development, tax strategy and implementation, risk management, internal control assessment and implementation, continuous controls monitoring, business performance management, shared service

center optimization and financial process improvement. Because Jefferson Wells does not attest to financial statements, we are positioned to support issuers in making the transition to IFRS without conflict-of-interest issues.

For additional information, please contact your local Jefferson Wells Business Development Manager.

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