

Hot Topic

Update on major accounting
and auditing activities



SEC roundtable – Performance of IFRS during the market turmoil

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Introduction

On 4 August 2008, the United States Securities and Exchange Commission (SEC) hosted a roundtable to discuss International Financial Reporting Standards (IFRS) and to update the Commission on IFRS developments, including the experience with the use of IFRS during the recent period of market turmoil.

The roundtable consisted of two panels and included representatives from investor groups, public companies, auditing firms, and various other parties. In addition, representatives from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) were present as observers.

While there was a general consensus that IFRS performed well during the recent market turmoil, panelists acknowledged that similar challenges exist in the application of both IFRS and US GAAP in areas such as fair value accounting. Panelists also commented that significant differences between IFRS

and US GAAP remain in areas such as revenue recognition and these differences can result in information that is confusing for investors.

This publication summarizes the views and comments of the two panels. As we have publicly stated, we strongly support having a single set of high quality global accounting standards, and we believe that the SEC should make a clear statement that it will require all US issuers to adopt IFRS as of a date certain.

Overview

While introducing the roundtable, SEC Chairman Christopher Cox stated that the roundtables would provide an opportunity to learn about “the reasons that companies are using IFRS in the United States and the experiences associated with their doing so.” Chairman Cox acknowledged the recent turmoil in the capital markets and stated that “the job of financial reporting is to make those effects on issuers transparent to investors.”

The roundtable focused on two broad topics, with the first panel addressing the issue of how IFRS performed relative to US GAAP during the recent market turmoil and exploring topics such as:

- ▶ Participants' experiences in accounting for off-balance sheet arrangements under both IFRS and US GAAP
- ▶ Challenges faced in applying fair value accounting standards under both IFRS and US GAAP

The second panel explored some of the differences that currently exist between IFRS and US GAAP, including:

- ▶ Inventory as it relates to the pricing of commodities
- ▶ Revenue recognition, with a particular focus on the software industry

Despite the different focus of the panels, many of the views expressed by the panelists were variations of the same theme. Specifically, panelists believed that IFRS has performed well thus far, but is still an "immature" set of standards that could benefit from additional application guidance to reduce inconsistencies in the current application.

Summary of panelists views

Off-balance sheet arrangements

Panelists expressed the view that accounting for off-balance sheet arrangements under IFRS is more complex and requires more work than arrangements accounted for under US GAAP. Panelists shared their belief that this is because US GAAP provides detailed rules to follow compared with IFRS, which sets out broader principles that require a significant amount of judgment in their application.

To illustrate the lack of guidance provided by IFRS in this area, panelists cited the example of how it is not uncommon for IFRS preparers to default to the quantitative

model in FASB Interpretation No. 46(R) under US GAAP when preparing quantitative analyses to support their position under IFRS, because there is a lack of specific guidance in IFRS on how to consider risks and rewards from a quantitative standpoint.

One panelist representing a public company discussed how her company, upon conversion from US GAAP to IFRS, was required to consolidate several hundred more special purpose vehicles under IFRS than was required under US GAAP. Though this was later interpreted by some as an indication that IFRS has "outperformed" US GAAP in this area by requiring more vehicles to be brought on-balance sheet, the panelist made clear in her response that the reason for the increase in the number of entities brought on-balance sheet under IFRS was because the entities used in the related transactions were originally structured to be Qualified Special Purpose Entities (QSPE) under US GAAP, where adherence to strict US GAAP rules allow QSPEs not to be consolidated, with any retained interests accounted for as separate financial instruments. Because IFRS does not have a similar notion of a QSPE, upon conversion to IFRS, the conditions that need to be satisfied to have a vehicle qualify as a QSPE under US GAAP were not as relevant to the IFRS analysis, and the related retained interests needed to be considered as part of the risk and rewards analysis.

Panelists were in agreement that accounting for off balance sheet arrangements under IFRS requires significantly more judgment than under US GAAP and requires a more thorough understanding of an arrangement, which many felt results in a more "realistic" answer. However, one panelist representing an investor group commented that the significant judgment required in accounting for off-balance sheet arrangements under IFRS can result in inconsistencies, which can ultimately create confusion for some investors.

Fair value accounting

Panelists generally agreed that similar challenges exist in the application of fair value accounting standards under both IFRS and US GAAP and that while the definitions of "fair value" under IFRS and US GAAP differ slightly, this generally does not create diversity in the application of the fair value standards in practice.

The topic that generated the most discussion among panelists was the requirement under IFRS No. 7, *Financial Instruments: Disclosures* (IFRS 7), that certain risk disclosures be provided in the notes to the audited financial statements, whereas these disclosures have typically been provided in the unaudited Management's Discussion and Analysis (MD&A) section of the financial statements by US registrants.

When panelists representing the investor community were asked if it makes a difference where this information is provided, the panelists commented that investors do not necessarily place a premium on where the information is located. Rather, the timeliness of the information is most important. The panelists went on to say that the most valuable information for investors is that which is provided timely, such as information provided in a press release, so long as that information also is validated in the audited notes or included in the MD&A section of financial reports.

One panelist representing preparers noted that there are very different processes involved in generating information that is included in the audited notes versus information presented elsewhere in a financial report, and that different levels of review are involved in compiling that information. To this point, a panelist shared his fear as a regulator that investors are often getting different "stories" in the audited financial statements than they are in MD&A because the information is being generated through different processes.

Ernst & Young's representative also shared his view that auditing the risk information now included in the notes to the financial statement because of IFRS 7 presented a level of discomfort for auditors as the information is forward-looking and forward-looking information of this type has historically not been included in the financial statement notes.

Significant differences

Panelists discussed areas in which IFRS and US GAAP provide investors with significantly different information. In particular, the panelists focused on the accounting for inventory and revenue recognition.

One panelist pointed out that because IFRS does not permit last in, first out (LIFO) inventory accounting, IFRS reported earnings for companies in certain industries (for example, oil and gas) have been significantly skewed as the pricing of commodities sold by these companies have been subject to significant volatility in the current market environment. However, representatives from the investor community pointed out that the effect of such volatility in inventory pricing is easy to factor into their analyses for companies using IFRS because most companies are generally using the same inventory costing methodology (that is, first in, first out, or FIFO) whereas under US GAAP, additional effort is required to factor in this volatility as some companies use a LIFO methodology while others use a FIFO methodology.

Panelists also discussed the need for a new revenue recognition model under IFRS, which currently does not provide guidance for a number of arrangements, particularly for more complex arrangements as are commonplace in the software industry. Panelists agreed on the need for a new model for revenue recognition and acknowledged the ongoing efforts of the FASB and IASB to develop such a model.

Panelists commented that understanding the existing differences between IFRS and US GAAP can be aided by clear and transparent disclosure and that a strong disclosure framework is needed for both IFRS and US GAAP.

Conclusion

In our view, the message from the roundtable is that, despite some of the challenges faced in the application of certain IFRS standards, IFRS has demonstrated through its performance during the recent market turmoil to be a high quality set of accounting standards. It was apparent from the panelists' comments that there is a growing demand for a single set of high quality global accounting standards and that IFRS should be that set of standards.

As we have previously stated, the SEC is in a unique position to add momentum to the goal of one set of standards. It can provide the impetus to accelerate change by other regulators and standard setters around the world and we continue to strongly encourage the SEC to make a clear statement that it will require all US issuers to adopt IFRS as of a date certain. While we expect more dialogue to take place on this topic over the next several months, the adoption of IFRS in the United States is becoming more a matter of "when" and "how" the transition will occur, rather than "if" it will occur.

List of Panelists

Paul Boyle

Chief Executive, Financial Reporting Council

Christopher Craig

Partner, Grant Thornton

Francisco Duque

Managing Director, TIAA-CREF Investment Management

Ron Graziano

Vice President, Credit Suisse

Roger Harrington

Vice President, Group Accounts, BP plc

Trevor Harris

Managing Director and Vice Chairman, Morgan Stanley

Charlotte Jones

Managing Director, Global Head of Accounting Policy Group, Deutsche Bank AG

Bob Laux

Senior Director, Financial Accounting and Reporting, Microsoft Corporation

Jeff Mahoney

General Counsel, Council of Institutional Investors

Ken Marshall

Partner, Ernst & Young

Paul Munter

Partner, KPMG

Tom Robinson

Head, Educational Content in the Education Division, CFA Institute

Matthew L. Schroeder

Managing Director, Goldman Sachs

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- ▶ **SEC Reporting Series**—Includes our Annual Guide to Quarterly Financial Reporting, our Overview of Proxy Statement Requirements, and our SEC Annual Reports publication.
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- ▶ Trends and articles on audit committee developments

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- ▶ Developments in US GAAP/IFRS convergence
- ▶ Ernst & Young's "Good Group" illustrative financial statements
- ▶ **IFRS outlook** (bi-monthly newsletter)
- ▶ Exposure Drafts and other materials issued by the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC).

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- ▶ Interim US Financial Reporting Checklist
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