I. Introduction

In legal and business circles, among the significant developments for which 2005 will be known is the onset of the widespread use of international accounting standards. For some time efforts have been underway to develop a high-quality set of international accounting standards. These standards, formally known as International Financial Reporting Standards (IFRSs), include the standards and interpretations issued by the International Accounting Standards Board (IASB) as well as the International Accounting Standards (IASs) and interpretations issued by the International Accounting Standards Committee, the predecessor organization to the IASB.  

Prior to 2005, the use of IFRSs were generally viewed as aspirational in nature and not mandated in most jurisdictions. That perspective has now dramatically changed. Beginning in 2005, a Deloitte & Touche study indicates that ninety-four countries will require or permit the use of IFRSs for publicly-traded companies and in other settings.

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1. The governing organization for the IASB is the International Accounting Standard Committee Foundation. The Foundation plays the critical role in appointing the members of the IASB, the standards setting body, and the other components of the Foundation that work with the IASB in setting international accounting standards.

From 1973 to 2001, the International Accounting Standards Committee issued IASs. LAWRENCE M. GILL, INTERNATIONAL FINANCIAL REPORTING STANDARDS IMPLICATIONS FOR SECURITIES MARKETS AND REGULATORS, 1-2 (2005). After the IASB succeeded the International Accounting Standards Committee, the existing IASs were adopted by the IASB, which numbered from 1 through 41, and, in turn, were renamed IFRSs. Id.

Interpretations prepared by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor, the Standing Interpretations Committee, constitute authoritative guidance on issues that are likely to receive divergent or unacceptable treatment in the absence of the additional guidance. See International Financial Reporting Interpretations Committee, http://www.iasb.org/about/ifric.asp (last visited Feb. 28, 2006).

2. Press Release, IASB & IASC Foundation News, IFRIC issues guidelines on restatements of financial reporting (Nov. 24, 2005), available at http://www.iasb.org/news/index.asp?showPageContent=no&xml=10...678...25...24112005...23112006.htm (last visited Feb. 28, 2006); see Deloitte, IAS PLUS, Use of IFRSs by
II. European Union

As of 2005, virtually all publicly-held companies listed on exchanges in the European Union, including banks and insurance companies, are required to use IFRSs. Members of the European Union have the option to extend this requirement to unlisted companies and to unconsolidated financial statements of parent companies. Member countries may also defer the adoption of IFRSs until 2007 for companies whose only listed securities are debt securities or for companies listed on exchanges outside of the European Union that currently prepare their primary financial statements using generally accepted accounting principles (GAAP) not used in the European Union, such as, in most cases, U.S. GAAP.

In 2004, the European Commission adopted a regulation endorsing the adoption, with the exception of two carve-outs of IAS 39 on Financial Instruments: Recognition and Measurement. "The first carve-out related to certain provisions on the use of the Full Fair Value Option; the second to certain provisions on hedge accounting." Later, the IASB published an amended version of IAS 39 that satisfactorily addressed the concerns of the European Commission as to the fair value carve-out. This led, in turn, to IAS 39 being adopted by the European Commission on a retroactive basis as of January 1, 2005. The second carve-out, which related to hedge accounting, remained.

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5. Deloitte International Accounting Standards, supra note 3, at July 2005: CESR Advice on National GAAP Equivalence to IFRSs. It should be noted that the Committee of European Securities Regulators (CESR) has concluded that the GAAPs of Canada, Japan, and the United States, when each is taken as a whole, are equivalent to IFRSs. Id. The European Commission has therefore been advised by CESR that non-European companies trading in European securities markets be allowed to submit financial statements in Canadian, Japanese, and U.S. GAAP without a full reconciliation of their accounts to IFRSs. However, they must provide information about certain specific differences between those national GAAPs and IFRSs. Id.


7. "As a result of the [European Union] Adopting Regulation, the [European Union] is a significant force behind the global adoption of IFRS." Gill, supra note 1, at 4. Before it can be mandated by the European Union, an IASB standard or IFRIC interpretation must be adopted in accordance with the procedure established by article 6(2) of Regulation (EC) no 1606/2002 of the European Parliament and of the Council of 19 July 2002, OJ L 243. Id. at 3-4. The procedure requires that the IASB standard or IFRIC interpretation be assessed by the European Financial Reporting Advisory Group; then submitted to the European Parliament and the Accounting Regulatory Committee; and, once it receives approval of a qualified majority member states in the Accounting Regulatory Committee and the favorable opinion of the European Parliament, be formally adopted by the European Commission. Id.

8. Id.

9. The European Commission has emphasized the need for the European Banking Federation and the IASB to come up with a resolution. In the interim, companies wishing to apply the carved-out hedge accounting provisions could do so since there is an absence of applicable European Union law on the issue. Id.
In 2005, the European Union adopted the 8th Company Law Directive on statutory audits of annual accounts and consolidated accounts. The new directive calls for the use of International Standards on Auditing (ISAs) for all statutory audits conducted in the European Union. The objective of the 8th Company Law Directive is to ensure that investors and other interested parties can rely fully on the accuracy of audited accounts to protect against the type of accounting scandals associated with companies such as Parmalat and Ahold.

The 8th Company Law Directive requires audited companies to set up an audit committee with independent members that would oversee the audit process and communicate directly with the auditor. The audit committee would also select the auditor and propose the appointment of the auditor to shareholders. Furthermore, if a company dismissed an auditor, it would need to explain the reasons to the relevant authority in the pertinent European Union country.

III. Other Countries

Australia, New Zealand, Hong Kong, Singapore, and the Philippines have adopted IFRSs, as have many countries bordering on the European Union. For example, Iceland, Liechtenstein, and Norway, though not members of the European Union, are members of the European Economic Area. As such, they are committed to follow directives of the European Union, including the accounting directives. Switzerland, as of 2005, requires that multinational main board companies listed within its jurisdiction use either IFRSs or U.S. GAAP.

Many small or developing countries, like Jamaica, Kenya, Guatemala, Guyana, Honduras, and Lebanon have turned to IFRSs as their GAAP. For example, in Malta, the Maltese Companies Act and tax regulations require that all limited liability companies prepare fi-

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11. See id.


14. The Philippines adopted, without modification, all of the IFRSs for 2005. These Philippine equivalents to IFRSs apply to all entities with public accountability. That includes those whose securities are listed in a public market or are in process of listing; all financial institutions including banks, insurance companies, security brokers, pension funds, mutual funds, and investment banking entities; public utilities; and other economically significant entities, defined as total assets in 2004 of at least 250 million pesos (US$5 million) or liabilities of at least 150 million (US$3 million). The auditor's report will refer to "conformity with Philippine Financial Reporting Standards."


16. See Deloitte Use of IFRSs, supra note 13, at note 1.
financial statements that comply fully with standards issued by the IASB and that those statements are audited in accordance with ISAs.\textsuperscript{17}

IV. Convergence

Most countries are moving towards IFRSs. In April 2005, Canada's Accounting Standards Board issued a draft strategic plan for the future direction of accounting standards in Canada.\textsuperscript{18} The plan calls for Canadian standards for publicly-held companies to converge with IFRSs over a five-year transitional period. At the end of that period, Canadian standards would cease to exist as a separate basis of financial reporting for publicly-held companies. Similarly, the Canadian Auditing and Assurance Standards Board has issued an invitation to comment on its new standard-setting approach, which proposes the convergence of Canadian Auditing and Assurance Standards with ISAs and with the pronouncements of the International Auditing and Assurance Standards Board.\textsuperscript{19}

China has announced that convergence with IFRSs is one of the fundamental goals of its standard-setting program.\textsuperscript{20} China is developing its Accounting Standards System for Business Enterprises with a view to achieving convergence of those standards with the equivalent IFRSs. The position China takes is that an enterprise applying China's accounting standards should produce financial statements that are the same as those of an enterprise that applies IFRSs.

In 2004, the IASB and the Accounting Standards Board of Japan agreed to initiate discussions about a joint project to minimize differences between IFRSs and Japanese accounting standards with the ultimate goal of convergence of their standards.\textsuperscript{21} In January 2005, the two boards announced their agreement to launch a joint project to reduce differences between IFRSs and Japanese accounting standards.

A. Convergence with U.S. GAAP

From the perspective of the United States, both the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) are very supportive of convergence.\textsuperscript{22} Formal efforts have been underway for a number of years to narrow the differences. But the movement toward convergence will continue to be incremental as a number of major differences have yet to be resolved.

For some time, the SEC allowed foreign issuers registered with the SEC to use IFRSs in meeting the SEC requirement of providing three years of audited financial statements.
prepared on a consistent basis. That reconciliation period was reduced in 2005 to two years. For registration statements filed during the first year in which IFRSs are adopted and for annual reports for eligible issuers, reconciliation is now permitted for two years rather than three years of statements of income, changes in shareholders' equity, and cash flows prepared in accordance with IFRSs. Consistent with the move towards convergence, the SEC announced in 2005 what was described as a roadmap of steps developed by its staff—these steps were needed to eliminate the requirement that non-U.S. companies listed in the United States reconcile with U.S. GAAP. Indeed, the European Union reached an agreement in 2005 with the SEC to remove the reconciliation requirement as early as 2007 and no later than 2009.

B. IMPACT OF IFRSs ON U.S. GAAP

As they become the prevailing international accounting standards, the impact of IFRSs on U.S. GAAP will only increase with convergence. Given the dominance of the United States as a source of capital, foreign companies are accustomed to using U.S. GAAP in order to raise capital in the United States. U.S. GAAP impacts all aspects of decision-making with respect to the conduct of U.S. business and the conduct of business in many parts of the world. But the dominance of U.S. GAAP can no longer be assumed. Nor can it be assumed that U.S. GAAP will continue to be the primary means by which businesses and business relationships are evaluated. U.S. companies, financial institutions, investors, and the lawyers for each must increasingly take into consideration IFRSs and their implications on a wide range of issues relating to the operation of a business. Similar considerations should be undertaken by non-U.S. companies and financial institutions that have customarily used U.S. GAAP.

C. DIFFERENCES BETWEEN IFRSs AND U.S. GAAP

Overall, IFRSs and U.S. GAAP are far more similar than they are different. The influence of U.S. GAAP and U.S. practices on IFRSs is substantial. As opposed to historical cost, both IFRSs and U.S. GAAP are increasingly based on a fair value asset and liability model. IFRSs are generally viewed as being more principles-based in orientation than U.S. GAAP, which are viewed as being more rule-based. By analogy and practice, IFRSs take more of a common law approach whereas U.S. GAAP represent an approach similar to the civil law.

D. IMPACT OF IFRSs ON U.S. COMPANIES

For U.S. companies, the broader their international activities, the more significant are the effect of IFRSs. Differences between the two standards exist. Unlike U.S. GAAP, which


25. See Deloitte October News Chronology, supra note 17, at Challenges to transition to IFRSs in Europe.

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do not require a parent and subsidiaries to conform their accounting policies, under IAS 27, IFRSs require a parent to present consolidated financial statements for subsidiaries it controls using uniform accounting policies.

U.S. subsidiaries of companies operating in jurisdictions like the European Union, where IFRSs represent the accepted standard, need to follow the same accounting standards as their corporate parent. A subsidiary's accounting policies must conform to its parent's accounting policies under IFRSs for similar transactions and events.26

Similarly, U.S. joint ventures with a venture partner operating in countries requiring the application of IFRSs will need to follow the same accounting standards as their venture partner. If a listed European Union company has a major investment in a U.S. company, the U.S. company will have to prepare information according to IFRSs for purposes of its investor's equity accounting.

Even if companies are not required to adopt IFRSs for reporting purposes, many U.S. companies looking to new markets will need to adopt IFRSs to secure licenses, raise capital, or comply with requirements of local regulators. Foreign customers, vendors, or lessors may also require the use of IFRSs.

V. Importance of Differences in Accounting Standards for Lawyers

Yet despite their common heritage and the movement toward convergence, the differences between IFRSs and U.S. GAAP can at times be significant. From a legal standpoint, the differences can have dramatic ramifications. Most significant are the critical disclosure obligations to shareholders that may arise. Conversion to IFRSs may be material in a number of respects.

The SEC's staff has taken the position that issuers should include a "discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made."27 Disclosure is also encouraged of "other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) . . . ."28

Disclosures may also be required relative to the implications of a change in accounting standards on important ratios. Of the information required to be disclosed by Form 6-K for foreign issuers registered with the SEC,29 a change in accounting standards may have an impact on "the financial condition and results of operations," "defaults upon senior securities," "material increases or decreases in the amount outstanding of securities or in-

26. For example, IAS 2 under IFRSs prohibits the valuation of inventory on the basis of the last-in, first-out method. But the last-in, first-out method is permitted under U.S. GAAP. The U.S. subsidiary of a parent company located in the European Union would have to use the average cost or first-in, first-out methods, whichever is used by its parent, as the method of valuing its inventory.


28. Id.

debtedness,” and “the granting of options or payment of other compensation to directors or officers."

In addition, special care must be exercised in the drafting of legal instruments that are tied to the financial statements of a company. For legal instruments linked to information contained in financial statements of entities now in the process of converting to IFRSs, the parties to those instruments and their attorneys need to review the provisions of the legal instruments to determine the impact of the change to IFRSs. The provisions may need to be revised or clarified or, alternatively, new arrangements may need to be negotiated. But the impact of the change to IFRSs cannot be disregarded.

Henceforth, agreements dependent in whole or in part on information in financial statements should, much like choice-of-law provisions in contracts, clearly define what accounting standards govern the financial statements to which they are linked. Drafters of legal instruments must take into consideration what accounting standards apply or are likely to apply and the implications of their application.

But the designation of applicable accounting standards in legal instruments must be an informed decision. Simply designating the governing standards can be counterproductive if conversion costs are not adequately considered. In many situations, conversion costs can be substantial. At times, incurring substantial conversion costs may be warranted. Yet, in many situations, the conversion costs cannot be justified, and functionally equivalent alternatives may need to be identified.

VI. The Emergence of IFRSs as a Set of Global Standards

But even with the emergence of IFRSs, a difference can still exist between IFRSs as adopted by the IASB and IFRSs as adopted by the European Union or a particular country. Much like the adoption of uniform laws by individual states in the United States, in adopting IFRSs, the European Union and some countries have made relatively modest modifications. As a result, any reference to IFRSs should not be unqualified.

Reference to the pertinent adopting body in referring to accounting standards is always prudent as a means of clarification. IFRSs, as adopted by the IASB, should be the point of reference for the unaltered standards. For example, IFRSs as adopted by the European Union or a particular country should be referred to as the respective version of IFRSs for the European Union or the particular country.

VII. Conclusion

While in the offing for many years, the convergence to IFRSs has now begun in earnest. No longer can it be assumed that U.S. GAAP are the accounting principles that govern the issuance of reports as to the financial status of business entities or that govern how the financial status of business entities are evaluated. Increasingly, those providing legal advice will need to exercise particular care to determine the implications of a change in accounting standards or the implications of accounting standards currently being used.

31. For example, other financial ratios or line items might be used to provide similar information that will not change depending upon whether IFRSs or U.S. GAAP are used. Reference might also be made to financial information that is entirely separate from financial statements or data that cannot be affected by a change in accounting standards.