

April 23, 2005

Update: SEC Chairman Addresses IFRS-US GAAP Convergence, Roadmap for Modification of US GAAP Reconciliation Rules and Deregistration Initiative

In a press release issued April 21, 2005, the SEC confirmed that the SEC Chairman, William Donaldson, in a meeting with EU Internal Market Commissioner Charles McCreevy, had reaffirmed his support for the convergence initiative being pursued by the US Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”), had addressed the recently announced “roadmap” for possible elimination of the current requirement that non-US SEC registrants (foreign private issuers) present financial statements in accordance with US GAAP or with a reconciliation to US GAAP, and addressed the ongoing SEC staff evaluation of solutions to the significant barriers to SEC deregistration by non-US SEC registrants.

This Update summarizes the items addressed in the press release. It is important to note that there is, at this point, no proposed rulemaking on any of these items. It is also important to note that the proposed elimination of the US GAAP reconciliation requirement would apply only to non-US companies that prepare and present their financial statements in accordance with International Financial Reporting Standards (“IFRS”), the standard now required, subject to phase-in, for companies incorporated in a member state of the European Union, or whose securities are traded within the EU.

The Roadmap

In an article published last week, the SEC’s Chief Accountant, Donald Nicolaisen, publicly addressed a question that has been raised regularly over the years: When will the SEC accept in registration statements and ongoing periodic reporting filed by non-US SEC registrants financial statements prepared in accordance with a basis of accounting other than US GAAP, and without the need for a US GAAP reconciliation? The article follows the adoption by the SEC earlier this month of final rules providing one-time accommodations to non-US SEC registrants that adopt IFRS prior to or for the first fiscal year starting on or after January 1, 2007.

Although the SEC has not answered that question with a definitive date or a definitive proposal, the Chief Accountant did lay out a roadmap that could well lead to the elimination of the US GAAP reconciliation requirement by 2009, if not sooner, for non-US companies

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that use IFRS. The SEC's April 21st press release confirmed that the SEC Chairman had discussed the roadmap with Commissioner McCreevy, strongly implying that the roadmap has the support of the SEC staff.

The SEC's views on the future of the US GAAP reconciliation requirement appear to be informed by two developments: the effectiveness of EU requirements for the mandatory use of IFRS by listed EU companies and progress by the FASB and the IASB in reducing the differences between IFRS and US GAAP.

The SEC expects that a "critical mass" of non-US companies with SEC reporting obligations will be preparing their underlying financial statements in accordance with IFRS (and reconciling such statements to US GAAP for purposes of their SEC filings). Of the approximately 1,200 such filers, 500 are Canadian. Of the remaining 700 filers, approximately 40 currently use IFRS and an estimated 300 filers will be using IFRS by the end of 2005, which number is expected to be closer to 400 by the end of 2007.

The roadmap contemplates a tiered approach, based principally on an evaluation by the SEC staff of the effectiveness, consistency and transparency of IFRS through review of filings made in 2006 and 2007. Although the roadmap does not provide a date certain for SEC action, the Chief Accountant expects that the US GAAP reconciliation requirement could be eliminated by 2009, if not sooner. The elements of the roadmap are:

- 2005: EU companies begin to phase-in IFRS
- 2005 and beyond: investors gain additional knowledge and experience with IFRS
- 2005 and beyond: investors, practitioners, auditors, standard setters, regulators and others share IFRS implementation experience
- 2005-07: SEC staff identifies changes to SEC rules necessary to give effect to elimination of the US GAAP reconciliation requirement
- 2006: approximately 300 non-US registrants file their 2005 IFRS financial statements
- 2006-07: SEC staff reviews faithfulness and consistency of 2005 IFRS financial statements and the accompanying US GAAP reconciliations
- 2007: SEC staff discusses review with investors, practitioners, auditors, standard setters, regulators and others
- 2007: SEC staff reviews progress of US GAAP-IFRS convergence work
- 2007-09: SEC staff reviews faithfulness and consistency of 2006 IFRS financial statements and the accompanying US GAAP reconciliation, and convergence work

- 2009 and possibly sooner: SEC staff decides whether and when it is in a position to recommend to the commissioners that the IFRS-to-US GAAP reconciliation requirement be eliminated

The process is designed to give the SEC staff the chance to evaluate IFRS (and in particular the consistent application thereof within industries, and across borders), not in a vacuum, but rather as actually applied by non-US companies. It will do so by evaluating the application of IFRS with the benefit of the accompanying US GAAP reconciliations.

The focus will be on the standards themselves, and of necessity given the newness of the standards, on the application thereof by registrants. The message here is that the success of this effort will depend in part on the diligence and effectiveness of first-time IFRS filers in properly applying IFRS.

Convergence

The convergence approach, documented in a Memorandum of Understanding in 2002 between the FASB and the IASB, contemplates, as the name implies, the provisions of US GAAP and IFRS coming together; that is, the reduction of the differences between the two sets of standards. This is occurring by choosing the better standard where differences exist and joint cooperation on new standards. Although differences will continue to exist, and thus the two standards will not necessarily produce the same result, the intention is to produce close alignment for the same or essentially the same transactions, generally comparable results in trends, a continued focus on reducing differences over time and transparency as to remaining significant differences.

Deregistration

The flip side of the US GAAP reconciliation issue is deregistration. We have, in prior Updates, addressed the ongoing concern on the part of non-US SEC registrants regarding the delisting/deregistration process in the US. In effect, although it is relatively easy to delist from a US stock exchange, it is virtually impossible to terminate SEC registration (by reason of the need to establish that a company's ordinary shares are held by fewer than 300 US residents). The SEC has for a few months been considering modifications to its rules to facilitate deregistration (by establishing other bases for deregistration, tied perhaps to market value of shares, or relative proportion of shares, held by US residents). The only news on this initiative is that the Chairman expects that the commissioners will consider a rule proposal by the end of the year.

Conclusion

Although there are no actionable agenda items at this point, the Chairman's statement on US GAAP reconciliation represents the first high level commitment to removing what has been, for many years, a significant disincentive to accessing the US capital markets or to otherwise becoming a listed company in the US (for example, as a result of a stock-for-stock acquisition of a public US target). Although other disincentives remain (namely, the

perceived high cost of compliance with rulemaking following the passage of the Sarbanes-Oxley Act), the same factor that may ultimately remove the barrier on financial statement presentation may well dilute concerns with the cost of compliance – namely, the trend towards global standards. The predicate for the liberalization of the financial statement requirements is the mandated use of IFRS in the EU and convergence between US GAAP and IFRS. On the compliance front, as regulators around the world move to tighten corporate governance standards, the differences between US standards and those in many other jurisdictions are likely to be reduced.

As for the benefit for the US capital markets: the statistics over the past few years speak for themselves. There has been a significant reduction in the number of non-US companies listing or conducting registered public offerings in the US, and one cannot attribute that reduction solely to market conditions. If the SEC staff can provide a reasonable exit for non-US registrants, that action together with the ability to present IFRS financial statements without a US GAAP reconciliation, should cause non-US companies (at least those incorporated in the EU, those incorporated outside the EU and the US that have securities listed in the EU, and others that report in IFRS) to view listing or raising capital through a registered public offering in the US in a different light.

The SEC's views in respect of IFRS-to-US GAAP reconciliation should also have a positive impact on the current assessment by EU authorities of whether US GAAP should be given reciprocal recognition as an "equivalent" standard for purposes of reporting requirements that will now be applicable to US companies (and other companies using US GAAP) that have securities listed in the EU.

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Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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