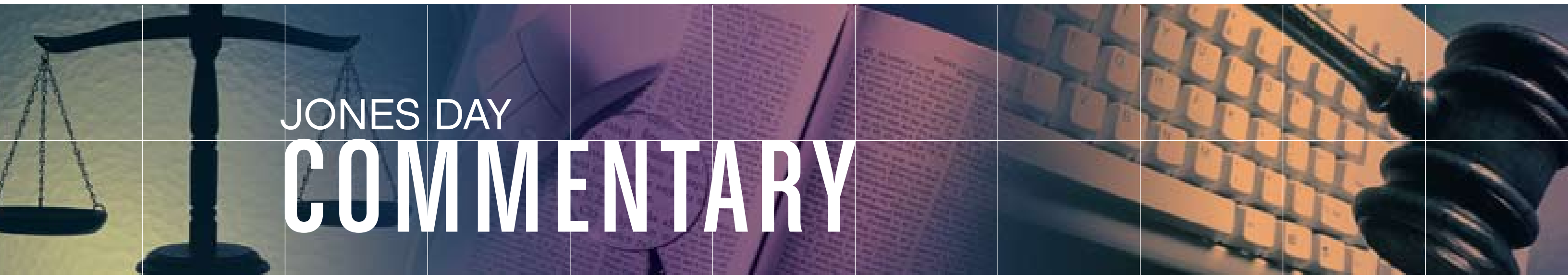
JANUARY 2009



SEC PROPOSES ADOPTION OF IFRS FINANCIAL REPORTING FOR U.S. ISSUERS

The SEC recently issued for comment a proposed roadmap for initially allowing and eventually requiring U.S. issuers to report financial results in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") rather than generally accepted accounting principles in the United States ("U.S. GAAP").

Converting to IFRS will impose special demands on issuers in the areas of governance, employee training, internal controls, contract fulfillment, and disclosure. It will also create opportunities for issuers that understand early on what IFRS requires of them. Management and boards should begin to consider the impact of IFRS conversion. The timeline to conversion may be shorter than anticipated, especially in the case of U.S. issuers eligible for early adoption.

IFRS AND U.S. GAAP

IFRS is a set of principles-based accounting standards published by the London-based IASB. The SEC has encouraged the development of IFRS as a uniform accounting framework to facilitate cross-border offerings. It has also encouraged the convergence of U.S. GAAP and IFRS standards. Since 2002, the Financial Accounting Standards Board ("FASB") has been working with the IASB to harmonize U.S. GAAP and IFRS with the goal of producing a single, high-quality set of accounting standards.

Despite the movement toward convergence, differences between U.S. GAAP and IFRS remain. Key areas of divergence include accounting for pension liability, taxes, financial instruments, and business combinations. In addition, IFRS and U.S. GAAP are fundamentally different in that U.S. GAAP standards are primarily rules-based, whereas IFRS standards are primarily principles-based. Rules-based standards typically offer more detailed application guidance. Principles-based standards require management to exercise more judgment in determining how to account for transactions. As a result, IFRS reporting demands more significant time and input from management.

IFRS has quickly become the *lingua franca* of accounting. More than 100 countries now permit or require IFRS reporting. Since 2005, all companies incorporated and listed in a member state of the European Union have been required to use it. Other significant countries allowing or requiring IFRS reporting include Russia and Australia.

In some of these countries, accounting oversight bodies have issued standards modifying IFRS as issued by the IASB. The SEC has resisted this trend on the ground that it would undermine the uniformity that was the primary purpose of IFRS. In the past year, for example, the SEC has begun permitting foreign private issuers to file audited financial statements prepared in accordance with IFRS without a U.S. GAAP reconciliation, but it has required them to use IFRS as issued by the IASB rather than home-country variations of IFRS. The SEC's support for a uniform IFRS is evident in its current proposal for U.S. issuers as well.

THE SEC'S CONVERSION PROPOSAL

The SEC has proposed allowing and eventually requiring public U.S. issuers to report financial results in accordance with IFRS as issued by the IASB.[1] The SEC's proposal envisions a period of voluntary conversion beginning with fiscal year 2009, followed by mandatory conversion beginning with fiscal year 2014. In either case, issuers converting to IFRS would begin IFRS reporting in their Annual Reports on Form 10-K. The Form 10-K would include audited IFRS financial statements for the transitional year as well as the two preceding fiscal years. Thus, an issuer adopting IFRS in 2014 would need to file audited IFRS financial statements for fiscal years 2012, 2013, and 2014 in its Form 10-K for the fiscal year ended 2014, while an issuer voluntarily adopting IFRS in 2009 would need to file audited IFRS financial statements for fiscal years 2007, 2008, and 2009 in its Form 10-K for the fiscal year ended 2009.[2]

Voluntary Conversion. The SEC proposes to allow voluntary conversion on a limited basis for fiscal years ending on or after December 15, 2009. A U.S. issuer would be eligible for voluntary IFRS reporting if (1) the issuer is among the 20 largest public companies in its industry worldwide as measured by market capitalization and (2) IFRS as issued by the IASB is used as the basis of financial reporting more often than any other basis of accounting by those 20 companies. Under this test, IFRS must be used by a plurality, though not necessarily a majority, of the issuer's industry peers. The test ensures that voluntary IFRS reporting enhances comparability of the issuer's financial statements.

For purposes of determining the scope of an issuer's industry, the proposal allows the issuer to look to a range of industry classification systems, including SIC codes at the two-digit level. A company is deemed to use a particular set of standards as the basis of financial reporting if it has published audited annual financial statements prepared in accordance with those standards. The Commission estimates that at least 110 U.S. companies in 34 industries would be eligible under these criteria.

An eligible U.S. issuer interested in voluntary conversion to IFRS must obtain a no-objection letter from the SEC's Division of Corporation Finance before proceeding. Once issued, the no-objection letter would be effective for three years. During that period, the issuer could begin filing IFRS financial statements in any Annual Report on Form 10-K for a fiscal year ending on or after December 15, 2009.

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1. The SEC's proposal was initially announced at its open meeting on August 27, 2008. It was formally confirmed in a notice-and-comment release issued on November 14, 2008.

2. Under the SEC's proposal, an issuer preparing its financial statements in accordance with IFRS for the first time would only be required to disclose three years of IFRS selected financial data in its transitional year. In each of the two subsequent years, the issuer would disclose an additional year of IFRS selected financial data until it was disclosing the full five years of selected financial data typically required.

   The SEC has also sought comment on a proposal that would allow an issuer to file only two years of audited IFRS financial statements in its first Form 10-K following conversion, provided that the issuer also provided three years of audited U.S. GAAP financial statements. The SEC has indicated that it is "not inclined" to adopt this latter proposal.

All early adopters under the SEC's voluntary program would need to reconcile their IFRS financial statements to U.S. GAAP. The SEC has sought comment on two alternative reconciliation proposals. Under "Proposal A," issuers would follow IFRS 1, which requires issuers to include an audited footnote in their financial statements for the transitional year, setting forth a one-time reconciliation from U.S. GAAP to IFRS. Under "Proposal B," issuers would provide the information required by IFRS 1 but would also provide, on an ongoing and indefinite basis, an unaudited reconciliation from IFRS to U.S. GAAP for the three years of audited financial statements included in each Form 10-K filed.

Mandatory Conversion. The SEC has stated that it will decide in 2011 whether IFRS reporting should be mandatory for U.S. issuers. The SEC has indicated that its decision will depend on, among other factors:

- the development of improved IFRS standards in certain areas (such as accounting for insurance contracts and extractive activities) where the SEC believes IFRS currently provides "limited guidance";
- the resolution of questions relating to the funding and accountability of the IASB;
- the development of an interactive data format (such as the eXtensible Business Reporting Language, or XBRL) for reporting IFRS financial data at a greater level of detail than is currently available;
- the education and training of U.S. investors, auditors, and others in IFRS; and
- the results of the voluntary conversion program described above.

The SEC has proposed to phase in any program of mandatory conversion on a size-of-issuer basis. Under the proposed scheme, large accelerated filers would be required to file their first IFRS financial statements with their Annual Reports on Form 10-K for fiscal year ended 2014. Accelerated and nonaccelerated filers would be required to file their first IFRS financial statements with their Annual Reports on Form 10-K for fiscal years ended 2015 and 2016, respectively.

Additional Consideration. The SEC has proposed not to permit investment companies, "smaller reporting companies," or employee stock purchase, savings, and similar plans to adopt voluntary IFRS reporting.

IFRS CHALLENGES

Conversion to IFRS will pose several challenges for a company accustomed to reporting in accordance with U.S. GAAP:

Governance. Under the Sarbanes-Oxley Act, the chief executive officer and chief financial officer of every public company filing Exchange Act reports must attest to the accuracy of the financial statements in each annual or quarterly report filed by the company. Rules of the NYSE, Nasdaq, and AMEX require members of each listed company's audit committee to possess financial sophistication, and the audit committee must have one member who qualifies as a "financial expert." If a company adopts IFRS, its management and board may need additional training in order to meet the level of financial expertise necessary for them to carry out these functions and satisfy these requirements.

Employee Training and Systems Overhaul. Because the need for financial literacy extends beyond corporate leadership, companies must ensure that their accounting departments and outside auditors are properly prepared for conversion to IFRS. Conversion may require software upgrades or other adjustments to ensure that data necessary for IFRS reporting are properly being gathered. Accounting staff must be prepared to record transactions in accordance with IFRS as early as January 2007 (in the case of voluntary adopters) or January 2012 (in the case of mandatory adopters).

Internal Controls. The Sarbanes-Oxley Act requires management to assess the effectiveness of the issuer's internal control over financial reporting. It also requires the issuer's independent auditor to attest to management's assessment of the issuer's internal controls. Because U.S. GAAP and IFRS standards may vary, management will have to reassess the effectiveness of internal controls in anticipation of IFRS conversion. It may find that controls must be modified or added. Management will also need to ensure that the issuer's independent auditor is satisfied with management's reassessment of controls.[3]

Contractual and Other Third-Party Commitments. The extent of a company's contractual and other commitments often depends on its reported financial results. Performance-based compensation, dividend policies, debt covenants, and regulatory capital requirements are just a few examples of commitments that may hinge upon a company's reported financial results. Such commitments may be formulated in terms of a company's U.S. GAAP results and may not envision or permit reporting in IFRS. Even if IFRS reporting is not forbidden, the company's financial results may be more or less favorable under IFRS than under U.S. GAAP, and conversion may consequently facilitate or impede the company's ability to meet its commitments. Companies that convert to IFRS should consider whether renegotiation, waiver, or other adjustment of their commitments is necessary.

Disclosure Changes. While management may enjoy more discretion in crafting accounting policies under a principles-based accounting regime, it should carefully evaluate the disclosure of how it exercises that discretion. Good disclosure is the antidote to the liability risk that comes with less prescriptive accounting standards. Management should explain clearly why it accounts for transactions as it does and how different accounting policies would affect the issuer's results. An issuer that converts to IFRS reporting should pay close attention to its MD&A disclosure, especially as it relates to critical accounting policies.

IFRS OPPORTUNITIES

While IFRS conversion is not without challenges, U.S. issuers may find that conversion offers opportunities:

Accounting Efficiencies. Foreign subsidiaries of U.S. issuers may already be using IFRS to prepare their statutory accounts. Converting the issuer's financial reporting to IFRS may significantly streamline the preparation of consolidated financial statements.

Competitive Advantage in Global Capital Markets. U.S. issuers that convert to IFRS reporting may find that it enhances their ability to compete for global capital by making their financial results more widely accepted and comparable. In particular, U.S. issuers may find that IFRS conversion makes it easier for them (i) to list their securities in foreign jurisdictions, (ii) to make employee offerings or private placements to foreign investors, (iii) to use their securities as acquisition currency for buying foreign-listed companies, and (iv) to attract foreign analyst coverage. Early IFRS adopters may thus enjoy a temporary advantage over their U.S. GAAP competitors in the global capital markets.

Investor and Analyst Relations. Management should view IFRS conversion as an opportunity to give interested investors and analysts a clearer picture of how the business really works and how its operations are translated into reported financial results. An attractive, but candid, explanation of the company's story can build the company's reputation with these important stakeholders.

Improved Accounting and Controls. An issuer can make a virtue out of necessity by using the reevaluation of its accounting systems and controls to improve them. The results that management gleans from its IFRS conversion may allow it to reduce organizational inefficiencies and other costs.

3. Management should bear in mind that the accounting firms that audit the issuer's financial statements cannot advise the issuer on the design of internal controls. The Sarbanes-Oxley Act prohibits an issuer's independent auditor from offering nonaudit services of that kind.

CONVERGENCE WITHOUT CONVERSION

Issuers should not resist IFRS out of fear that the SEC will abandon its conversion proposal down the line. As noted above, the SEC has encouraged the convergence of U.S. GAAP and IFRS accounting standards, and the FASB has recently issued or revised accounting statements with a view toward eventual convergence. The commitment of domestic authorities toward convergence ensures that U.S. GAAP and IFRS will continue to gravitate toward one another even if IFRS never supplants U.S. GAAP. The rise of IFRS is thus best viewed as another step in the gradual globalization of financial regulatory regimes. As with this broader process, the adoption of IFRS (whether through conversion or convergence) should streamline compliance for multinational issuers and should be regarded as a salutary event. If management and the board resolve at an early date to confront the challenges posed by IFRS, they will be in a better position to reap its rewards in the future.

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