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The Eligibility Question

A look at which U.S. issuers may be allowed to use IFRS

More U.S. companies are inquiring about the Securities and Exchange Commission's (SEC) proposed roadmap for potential mandatory adoption of IFRS by all U.S. issuers and the related proposal that would permit the optional use of IFRS sooner for certain U.S. issuers. Would your company be eligible for early adoption — or even required to adopt IFRS?

Companies wishing to adopt IFRS early must assess the criteria proposed by the SEC (noted in the Sidebar, *Proposed Rule Criteria*) to see if they are eligible. While these requirements are a starting place today, they are not yet final and may change based on public commentary. For companies considering early adoption in order to get ahead of competitors on the IFRS curve, this is encouraging news. With further analysis, such companies may discover that they qualify for early adoption of IFRS — and can receive approval from the SEC.

While the SEC estimates that at least 110 companies across 34 industries will be eligible for early adoption, it is not anticipated that this list of companies

Proposed Rule Criteria

Under the proposed rule, U.S. issuers that meet both of the following criteria would be eligible to use IFRS in their financial statements filed with the SEC for fiscal years ending on or after December 15, 2009:

- The U.S. issuer is globally among the 20 largest companies in its industry, as measured by market capitalization.
- IFRS, as issued by the IASB, are used as the basis for financial reporting more often than any other basis of accounting by the 20 largest companies globally in that industry.

The objective of the eligibility criteria is to identify categories of U.S. issuers whose use of IFRS would promote comparability with their global industry competitors.

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The Eligibility Question (cont.)

A look at which U.S. issuers may be allowed to use IFRS

or industries will be released. That is, the SEC does not intend to limit the eligibility of those U.S. issuers seeking a letter of 'no objection' from the SEC to use IFRS. Companies considering early IFRS adoption will need to perform their own analysis to determine eligibility. Although early adoption criteria require quantitative measurements, the SEC has indicated that there will be flexibility in how companies determine whether they are eligible.

Companies may proactively begin to assess whether they could qualify for early adoption with these considerations:

- The company's industry designation will need to be determined. Based upon our understanding, it appears that the first two digits of U.S. Standard Industrial Classification ("SIC") codes were used in the SEC's analysis. SIC codes are four digit numeric codes assigned by the U.S. government to companies to identify their primary businesses. The first two numbers represent the major industry group, the third represents industry grouping, and the fourth represents industry. Even though the SEC staff used these codes, we also understand that other acceptable methods such as the North American Industry Classification System might be used to determine a company's industry.
- The top 20 global companies in the industry must be determined based upon market capitalization. Though not a complex exercise, this process will require some judgment as there currently is no required date at which market capitalization needs to be measured.
- The company needs to determine if IFRS are used, more than any other basis of accounting, by the industry's top 20 global companies. For example, of an industry's top 20 global companies, if 8 use IFRS, 7 use U.S. GAAP, and 5 use other local GAAPs, then those U.S. companies currently using U.S. GAAP would be eligible to early adopt because the top 20 global companies predominantly use IFRS.

Analyzing these factors – the SEC's proposed rule changes, along with informal discussions with the SEC staff, and our understanding of an acceptable methodology using the first two digits of the SIC codes – we have estimated which companies and industries will be eligible to use IFRS in their financial statements for fiscal years ending on or after December 15, 2009. Examples of industries we found to be predominantly using IFRS include: electric, gas, sanitary, water, air, and transportation.

Interest in early IFRS adoption appears to be escalating among companies of various sizes and industries. In fact, companies are expressing a desire for the SEC to expand its proposed eligibility criteria. According to a recent Deloitte Dbriefs webcast poll of financial executives[1], 51% of respondents indicated that they thought the SEC should allow more U.S. issuers to adopt IFRS early. (See Figure 1.) Furthermore, almost a third of respondents noted that all issuers should be given the option of using IFRS, as illustrated in Figure 2. These results suggest that that the appeal of early IFRS adoption among U.S. companies is quite strong.

The proposed IFRS roadmap and proposed rule changes will be issued for public comment. The public will have 60 days after issuance in the Federal Register to respond with their comments, after which the SEC will assess the comments received and vote on a final roadmap and rule for early adoption. We encourage comments as these will form the basis for future steps that will affect all issuers in the United States.

Figure 1. Do you believe the SEC should change its criteria in the proposed rule to allow more U.S. issuers to early adopt IFRS?

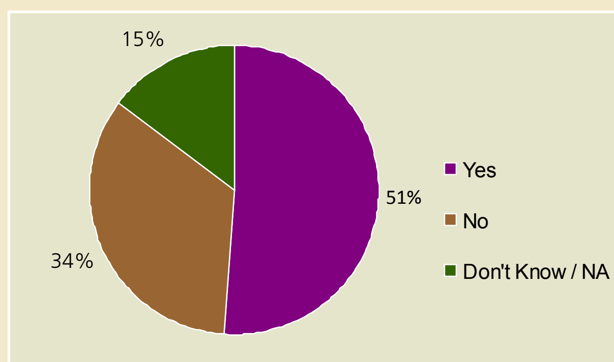
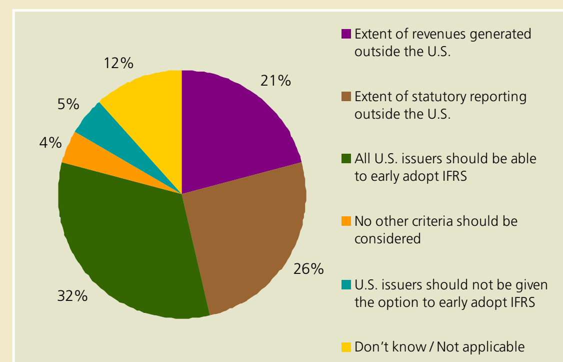


Figure 2. What other criteria should be considered when determining eligibility to early adopt IFRS?



[1] Financial Reporting Dbriefs webcast, "IFRS: What does the latest SEC Activity mean for you?" held on September 19, 2008, with over 3500 respondents.

Making It Happen: M&A Considerations for IFRS

What buyers and sellers should know

With the growing reach of IFRS on many aspects of business – including M&A activity – it has become increasingly important for executives to understand the implications of IFRS as they develop near and long-term growth strategies. So, what does the trend toward IFRS mean for the arena of mergers and acquisitions today? And how might IFRS impact deals?

Buyers and potential U.S. corporate partners – especially multinational companies – have greater reason to assess IFRS implications on deal structures even as they contemplate their own migration to IFRS. In doing so, dealmakers will need to be "bilingual" in terms of understanding the languages of both U.S. GAAP and IFRS. In this article, we'll focus on two areas of differences that are of particular interest to M&A buyers and sellers in considering structures: liability/equity classification and consolidation rules.

- With respect to liability/equity classification, puttable or contingently redeemable shares (features sometimes requested by PEI's) that might qualify for equity or temporary equity treatment under U.S. GAAP generally results in liability classification under IFRS. Furthermore, more instruments are likely to qualify for derivative treatment under IFRS as no "net settlement" requirement exists in the IFRS definition.
- With respect to consolidation rules, two primary differences exist. First, IFRS does not have the same "variable interest" framework that exists under U.S. GAAP. Secondly, IFRS considers potential voting rights (options, convertible instruments) in determining whether one party controls another party. As a result, buyers need to be cognizant of the fact that a target company may not consolidate the same set of entities under IFRS that would be required under U.S. GAAP.

Similarly, for due diligence on any target company reporting under IFRS, a U.S. buyer will need to understand the present differences in relation to U.S. GAAP, particularly if the target company will not continue to report under IFRS. The need to understand differences, however, may not stop there, as differing local country or company interpretations of IFRS may exist, resulting in challenges in benchmarking and valuation multiples at the outset, and increased disputes over purchase price adjustments and earn-out targets over time.

Today, buyers may find foreign corporations already reporting under IFRS – or those multinational corporations whose subsidiaries are already reporting under IFRS – increasingly attractive. The challenges facing a buyer will relate to cost and effort required to transition to IFRS. Besides working through the accounting mechanics of adopting IFRS, issuers may need to train staff, adjust forecasts, restructure debt agreements and covenants, change information systems, and consider the impact on tax structures. All these factors should be addressed in developing an effective response and comprehensive strategy for IFRS.

For more information about M&A and IFRS, see the Deloitte article, "The move to IFRS – what buyers (and sellers) should know."

New publication: Buckle Up (On the Road to IFRS)

Straight Talk Book No. 11

Buckle up

(On the road to IFRS)

No. 11 in Deloitte's Straight Talk series, this book is designed to help executives understand the accounting, tax, systems and organizational aspects of International Financial Reporting Standards (IFRS) conversion — and their role in addressing the changes IFRS will bring. The publication offers practical insights on taking a strategic approach to the transition.

Access "Buckle Up" at www.deloitte.com/us/ifrs/buckleup

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Technical Corner: IFRS 3 (2008)

Accounting for business combinations

Mergers and acquisitions (M&A) represent a core growth strategy for companies. Although accounting considerations should not drive M&A decisions, they can have a significant impact on deal structures. Consequently one of the key convergence projects undertaken by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) has been the accounting for business combinations. This has resulted in changes to IFRS and, to a greater extent, U.S. GAAP.

Following the issuance of FAS 141(R), Business Combinations and IFRS 3, Business Combinations, IFRS and U.S. GAAP are substantially converged in the treatment of business combinations. However important differences remain, some of which are highlighted below.

- Control – The IASB's definition of control is "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities." Whereas, the FASB's definition is based on a "controlling financial interest", which can be based on a variable interest or voting interest model.

- Contingencies – IFRS 3 requires recognition of a contingent liability assumed in a combination if it is a present obligation that arises from past events and its fair value can be measured reliably. On the other hand, FAS 141(R) distinguishes between contractual and non-contractual contingencies and requires a contractual liability be recognized regardless of whether it is reliably measurable. Non-contractual contingencies must be assessed as to whether it is more likely than not that the contingency gives rise to an asset or liability. If so, such contingencies are recognized at fair value.

- Non-controlling interests – IFRS 3 allows a transaction by transaction choice for measuring non-controlling interest at either fair value or proportionate interest in net assets. Alternatively, FAS 141(R) requires non-controlling interests be measured at fair value.

Although substantial convergence has been achieved with accounting for business combinations under IFRS and U.S. GAAP, significant differences still exist. It is critical to be aware of these differences when considering a conversion to IFRS or when considering acquiring a company that uses IFRS. Key questions to ask include:

- How will the terms and structuring of future business combination transactions be impacted?

- What will be the impact of any differences in the valuation of assets acquired and liabilities assumed?

- How will any future "exit strategy" related to acquired businesses be impacted?

IFRS Case Study

This month, we feature a case study of a multinational company in the technology sector with IFRS experience.

- **Overview:** A large global company with more than 100 subsidiaries in 70 countries sought to consolidate and enhance its statutory reporting processes to reduce complexity, decrease potential reputational risk, and increase transparency and efficiency of its global finance organization.
- **The Challenge:** With limited visibility into the statutory reporting processes and requirements, the company was not fully aware of its existing risk exposure at the subsidiary level, or opportunities to simplify its reporting.
- The company, with outside assistance, conducted an assessment to determine an appropriate approach for adapting to (and eventually) adopting IFRS as a basis for financial reporting. The project included the following components: a comprehensive evaluation of the "IFRS landscape" facing the company and its subsidiaries; and an assessment of readiness for an IFRS conversion
- **Lessons Learned:** As a result, the company is recognizing improvements in its financial and tax reporting processes, and also identified areas for improvement within its treasury processes and internal controls. In streamlining the global finance organization, cost savings and opportunities for simplification were also identified.

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