1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The year 2005 marked the start of a new era in global conduct of business, and the fulfillment of a thirty-year effort to create the financial reporting rules for a worldwide capital market. For during that year's financial reporting cycle, as many as 7,000 listed companies in the 25 European Union member states, plus many others in countries such as Australia, New Zealand, Russia, and South Africa were expected (in the EU, required) to produce annual financial statements in compliance with a single set of international rules—International Financial Reporting Standards (IFRS). Many other business entities, while not publicly held and not currently required to comply with IFRS, will also do so, either immediately or over time, in order to conform to what is clearly becoming the new worldwide standard. Since there are about 15,000 SEC-registered companies in the USA that prepare financial statements in accordance with US GAAP (plus countless nonpublicly held companies also reporting under GAAP), the vast majority of the world's large businesses are now reporting under one or the other of these two comprehensive systems of accounting and financial reporting rules.

Most other national GAAP standards have been reduced in importance or are being phased out as nations all over the worlds are now embracing IFRS. For example, Canada announced that Canadian GAAP (which was very similar to US GAAP) will be eliminated and replaced by IFRS in 2011. More immediately, China has required that listed companies employ IFRS beginning with 2007 financial reporting. Both 2007 and 2008 (to date) have proven to be watershed years for the growing acceptability of IFRS, as well. In 2007 the SEC dropped the former reconciliation requirement (to US GAAP) that had long applied to foreign private registrants reporting under fully compliant IFRS. This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listings in the US led, quite naturally, to a call for permitting domestic companies to freely choose between financial reporting under US GAAP and IFRS. As of late 2008, the SEC has begun the process of acquiescence, first for the largest companies in those industries having (worldwide) the preponderance of IFRS adopters, and later for all publicly held companies. Nonetheless, it is highly probable that only US GAAP will for the foreseeable future remain as the set of financial reporting standards of choice by the vast majority of US businesses, which are privately held and not subject to SEC requirements.

The impetus to convergence of presently disparate financial reporting standards has been, in the main, to facilitate the free flow of capital so that, for example, investors in the United States will be willing to finance business in, say, China or the Czech Republic. Having access to financial statements that are written in the same "language" would eliminate what has historically been a major impediment to engendering investor confidence. Additionally, the ability to list a company's securities on a stock exchange has generally required filings with national regulatory authorities that have insisted on either conformity with local GAAP or formal reconciliation to local GAAP. Since either of these procedures was tedious and time-consuming, and the human resources and technical knowledge to do so were in short supply, many otherwise anxious would-be registrants forwent the opportunity to broaden their investor bases and potentially lower their cost of capital.

These difficulties are probably soon coming to an end, however. The historic 2002 Norwalk Agreement between the US standard setter, FASB, and the IASB called for "convergence" of the two sets of standards, and indeed a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment, with more changes expected in the immediate future. More recently, as noted, the US Securities and Exchange Commission waived the longstanding requirement that foreign private issuers (i.e., registrants) filing financial statements prepared in accordance with full IFRS (i.e., *not* European or other national versions of IFRS) reconcile those financial statements to US GAAP. It has made a rule change that will permit US domestic registrants to choose between compliance with US GAAP and IFRS. These current and prospective changes, coupled with ongoing convergence efforts, seemingly portend a greatly expanded usage of IFRS in world commerce.

It thus is expected that, by the early to midportion of the next decade, all or virtually all distinctions between US GAAP and IFRS will be eliminated, if US GAAP remains an important force at all, although there remain challenging issues to be resolved. For one example, while IFRS bans the use of LIFO costing for inventories, it remains a popular financial reporting method under US GAAP because of a "conformity rule" that permits entities to use the method for tax reporting only if it is also used for general-purpose external financial reporting. In times of increasing costs, LIFO almost inevitably results in tax deferrals and is thus widely employed.

Origins and Early History of the IASB

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematized form of accounting regulation developed in continental Europe, starting in France in 1673. Here a requirement for an annual fair value statement of financial position was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic actors was copied by other states and later incorporated in the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon's efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This "code law" family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on profits started to be introduced, mostly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual company and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses that are not financially sound or were run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their (nonmanagement) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialized. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting began to become focused on consolidated accounts and the group, rather than the individual company. For different reasons, neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

The second model of financial reporting, generally regarded as the Anglo-Saxon financial reporting approach, can be characterized as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC's mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed at the investor, not the government.

Neither of the two above-described approaches to financial reporting is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonized by industrialized nations) they have adopted variants of one or the other of these two models.

IFRS are an example of the second, capital market-oriented, systems of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC), was formed in 1973, during a period of considerable change in accounting regulation. In the US the Financial Accounting Standards Board (FASB) had just been created, in the UK the first national standard setter had recently been organized, the EU was working on the main plank of its own accounting harmonization plan (the Fourth Directive), and both the UN and the OECD were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (Institute of Chartered Accountants in England and Wales—ICAEW) and the American profession (American Institute of Certified Public Accountants—AICPA).

A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands, and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

The actual reasons for the IASC's creation are unclear. A need for a common language of business was felt, to deal with a growing volume of international business, but other more political motives abounded also. For example, some believe that the major motivation was that the British wanted to create an international standard setter to trump the regional initiatives within the EU, which leaned heavily to the Code model of reporting, in contrast to what was the norm in the UK and almost all English-speaking nations.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to become a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

Both the UN and OECD were active in international rule making in the 1970s but the IASC successfully persuaded them that they should leave recognition and measurement rules to the IASC. However, having established itself as the unique international rule maker, IASC had great difficulty in persuading anyone to use its rules. Although member professional bodies were theoretically committed to pushing for the use of IFRS at the national level, in practice few national bodies were influential in standard setting in their respective countries, and others (including the US and UK) preferred their national standards to whatever IASC might propose. In Europe, IFRS were used by some reporting entities in Italy and Switzerland, and national standard setters in some countries such as Malaysia began to use IFRS as an input to their national rules, while not necessarily adopting them as written by the IASC or giving explicit recognition to the fact that IFRS were being adopted in part as national GAAP.

IASC's efforts entered a new phase in 1987, which led directly to its 2001 reorganization, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was interested in identifying a common international "passport" whereby companies could be accepted for secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to endorse IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to a quality and comprehensiveness level that IOSCO stipulated.

Historically, a major criticism of IFRS had been that it essentially endorsed all the accounting methods then in wide use, effectively becoming a "lowest common denominator" set of standards. The trend in national GAAP had been to narrow the range of acceptable alternatives, although uniformity in accounting had not been anticipated as a near-term result. The IOSCO agreement energized IASC to improve the existing standards by removing the many alternative treatments that were then permitted under the standards, thereby improving comparability across reporting entities. The IASC launched its *Comparability and Improvements Project* with the goal of developing a "core set of standards" that would satisfy IOSCO. These were complete by 1993, not without difficulties and spirited disagreements among the members, but then—to the great frustration of the IASC—these were not accepted by IOSCO. Rather than endorsing the standard-setting process of IASC, as was hoped for, IOSCO seemingly wanted to cherry-pick individual standards. Such a process could not realistically result in near-term endorsement of IFRS for cross-border securities registrations.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further period of frenetic activities, where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps in IFRS. This time the set of standards included, among others, IAS 39, on recognition and measurement of financial instruments, which was endorsed, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the same time, the IASC had undertaken an effort to consider its future structure. In part, this was the result of pressure exerted by the US SEC and also by the US private sector standard setter, the FASB, which were seemingly concerned that IFRS were not being developed by "due process." While the various parties may have had their own agendas, in fact the IFRS were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events. The challenges presented to IASB ultimately would serve to make IFRS stronger.

If IASC was to be the standard setter endorsed by the world's stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but possibly where national standard setters appointed representatives—or a small, professional body of experienced standard setters which worked independently of national interests.

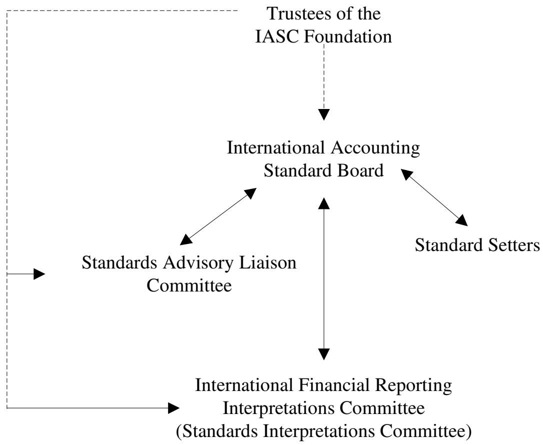
The end of this phase of the international standard setting, and the resolution of these issues, came about within a short period in 2000. In May of that year, IOSCO members voted to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which itself was quickly exceeded by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the EU eclipsed the lukewarm IOSCO approval, and since then the EU has appeared to be the more influential body insofar as gaining acceptance for IFRS has been concerned. Indeed, the once-important IOSCO endorsement has become of little importance given subsequent developments, including the EU mandate and convergence efforts among several standard-setting bodies.

In July 2000, IASC members voted to abandon the organization's former structure, which was based on professional bodies, and adopt a new structure: beginning in 2001, standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

The Current Structure

The formal structure put in place in 2000 has the IASC Foundation, a Delaware corporation, as its keystone. The Trustees of the IASC Foundation have both the responsibility to raise the $19 million a year currently needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council (SAC).

The Standards Advisory Council (SAC) meets with the IASB three times a year, generally for two days. The SAC consists of about 50 members, nominated in their personal (not organizational) capacity, but are usually supported by organizations that have an interest in international reporting. Members currently include analysts, corporate executives, auditors, standard setters, and stock exchange regulators. The members are supposed to serve as a channel for communication between the IASB and its wider group of constituents, to suggest topics for the IASB's agenda, and to discuss IASB proposals.



The International Financial Reporting Interpretations Committee (IFRIC) is a committee comprised mostly of technical partners in audit firms but also includes preparers and users. It succeeded the Standards Interpretations Committee (SIC), which had been created by the IASC. IFRIC's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different rules. In recent times it has also proposed modifications to standards to the IASB, in response to perceived operational difficulties or need to improve consistency. IFRIC liaises with the US Emerging Issues Task Force and similar bodies liaison as standard setters, to try at preserve convergence at the level of interpretation. It is also establishing relations with stock exchange regulators, who may be involved in making decisions about the acceptability of accounting practices, which will have the effect of interpreting IFRS.

The liaison standard setters are national bodies from Australia, Canada, France, Germany, UK, USA, and Japan. Each of these bodies has a special relationship with a Board member, who normally maintains an office with the national standard setter and is responsible for liaison between the international body and the national body. This, together with the SAC, was the solution arrived at by the old IASC in an attempt to preserve some degree of geographical representation. However, this has been somewhat overtaken by events: as far as the EU is concerned, its interaction with the IASB is through EFRAG (see below), which has no formal liaison member of the Board. The IASB Deputy Chairman has performed this function, but while France, Germany and the UK individually have liaison, EFRAG and the European Commission are, so far, outside this structure.

Furthermore, there are many national standard setters, particularly from developing countries, that have no seat on the SAC, and therefore have no direct link with the IASB, despite the fact that many of them seek to reflect IASB standards in their national standards. At the 2002 World Congress in Hong Kong, the IASB held an open meeting for national standard setters, which was met with enthusiasm. As a result, IASB began to provide time concurrent with formal liaison standard setters' meetings for any other interested standard setters to attend. While this practice was not enshrined in either the Constitution or the

IASB's operating procedures, both are under review at the moment, and any changes made will be in place by the end of 2009.

Process of IFRS Standard Setting

The IASB has a formal due process which is set out in the *Preface to IFRS*, revised in 2001. At a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the SAC, liaison standard setters, the international audit firms and others. These are debated by IASB and tentative conclusions are discussed with the various consultative bodies. The IASB also has a joint agenda committee with the FASB. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

The agenda was largely dominated in the years after 2001 by the need to round out the legacy standards, to ensure that there would be a full range of standards for European companies moving to IFRS in 2005. Also, it was recognized that there was an urgent need to effect modifications to many standards in the name of convergence (e.g., acquisition accounting and goodwill) and to make needed improvements to other existing standards. These needs were largely met by mid-2004.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by IASB in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper which is debated at a subsequent meeting. In theory there is an internal process where the staff proposes solutions, and IASB either accepts or rejects them. In practice the process is more involved: sometimes (especially for projects like financial instruments) specific Board members are allocated a special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one thing or another.

The process usually involves: (1) discussion of a paper outlining the principal issues; (2) preparation of an Exposure Draft that incorporates the tentative decisions taken by the Board—during which process many of these are redebated, sometimes several times; (3) publication of the Exposure Draft; (4) analysis of comments received on the Exposure Draft; (5) debate and issue of the final standard, accompanied by application guidance and a document setting out the *Basis for Conclusions* (the reasons why IASB rejected some solutions and preferred others). Final ballots on the Exposure Draft and the final standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB Web site and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where IASB takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. If the project is controversial or particularly difficult, IASB may issue a discussion paper before proceeding to Exposure Draft stage. It reissued a discussion paper on stock options before proceeding to IFRS 2, *Share-Based Payment.* It is also following this pattern with its financial statement presentation project and its project on standards for small and medium-sized entities. Such a discussion paper may just set out what the staff considers to be the issues, or it may do that as well as indicate the Board's preliminary views.

IASB may also hold some form of public consultation during the process. For example, when revising IAS 39, *Financial Instruments: Recognition and Measurement,* in 2003, IASB held round table discussions. Respondents to the Exposure Draft were invited to participate in small groups with Board members where they could put forward their views and engage in debate.

Apart from these formal consultative processes, IASB also carries out field trials of some standards (as it recently did on performance reporting and insurance), where volunteer preparers apply proposed new standards. The international audit firms receive IASB papers as a result of their membership on IFRIC and are also invited to comment informally at various stages of standard development.

Constraints

The debate within IASB demonstrates the existence of certain pervasive constraints that will influence the decisions taken by it. A prime concern has, heretofore, been achieving *convergence*. In October 2002, the IASB signed an agreement with the FASB (the so-called Norwalk Agreement) stating that the two boards would seek to remove differences and converge on high-quality standards. This agreement set in motion short-term adjustments and both standard setters subsequently issued a number of Exposure Drafts and final standards changing their respective standards in order to converge with the other on certain issues. The agreement also involved a commitment to the long-term development of joint projects (business combinations, performance reporting, revenue recognition, etc.).

The desire for convergence was driven to a great extent by the perception that international investment is made riskier by the use of multiple reporting frameworks, and that the global capital market would benefit from the imposition of a single global reporting basis—but also specifically by the knowledge that European companies that wished to be listed in the US needed to provide reconciliations of their equity and earnings to US GAAP when they did this. Foreign companies registered with the SEC are required to prepare an annual filing on Form 20-F that, until late 2007—if the entity did not prepare its financial statements under US GAAP—required a reconciliation between the entity's IFRS or national GAAP and US GAAP for earnings and equity. This reconciliation was said to be costly to prepare, and resulted in companies reporting, in effect, two different operating results for the year, which was not always understood or appreciated by the capital markets. As of year-end 2007, this requirement was eliminated, provided that the foreign private issuers (i.e., SEC registrants) complied fully with IFRS. Note that IFRS as adopted by the European Union contains departures from IFRS as promulgated by the IASB, and thus reconciliation has not been (thus far, at least) waived.

A major concern for financial reporting is that of *consistency*, but this is a complex matter, since IASB has something of a hierarchy of consistency. As a paramount consideration, IASB would want a new standard to be consistent with its *Conceptual Framework* (discussed below). Thereafter, there may be conflicts both between being consistent with US GAAP and being consistent with preexisting IFRS. However, there is little or no desire to maintain consistency with standards marked for extinction or in clear need of major revision. For example, IASB believes that a number of extant standards are inconsistent with the *Framework* (e.g., IAS 20 on government grants), and need to be changed, or are ineffective or obsolete (e.g., IAS 17 on leases), so there is little purpose in seeking to make a new standard consistent with them. Equally, since it aims to converge with US GAAP, it seems illogical to adopt a solution that is deliberately at variance with US GAAP, which will then have to be reconsidered as part of the convergence program. (Note that the convergence effort is expected, at least in the near term, to continue, notwithstanding the elimination of the SEC's reconciliation requirement and the prospective replacement of US GAAP for public company financial reporting by IFRS.)

Those members of IASB who have worked in North America are concerned that standards avoid creating abuse opportunities. Experience has sadly shown that there may well be attempts by preparers to evade the intended result of accounting standards, using so-called "financial engineering," in order to be able to achieve the earnings or presentations in the statement of financial position that are desired, particularly in the short term (e.g., quarterly earnings). This concern is sometimes manifested as a desire to impose uniform and inflexible standards, allowing few or no exceptions. There is a justifiable perception that many standards become very complicated because they contain too many exceptions to a simple and basic rule (for example: eliminate complex lease accounting requirements and simply report the property rights and debt obligations implicit in all lease arrangements).

IASB also manifests some concerns about the practicality of the solutions it mandates. While some preparers might think that it is not sympathetic enough in this regard, it actually has limited the extent to which it requires restatements of previous years' reported results when the rules change, particularly in IFRS 1, *First-Time Adoption*. The *Framework* does include a cost/benefit constraint—that the costs of the financial reporting should not be greater than the benefits to be gained from the information—which is often invoked during debates over proposed standards, although IASB considers that preparers are not the best ones to measure the benefits of disclosure.

There is also a procedural constraint that IASB has to manage, which is the relationship between the Exposure Draft and the final standard. IASB's due process requires that there should be nothing introduced in the final standard that was not exposed at the Exposure Draft stage, as otherwise there must be reexposure of the material. This means that where there are several solutions possible, or where a line can be drawn in several places, IASB may tend towards the most extreme position in the Exposure Draft, so as not to narrow its choices when further deliberating the proposal in the light of constituents' comments.

Conceptual Framework for Financial Reporting

The IASB inherited the IASC's *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*). Like the other current conceptual frameworks among Anglo-Saxon standard setters, this derives from the US conceptual framework, or at least those parts of it completed in the 1970s. The *Framework* states that "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions." The information needs of investors are deemed to be of paramount concern, but if financial statements meet their needs, other users' needs would generally also be satisfied.

The *Framework* holds that users need to evaluate the ability of the entity to generate cash and the timing and certainty of its generation. The financial position is affected by the economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

The qualitative characteristics of financial statements are understandability, relevance, reliability and comparability. Reliability comprises representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint and that in practice there will often be a trade-off between characteristics. The *Framework* does not specifically include a "true and fair" requirement, but says that application of the specified qualitative characteristics should result in statements that present fairly or are true and fair. IAS 1, *Presentation of Financial Statements*, as revised in 2007, states that financial statements are "a structured representation of the financial position and financial performance of an entity…(whose) objective…is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions." It further states that "fair presentation requires faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria…set out in the *Framework*….The application of IFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation."

Of great importance are the definitions of assets and liabilities. According to IASB, "an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." A liability is a "present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying future benefits." Equity is simply a residual arrived at by deducting the liabilities from assets. Neither asset nor liability are recognized in the financial statements unless they have a cost or value that can be measured reliably—which, as the *Framework* acknowledges, means that some assets and liabilities may remain unrecognized.

The asset and liability definitions have, in the past, not been central to financial reporting standards, many of which were instead guided by a "performance" view of the financial statements. For example, IAS 20 on government grants has been severely criticized and targeted for either revision or elimination, in part because it allows government grants to be treated as a deferred credit and amortized to earnings, while a deferred credit does not meet the *Framework* definition of a liability. Similarly, IFRS 3 requires that where a bargain purchase is identified in a business combination, a gain on a bargain purchase (negative goodwill) should be released to profit or loss immediately—IAS 22 treated it as a deferred credit, which however did not actually meet the defined criteria for recognition as a liability.

Accounting standards are now largely driven by statement of financial position considerations. Both FASB and IASB now intend to analyze solutions to reporting issues in terms of whether they cause any changes in assets or liabilities. The revenue recognition project that both bodies are pursuing is perhaps the ultimate example of this new and rigorous perspective. This project has tentatively embraced the view that where an entity receives an order and has a legally enforceable contract to supply goods or services, the entity has both an asset (the right to receive future revenue) and a liability (the obligation to fulfill the order) and it follows that, depending upon the measurement of the asset and the liability, some earnings could be recognized at that point. This would be a sharp departure from existing GAAP, under which executory contracts (i.e., contracts upon which neither party has yet performed) are almost never formally recognized, and never create earnings.

The IASB *Framework* is relatively silent on measurement issues. The three paragraphs that address this matter merely mention that several different measurement bases are available and that historical cost is the most common. Revaluation of tangible fixed assets is, for example, perfectly acceptable under IFRS for the moment. In practice IFRS have a mixed attribute model, based mainly in historical cost, but using value in use (the present value of expected future cash flows from the use of the asset within the entity) for impairment and fair value (market value) for some financial instruments, biological assets, business combinations and investment properties.

FASB and IASB have been, since 2005, revisiting their respective conceptual frameworks, the objective of which is to build on them by refining and updating them and developing them into a common framework that both can use in developing accounting standards.

With concurrent IASB and FASB deliberations and a single integrated staff team, this is truly an international project. IASB believes that it has made good progress on the first phase of the project. Most of the debate for the first year or so focused on the objectives of financial reporting and the qualitative characteristics of decision-useful financial reporting information, and a joint Discussion Paper on these matters was issued in late 2006. This was followed, in May 2008, by Exposure Drafts of the first two (of eight) chapters for the proposed new conceptual framework. The first two chapters deal with, respectively, the objective of financial reporting and the qualitative characteristics of decision-useful financial reporting information.

Regarding the objective of financial reporting, the Exposure Draft proposes the following definition:

> *The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Capital providers are the primary users of financial reporting. To accomplish the objective, financial reports should communicate information about an entity's economic resources, claims on those resources, and the transactions and other events and circumstances that change them. The degree to which that financial information is useful will depend on its qualitative characteristics.*

As with the existing FASB Conceptual Framework, this definition of the objective for financial reporting has a wider scope than financial statements, *per se*. It actually sets forth the objective of financial reporting in general, including a range of possible narrative and other presentations that would accompany and amplify the financial statements.

Financial reporting is aimed primarily at capital providers. That does not mean that others, such as management, will not find financial reports useful, but rather that, in deciding on the principles for recognition, measurement, presentation, and disclosure, the information needs of capital providers are to be given paramount consideration.

The draft holds that *decision usefulness* to capital providers is the overriding purpose of financial reporting. Providing information about *management stewardship* of the assets entrusted to it is an important part of that objective, however. The language of the Exposure Draft cites *present and potential* investors as its means of acknowledging that general purpose financial reports are used both for future investment decisions as well as assessing the stewardship of resources already committed to the entity.

The draft identifies equity investors, lenders and other creditors (including suppliers, employees and customers) as *capital providers*, which are those whose information needs are to be met through general purpose financial reports. Governments, their agencies, regulatory bodies, and members of the public are identified as groups that may find the information in general purpose financial reports useful, but these are not defined as being primary users.

The Exposure Draft continues with the current philosophy that financial reporting should provide information that enables capital providers to assess the entity's ability to generate net cash inflows, coupled with an ability to assess management's ability to protect and enhance the capital providers' investments.

The *stewardship responsibilities of management* are addressed explicitly by the draft document, which notes that management "is accountable to the entity's capital providers for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use" and that the entity complies with applicable laws, regulations and contractual requirements. The ability of management to discharge these responsibilities effectively has an obvious impact on the entity's ability to generate future net cash inflows, suggesting that potential investors are also assessing management performance as they make their investment decisions.

IASB and FASB both note that users of financial reports should be aware of the limitations of the information included in financial reports—specifically because the information is heavily based on estimates, rather than exact measures, and thus involve the application of judgment. Also, users are cautioned to recognize that financial reports are only one source, of potentially many, of information needed by those making investment, credit and similar resource allocation decisions. Thus, other sources of relevant information must also be consulted, for insights about general economic conditions, political events and industry outlooks, among possibly many other topics.

The draft holds that information about the effects of transactions and other events that change assets and liabilities is also essential. Financial reporting must also include management's explanations (an example being the *management discussion and analysis* required under SEC filings in the US), since management knows more about the entity than could any external users. Such explanations, properly constructed and communicated, should provide insight into significant estimates and assumptions used by management.

Chapter two of the proposed new conceptual framework document, which has also been exposed for comment, addresses the qualitative characteristics and constraints of decision-useful financial reporting information. IASB and FASB have refined the approach first seen in the earlier (2006) Discussion Paper, such that there are now two fundamental qualitative characteristics:

- Relevance, and
- Faithful representation.

In addition, there are certain characteristics that are said to enhance the decision-usefulness of financial information. These are complementary to the fundamental qualitative characteristics and are: comparability (including consistency), verifiability, timeliness and understandability. These are defined as follows by the Exposure Draft:

> **Relevant** information is that which has predictive value, confirmatory value or both; in other words it is capable of influencing the decisions of capital providers. The users do not need to use such information, but merely have to be given access to it.
>
> **Faithful representation** implies that decision-useful financial information represents faithfully the economic phenomenon (those affecting financial position and results of operations) that it purports to represent.
>
> The enhancing qualitative characteristics are said to help users to distinguish more useful information from less useful information.
>
> **Timeliness** means that the information is provided when it is still highly useful for decision-making purposes.
>
> **Comparability** refers to the ability to identify similarities in—and differences between—two sets of economic phenomena. It is not to be confused with uniformity, which still does not exist under either US GAAP or IFRS (although the range of alternatives has narrowed over recent decades). *Consistency* (the use of the same accounting policies and procedures within an entity from period to period, or in a single period across entities) aids comparability.
>
> **Verifiability** helps to assure users that information represents faithfully the economic phenomena that it purports to represent. It implies that knowledgeable and independent observers could reach a general consensus (but not necessarily absolute agreement) that the information does represent faithfully the economic phenomena it purports to represent without material error or bias, or that an appropriate recognition or measurement method has been applied without material error or bias. It means that independent observations would yield essentially the same measure or conclusions.
>
> **Understandability** enables users who have a reasonable knowledge of business and economic and financial activities and financial reporting, and who apply reasonable diligence to comprehend the information, to gain insights into the reporting entity's financial position and results of operations, as intended. Understandability is enhanced when the information is

classified, characterized and presented clearly and concisely. The draft asserts that relevant information should not be excluded solely because it may be too complex or difficult for some users to understand.

The Basis for Conclusions accompanying the Exposure Draft lists additional candidate attributes that were considered by the Boards, but not included in the proposals. These include *transparency* (which was concluded was subsumed within faithful representation and understandability); *true and fair view* (deemed to be equivalent to faithful representation); *credibility* (which is implied by verifiability); and *high quality* (which generally is achieved by adherence to the objective and qualitative characteristics of financial reporting). One other candidate, *internal consistency*, was rejected because IASB and FASB concluded that this, while desirable and a goal of both bodies, could impede the evolution of financial reporting standards.

Two pervasive constraints may also limit the information provided in useful financial reports:

- Materiality, and
- Cost

Regarding *materiality*, which has long been invoked but often not defined in terms precise enough for users and preparers, information is to be deemed material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information. Materiality is not a matter to be considered by standard-setters but by preparers and their auditors. That is, financial reporting requirements will be promulgated without regard to materiality criteria, but actual adherence to such rules may be omitted when the effect of doing so would not be material to the users.

As concerns the *cost-benefit* criterion, it has been stated that the benefits of providing financial reporting information should justify the costs of providing that information. Presumably this will constrain the imposition of certain new requirements, although this is a relative concept, and as information technology continues to evolve and the cost of preparing and distributing financial and other information declines, this constraint conceivably will be relaxed as well.

Discussion has since moved on to the elements of financial statements, in particular the definitions of an asset, a liability, and equity, and on what constitutes the reporting entity, and a Discussion Paper on reporting entity in May 2008. An Exposure Draft on this segment of the conceptual framework is promised for the latter part of 2009.

Other components of the conceptual framework project, which will address elements and recognition, presentation and disclosure, purpose and status, and application to not-for-profit entities, will follow, but the timing is uncertain. Elements and presentation and disclosure are the most active projects and may result in Discussion Papers, at a minimum before year-end 2009.

Hierarchy of Standards

The *Framework* is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts will articulate their arguments in terms of the *Framework*. However, the *Framework* is not intended normally to be used directly by preparers and auditors in determining their accounting methods. In its 2003 revision of IAS 8, IASB introduced a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1. IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.

2. In the absence of such a directly applicable standard, judgment is to be used to develop and apply an accounting policy that is relevant to the economic decision-making needs of the users, and is reliable in that the financial statements: represent faithfully the financial position, financial performance and cash flows of the reporting entity; reflect the economic substance of transactions, events and conditions, rather than merely the legal forms thereof; are neutral; are prudent; and are complete in all material respects.
3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop its standards, as well as other accounting literature and industry practices that do not conflict with higher level guidance.
4. Only if that also fails should the preparer look to the IASB *Framework* directly.

In effect, therefore, if existing IFRS do not address an accounting issue, the preparer should look to analogous national GAAP, and the most obvious choice is US GAAP, partly because that is the most complete set of standards, and partly because in the global capital market, US GAAP is the alternative best understood. In any event, given the professed intention of IFRS and US GAAP to converge, it would make little sense to seek guidance in any other set of standards, unless US GAAP were also silent on the matter needing clarification.

The IASB and the US

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only at the beginning of the 1990s that FASB started to become interested in IASC. This was the period when IASC was starting to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to consider the international financial reporting area, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO's efforts to create a single passport for secondary listings, and IASC's role as its standard setter, while intended to operate worldwide, would have the greatest practical significance for foreign issuers in terms of the US market. It was understood that if the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US markets would be greatly facilitated. The SEC has therefore been a key factor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987. It also observed that there were too many options under IAS, and that it would be more favorably inclined to consider acceptance of IAS (now IFRS) if such alternatives were reduced. When IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) saying that, to be acceptable, IFRS would need to satisfy three criteria.

1. They must include a core set of standards that constituted a comprehensive basis of accounting;
2. The standards must be high quality, and enable investors to analyze performance meaningfully both across time periods and between companies; and
3. The standards must be rigorously interpreted and applied, because otherwise comparability and transparency would not be achieved.

The plan was predicated on the completion of a core set of standards, then handing these over to IOSCO, which in turn would ask its members to evaluate them, and finally IOSCO would issue its verdict. It was in this context that the SEC issued a "concept release" in 2000, in which it asked for comments on the acceptability of the core set of standards, but crucially on whether there was a sufficient compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, that auditors would ensure this and stock exchange regulators would check compliance.

This latter element is something which remains beyond the control of IASB, which is the domain of national bodies or professional organizations in each jurisdiction. The Standards Interpretations Committee was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to build liaison channels with stock exchange regulators and national interpretations bodies, but the rest is in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies. The SEC concepts release resulted in many comment letters, which can be viewed on the SEC Web site (www.sec.gov), but in the five years since its issue, the SEC has taken no definitive position.

The SEC's stance at the time was that it genuinely wanted to see IFRS used by foreign registrants, but that it preferred convergence (so that no reconciliation would be necessary) to acceptance without reconciliation of the IFRS as they were in 2000. In the years since, the SEC in its public pronouncements regularly supports convergence and has strongly implied that reconciliations might be waived as soon as 2008 if convergence progress continues to be made. Thus, for example, the SEC welcomed publicly the changes to US standards proposed by the FASB in December 2003, made to converge with IFRS.

Relations between FASB and IASB have grown warmer since IASB was restructured, perhaps influenced by the growing awareness that IASB would assume a commanding position in the financial reporting standard-setting domain. The FASB joined the IASB for informal meetings in the early 1990s, and this led to the creation of the G4+1 group of Anglo-Saxon standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer) in which FASB was an active participant. IASB and FASB signed the Norwalk Agreement in October 2002, which set out a program of convergence, and their staffs now work together on a number of projects, including business combinations and revenue recognition. Video links are used to enable staff to observe and participate in board meetings. The two boards have a joint agenda committee whose aim is to harmonize the timing with which the boards discuss the same subjects. The boards are also committed to meeting twice a year in joint session.

However, there remain problems, largely of the structural variety. FASB works in a specific national legal framework, while IASB does not. Equally, both have what they term "inherited" GAAP (i.e., differences in approach that have a long history and are not easily removed). FASB also has a tradition of issuing very detailed, prescriptive ("rules-based") standards that give bright line audit guidance, which are intended to make compliance control easier and remove uncertainties. In the post-Enron world, after it became clear that such prescriptive rules had been abused, there was a flurry of interest in standards that supposedly express an objective and then explain how to reach it ("principles-based" standards), without attempting to prescribe responses to every conceivable fact pattern. However, as the SEC study (mandated under the Sarbanes-Oxley Act of 2002) into principles-based standards observed, use of principles alone, without detailed guidance, reduces comparability. The litigation environment in the US also makes companies and auditors reluctant to step into areas where judgments have to be taken in uncertain conditions.

Events in the mid- to late-2000s have served to accelerate the pressure for full convergence between US GAAP and IFRS. In fact, the US SEC's decision in late 2007 to waive reconciliation requirements for foreign registrants complying with "full IFRS" was a clear indicator that the outright adoption of IFRS in the US is on the horizon, and that the convergence process may be made almost irrelevant. The SEC has since granted selected US registrants the limited right to begin reporting under IFRS in 2009, after which (in 2011) it will determine the future path of full-scale abandonment of US GAAP in favor of IFRS. As of late 2008, the SEC was expected to announce its so-called "roadmap" toward IFRS adoption at any moment. While at first this will promote or require IFRS adoption by multinational and other larger business entities, and then by all publicly held companies, in the longer run, even medium- and smaller-sized entities will probably opt for IFRS-based financial reporting, because some involvement in international trade is increasingly a characteristic of all business operations, and because the notion of reporting under "second-class GAAP" rather than under the standards employed by larger competitors will likely prove to be unappealing.

The IASB and Europe

While France, Germany, the Netherlands and the UK were founding members of IASC and have remained heavily involved, the European Commission as such has generally had a difficult relationship with the international standard setter. The EC did not participate in any way until 1990, when it finally became an observer at Board meetings. It had had its own regional program of harmonization since the 1960s and in effect only officially abandoned this in 1995, when, in a policy paper, it recommended to member states that they seek to align their rules for consolidated financial statements on IFRS. Notwithstanding this, the Commission gave IASB a great boost when it announced in June 2000 that it wanted to require all listed companies throughout the EU to use IFRS beginning in 2005 as part of its initiative to build a single European financial market. This intention was made concrete with the approval of the IFRS Regulation in June 2002 by the European Council of Ministers (the supreme EU decision-making authority).

The EU decision was all the more impressive in that, to be effective in legal terms, IFRS have to become enshrined in EU statute law, creating a situation where the EU is in effect rubber-stamping laws created by a small, self-appointed, private sector body. This proved to be a delicate situation, which proved within a very short time that it contained the seeds of unending disagreements: politicians were being asked in effect to endorse something over which they have no control, and were soon being lobbied by corporate interests that had failed to influence IASB directly to achieve their objectives. The EU endorsement of IFRS turns out to have the cost of exposing IASB to political pressures in the same way that FASB has at times been the focus of congressional manipulations in the US (e.g., over stock-based compensation accounting rules).

The EU created an elaborate machinery to mediate its relations with IASB. It preferred to work with another private sector body, created for the purpose, as the formal conduit for EU inputs to IASB. The European Financial Reporting Advisory Group (EFRAG) was formed in 2001 by a collection of European representative organizations (for details see www.efrag.org), including the European Accounting Federation (FEE) and European employer organization (UNICE). This in turn formed a small Technical Expert Group (TEG) which does the detailed work on IASB proposals. EFRAG consults widely within the EU, and particularly with national standard setters and the European Commission to canvass views on IASB proposals, and provides inputs to IASB. It responds formally to all discussion papers and Exposure Drafts.

At a second stage, when a final standard is issued, EFRAG is asked by the Commission to provide a report on the standard. This report should state whether the standard has the required qualities and is in conformity with the European company law directives. The European Commission then asks a new committee, the Accounting Regulation Committee (ARC), whether it wishes to endorse the standard. ARC consists of permanent representatives of the EU member state governments. It should normally only fail to endorse IFRS if it believes they are not in conformity with the overall framework of EU law; it should not take a strategic or policy view. However, the European Parliament also has the right to comment, if it wishes. If ARC fails to endorse a standard, the European Commission may still ask the Council of Ministers to override that decision.

Experience has shown that the system suffers from a number of problems. First, although EFRAG is intended to enhance EU inputs to IASB, it may in fact isolate people from IASB, or at least increase the costs of making representations. For example, when IASB revealed its intentions of issuing a standard on stock options, it received nearly a hundred comment letters from US companies (who report under US GAAP, not IFRS), but only one from EFRAG, which represented about 90% of IASB's constituents in the early 2000s. It is easy to feel in this context that EFRAG is seen at IASB as a single respondent, so people who have made the effort to work through EFRAG feel underrepresented. In addition, EFRAG is bound to present a distillation of views, so it is already filtering respondents' views before they even reach IASB. The only recourse is for respondents to make representations not only to EFRAG but also directly to IASB.

However, resistance to the financial instruments standards, IAS 32 and IAS 39, put the system under specific strain. These standards were already in existence when the European Commission announced its decision to adopt IFRS for European listed companies, and had been exhaustively debated before enactment. European adoption again exposed these particular standards to strenuous debate.

The first task of EFRAG and ARC was to endorse the existing standards of IASB. They did this—but excluded IAS 32 and 39 on the grounds that they were being extensively revised as part of IASB's then-ongoing *Improvements Project*.

During the exposure period of the improvements proposals—which exceptionally included round table meetings with constituents—the European Banking Federation, under particular pressure from French banks, lobbied IASB to modify the standard to permit special accounting for macrohedging. The IASB agreed to do this, even though that meant the issuance of a new Exposure Draft and a further amendment to IAS 39 (which was finally issued in March 2004). The bankers did not like the terms of the amendment, and while it was still under discussion, they appealed to the French president and persuaded him to intervene. He wrote to the European Commission in July 2003, saying that the financial instruments standards were likely to make banks' figures volatile, would destabilize the European economy, and should not be approved. He also said that the Commission did not have a sufficient input to the standard-setting process.

This desire to alter the requirements of IAS 39 was further compounded when the European Central Bank complained in February 2004 that the "fair value option," introduced to IAS 39 as an improvement in final form in December 2003, could be used by banks to manipulate their prudential ratios, and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although again this meant issuing an Exposure Draft and a further amendment to IAS 39 which was not finalized until mid-2005. IASB, when it debated the issue, took a pragmatic line that no compromise of principle was involved, and that the principal bank regulator of the Board's largest constituent by far should be accommodated. The fact that the European Central Bank had not raised these issues at the original Exposure Draft stage was not discussed, nor was the legitimacy of a constituent deciding unilaterally it wanted to change a rule that had just been approved. The Accounting Standards Board of Japan lodged a formal protest and many other constituents have not been delighted.

Ultimately, ARC approved IAS 32 and IAS 39, but a "carve out" from IAS 39 was prescribed. Clearly the EU's involvement with IFRS is proving to be a mixed blessing for IASB, both exposing it to political pressures that are properly an issue for the Commission, not IASB, and putting its due process under stress. Some commentators consider that the EU might abandon IFRS, but this is not a realistic possibility, given that the EU has already tried and rejected the regional standard-setting route. What is more probable is that we are enduring a period of adjustment, with both regulators and lobbyists uncertain as to how exactly the system works, testing its limits, but with some *modus vivendi* evolving over time. However, it is severe distraction for IASB that financial instruments, arguably the controversy of the 1990s, is still causing trouble, when it has on its agenda more radical ideas in the areas of revenue recognition, performance reporting and insurance contracts.

The "carve-outs" have most recently had the result that the US SEC's historic decision to eliminate reconciliation to US GAAP for foreign private issuers has been restricted to those registrants that file financial statements that comply with "full IFRS" (i.e., those using "Euro-IFRS" and other national adaptations of IFRS as promulgated by the IASB will not be eligible for this deletion). Registrants using any derivation of IFRS, and those using any national GAAP, will continue to be required to present a reconciliation to US GAAP. Over time, it can be assumed that this will add to the pressure to report under "full IFRS."

The Future Agenda for IFRS

The matter of performance reporting (now renamed financial statement presentation) is a priority project for IASB. The project was bifurcated, and the first part, dealing with what financial statements are to be presented, led to a mid-2006 Exposure Draft and the late 2007 promulgation of revised IAS 1 (discussed in greater detail later in this chapter). The second phase, which addresses presentation on the faces of the financial statements, has culminated with the issuance of a joint IASB-FASB Discussion Paper in October 2008. The announced intent is to promulgate revisions to IAS 1 based on this exposure document by 2010.

IASB is also pursuing a revenue recognition project. The purpose of this undertaking is to revisit revenue recognition through an analysis of assets and liabilities, instead of the existing approach which focuses on completed transactions and realized revenue. Such an approach has major implications for the timing of earnings recognition—it would potentially lead to revenue recognition in stages throughout the transaction cycle. It is unlikely that this project will lead to short-term changes, given the fundamental nature of the issues involved. IASB is projecting that a discussion document will be produced in late 2008, but that an Exposure Draft will not be released until 2010, with the goal being to promulgate a final standard in 2011.

Linked to these projects, which are revisions and extensions of the conceptual framework, is a joint project with the Canadian Accounting Standards Board on initial measurement and impairment, and a catch-up project with FASB on accounting for, and distinguishing between, liabilities and equity, which has eluded definitive resolution for well over a decade.

The very important topic of accounting for business combinations has been pursued in coordination with FASB over several years. In 2008, both Boards completed Phase II of their respective projects, resulting in the issuance of revised IFRS 3 and the release of FAS 141(R) and FAS 160 for US GAAP. Among the important changes to prior practice are the imposition of acquisition accounting, the requirement that minority interests be included in group equity, and the optional procedure for the inclusion of goodwill calculated with reference to 100% of the shareholders, rather than for just the holdings of the controlling group. Additionally, contingent assets and liabilities acquired in a combination will be recognized at fair value at the date of the transaction. Full details of IFRS 3 as revised are set forth in Chapter 11.

IASB is also working on revisions to the criteria for consolidation (IAS 27) which it hopes to develop to deal more effectively with issues such as latent control and special-purpose entities. As of late 2008, this remains under active development.

IASB is currently working on its own in the area of what had been known as SME accounting (tailored standards for small and medium-sized entities) and is now referred to as IFRS for private entities (PE). Broadly, the intention of this project (which was the subject of an IASB Discussion Paper in 2004) is to produce a single accounting standard for PE, to consist of simplified versions of the existing IFRS, in a manner analogous to what was achieved in the UK some years ago (financial reporting standards for smaller enterprises, or FRSSE, since revised several times). IASB was initially reluctant to involve itself in this area, but was persuaded by a number of institutions, including the UN and the European Commission, that this was an urgent need. The crucial issue of what is a PE is couched in conceptual terms, as being an entity in which there is no public interest, but precise size terms are left to individual jurisdictions to determine. The definition excludes entities with listed equity or debt or that have certain defined types of public accountability, such as financial institutions.

IASB issued a draft standard in early 2006, which, if adopted, will serve as an optional "all in one" standard for entities that have no public accountability (i.e., privately held entities with no fiduciary obligations to nonowners). A final standard has been promised for 2009. This proposal is discussed in detail later in this chapter.

While IFRS 4, issued in March 2004, provides a first standard on accounting for insurance contracts, this is only an interim standard issued to meet the needs of 2005 adopters, and it permits the retention of many existing national practices. IASB is committed to a full standard, an exposure document for which is now projected to be released in 2009. The project should now enter full development. Analysis thus far, based on an asset and liability approach, would potentially allow recognition of some gain on the signing of a long-term contract. This will undoubtedly cause insurance regulators some concerns. IASB is also using fair value as a working measurement assumption, which has aroused opposition from insurers, many of whom have long used an approach which smoothed earnings over long periods and ignored the current market values of insurance assets and liabilities. They claim that fair value will introduce volatility, which is likely true: IASB members have observed that the volatility is in the marketplace, and that the insurers' accounts just do not reflect economic reality.

A project addressing IAS 30 disclosure requirements came to fruition in mid-2005 with the issuance of IFRS 7. This standard eliminated IAS 30, which had set forth disclosures for banks, and merges them with requirements formerly presented in IAS 39. Because of issues arising during the "credit crises" of 2008, IASB quickly considered certain amend-ments to IFRS 7, and by late 2008 had issued an Exposure Draft, *IFRS 7: Disclosures.* If adopted, these changes would become effective mid-2009. The revised disclosures would closely parallel those mandated by US GAAP standard FAS 157, imposing a hierarchy of fair value measures that would drive the structuring of disclosures.

In mid-2005 IASB issued an Exposure Draft of an amendment to IAS 37. This evolved as part of the ongoing efforts to converge IFRS with US GAAP. In particular, it is responsive to the differences between IAS 37 (on provisions) and FAS 146, addressing certain disposal and exit activities and the costs properly accrued in connection with them. FAS 146 was promulgated by FASB, in part, to curtail certain abuses commonly called providing "cookie jar reserves" during periods of corporate downsizing, when too-generous estimates were often made of future related costs, which in some instances served to absorb costs that would properly have been chargeable to future periods. In other cases, excess reserves (provisions) were used for later release into income, thereby overstating operating results of one or more later periods. FAS 146 applies strict criteria so that reserves that do not meet the definition of liabilities at the end of the reporting period cannot be recorded, since they do not represent present obligations of the reporting entity. The proposal to revise IAS 37 also hews more closely to US GAAP's approach to guarantees, which distinguish between the unconditional element—the promise to provide a service for some defined duration of time—and the conditional element, which is contingent on the future events, such as terminations, occurring.

If adopted, the amended IAS 37 (discussed in great detail in Chapter 12) would eliminate the terms *contingent liability* and *contingent asset,* and would restrict the meaning of constructive obligations so that these would be recognized as liabilities only if the reporting entity's actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform. Furthermore, the probability criterion would be deleted, so that only if a liability is not subject to reasonable measurement would it be justifiable to not record it. Certain changes are also made to IAS 19 by this draft. As of late 2008, these proposed revisions to IAS 37 remain under discussion by the IASB.

IASB also has expressed its intent to replace IAS 20, and an Exposure Draft had been promised for late 2005 but has yet to appear. It now appears that this project will not be addressed for perhaps several more years, since the first conceptualized approach, using the model in IAS 41, has now been judged inadequate. (See discussion in Chapter 26.) One change to IAS 20 was made, however, as part of the 2007 Annual Improvements project; this required explicit recognition (as grant income) of the benefit conferred by below-market interest on loans made to an entity.

Yet another short-term convergence project has resulted in the elimination from IAS 23 of the former option of expensing borrowing costs associated with long-term asset construction efforts. IAS 23, as revised in 2007, thus converged to the parallel US GAAP standard (FAS 34), which requires capitalization of interest under defined circumstances.

Income taxes and segment disclosures were two additional subject areas where IASB expected to converge to the US GAAP positions. As to income taxes, both IFRS and US GAAP have long embraced comprehensive interperiod allocation using the liability method, but certain exceptions are permitted, and these are expected to be narrowed or eliminated by revisions still under consideration. Also to be conformed is the computation of deferred tax assets and liabilities, and the treatment of uncertain tax positions (US GAAP has recently been revised to address this, while IFRS has yet to do so). An exposure document is promised for late 2008, with a final standard expected for 2010.

Regarding segment disclosures, IFRS now replicates US GAAP, thanks to the promulgation of IFRS 8. This is expected to ease the current challenge of developing segment data under IFRS.

Other convergence projects still under development on discussion include those addressing derecognition criteria (exposure document expected early 2009), accounting for noncurrent assets held for sale (Exposure Draft issued late 2008, final standard due by mid-2009), revisions to earnings per share computations (Exposure Draft issued mid-2008, final standard anticipated for late 2009), refinement to IFRS 1 regarding transition to IFRS (expected late 2009), and amendments to the requirements for related-party disclosures (late 2009). A joint project with FASB to revise lease accounting requirements is not expected to reach the exposure document stage until 2010.

Finally, accounting requirements for joint ventures will likely be changed to delete the currently available option of applying the proportionate consolidation method, thus permitting only the equity method, as is the case under US GAAP. (Note that there are a few instances where US GAAP does permit proportionate consolidation, and IFRS may preserve limited options as well.) An Exposure Draft was published in late 2007, and a final standard is anticipated for early to mid-2009.

Europe 2008 Update

The IASB's long effort to gain acceptance for IFRS began to bear fruit several years ago, when the EU briefly considered and then, significantly, abandoned a quest to develop Euro-GAAP, and when IOSCO endorsed, with some qualifications, the "core set of standards" following major revisions to most of the then-extant IFRS. A significant impediment was removed with the recent (late 2007) decision by the US Securities and Exchange Commission to eliminate the longstanding requirement for reconciliation of major items to US GAAP. However, since "Euro-IFRS" contains several "carve-outs" from the standards promulgated by IASB, this waiver will not apply to European publicly held entities. This may serve as an impetus for changes in the EU rules previously adopted.

Beginning January 1, 2005, all European Union (EU) companies having securities listed on an EU exchange have been required to prepare consolidated (group) accounts in conformity with IFRS. It is estimated that this requirement has affected approximately 7,000 companies, of which some 3,000 are in the United Kingdom. Companies traded both in the EU and on a regulated market outside the EU that were already in 2005 applying another set of internationally accepted standards (for example US Generally Accepted Accounting Principles (GAAP), and companies that have issued debt instruments but not equity instruments could be temporarily exempted by the member states and not required to comply with IFRS until January 1, 2007. Consequently, those companies which took advantage of this exemption were required to implement IFRS in 2007 (for example Deutsche Bank).

On November 15, 2007, the US Securities and Exchange Commission (SEC) eliminated the requirement for foreign registrants to reconcile their financial statements to US GAAP, if the financial statements fully adhere to IFRS as published by the IASB. This regulation helped EU companies, such as Deutsche Bank, in their financial reporting requirements for listing in the US. SEC thus acknowledged that IFRS has the potential to become the global set of high-quality reporting standards, and that investors, issuers, and markets would benefit from the improved comparability of financial reporting across national borders.

It is thought to be quite possible that, within some reasonable interval of time, all the EU states will at least *permit* IFRS in the consolidated accounts of nonlisted companies, although this permission, in some states, might not extend to certain types of companies such as small entities or charities. Additionally, it is possible that most of the EU states will permit IFRS in the annual (i.e., not consolidated, so-called statutory) accounts of all companies, again possibly subject to some exceptions. Furthermore, some EU states, such as the UK, have already begun to converge their national accounting rules with IFRS.

Privately held EU companies may, if permitted to do so, choose to utilize IFRS for many sound reasons (e.g., for comparability purposes), in anticipation of eventual convergence of national standards with IFRS, and at the specific request of stakeholders such as the entities' credit and investment constituencies.

The remaining impediment to full IFRS conformity among the affected EU companies pertains to the financial instruments standard, IAS 39 which has proved to be extraordinarily controversial, at least among some reporting entities, particularly financial institutions in some, but not all, European countries. Originally, as noted above, all IAS/IFRS standards were endorsed, *except* IAS 32 and IAS 39, as to which endorsement was postponed, nominally because of expected further amendments coming from IASB, but actually due to the philosophical or political dispute over use of fair value accounting for financial instruments and hedging provisions. The single most important of the concerns pertained to accounting for "core deposits" of banks, which drew objections from five of the six dissenting votes on the EFRAG (European Financial Reporting Advisory Group) Technical Expert Group

(TEG). In fact, the dissents were a majority of the eleven-member TEG, but since it takes a two-thirds vote to refuse endorsement, the tepid support would be sufficient.

Notwithstanding that IASB had promised a "stable platform" of rules (i.e., no changes or new standards to be issued during the massive transition to IFRS in Europe, so that preparers could be spared the frustration of a moving target as they attempted to prepare, usually, January 1, 2004 restated statements of financial position and 2004 and 2005 financial statements under IFRS), the controversy over IAS 39 resulted in a number of amendments being made in 2005, mostly in order to mollify EU member states. Thus, IAS 39 was (separately) amended to deal with macrohedging, cash flow hedges of forecast intragroup transactions, the "fair value option," and financial guarantee contracts. (These changes are all addressed in this publication.)

Notwithstanding these efforts to satisfy EU member state concerns about specific aspects of IAS 39, the final EU approval was still qualified, with an additional "carve out" identified. Thus, there is the specter of partial compliance with IFRS, and independent auditors were forced to grapple with this when financial statements prepared in accordance with Euro-IFRS were first prepared for issuance in early 2006. At this point in time, the representation that financial statements are "in accordance with IFRS" can be invoked only when the reporting entity fully complies with IFRS, as the standards have been promulgated (and amended, when relevant), but without any deviations permitted in the EU legislation. Auditor references to IFRS have therefore been tempered by citing IFRS as endorsed by the EU as the basis of accounting.

Impact of IFRS Adoption by EU Companies

The effect of the change to IFRS has varied from country to country and from company to company. National GAAP of many European countries were developed to serve or facilitate tax and other regulatory purposes, so principles differed from state to state. The case study of a Belgian company, included in an appendix to this chapter, reveals the nature of many of the differences between IFRS and national GAAP reporting.

Complexity usually means additional cost. One survey of 1,000 European companies indicated that the average compliance cost across UK companies will be about £360,000. This figure rises to £446,000 for a top-500 company; £625,000 for companies with a market capitalization value between £1bn-£2bn; and over £1m for companies valued at more than £2bn.

Implementation, however, is not the only difficulty, and possibly not even the most significant one. Changes in principles can mean significant changes in statements of comprehensive income or statements of financial position. In a 2002 survey of EU companies, two-thirds of respondents indicated that the adoption of IFRS would have a medium to high impact on their businesses.

One of the most important effects of the change to IFRS-basis financial reporting will reverberate throughout companies' legal relationships. Obviously, companies must make appropriate disclosure to their stakeholders in order to properly explain the changes and their impact. Additionally, accountants and lawyers will also have to review the significantly expanded footnote disclosures required by IFRS in financial statements.

In addition to appropriate stakeholder disclosure, companies must reexamine legal relationships which are keyed to accounting reports. Changed accounting principles can undermine carefully crafted financial covenants in shareholder agreements, financing contracts and other transactional documents.

Drafters must examine the use of "material adverse change" triggers in the context of businesses whose earnings may be subject to accounting volatility. Debt, equity and lease financing arrangements may require restructuring due to unanticipated changes in reported results arising from the use of IFRS.

For example, IFRS may require a reclassification of certain financial instruments previously shown as equity on a company's statement of financial position into their equity and debt components. Additionally, IFRS permits companies to adjust the carrying values of investment property (real estate) to fair market values with any gains being reflected in profit or loss for the period.

Executives may be concerned about compensation systems tied to earnings increases between measurement dates when earnings can be so volatile, or they may simply be concerned that compensation arrangements are keyed to results which are no longer realistic.

Few companies want to entertain dated or "frozen" GAAP for document purposes because of the costs involved in maintaining two separate systems of accounting or an extensive set of "off-line" adjustments. As a result, companies, their lawyers and accountants will have to reexamine agreements in light of the anticipated effect of IFRS on companies' financial statements.

APPENDIX A

CURRENT INTERNATIONAL FINANCIAL REPORTING STANDARDS (IAS/IFRS) AND INTERPRETATIONS (SIC/IFRIC)

(Recent revisions noted parenthetically)

IAS 1	Presentation of Financial Statements (revised 2007, effective 2009)
IAS 2	Inventories (revised 2003, effective 2005)
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors (revised 2003, effective 2005)
IAS 10	Events After the Reporting Period (revised 2003, effective 2005)
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 14	Reporting Financial Information by Segment (superseded, effective 2009, by IFRS 8)
IAS 16	Property, Plant, and Equipment (revised 2003, effective 2005)
IAS 17	Accounting for Leases (revised 2003, effective 2005)
IAS 18	Revenue
IAS 19	Employee Benefits (revised 2004)
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates (revised 2003, effective 2005; minor further amendment 2005)
IAS 23	Borrowing Costs (revised 2007, effective 2009)
IAS 24	Related-Party Disclosures (revised 2003, effective 2005)
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements (revised 2008, effective 2009)
IAS 28	Accounting for Investments in Associates (revised 2003, effective 2005)
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Financial Reporting of Interests in Joint Ventures (revised 2003, effective 2005)
IAS 32	Financial Instruments: Presentation (revised 2003, effective 2005; disclosure requirements removed to IFRS 7 effective 2007)
IAS 33	Earnings Per Share (revised 2003, effective 2005)
IAS 34	Interim Financial Reporting
IAS 36	Impairments of Assets (revised 2004)
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets
IAS 38	Intangible Assets (revised 2004)
IAS 39	Financial Instruments: Recognition and Measurement (amended 2005)
IAS 40	Investment Property (revised 2003, effective 2005)
IAS 41	Agriculture

IFRS 1	First-Time Adoption of IFRS (minor amendment 2005)
IFRS 2	Share-Based Payment
IFRS 3	Business Combinations (revised 2008, effective 2009)
IFRS 4	Insurance Contracts
IFRS 5	Noncurrent Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
SIC 7	Introduction of the Euro
SIC 10	Government Assistance—No Specific Relation to Operating Activities
SIC 12	Consolidation—Special-Purpose Entities
SIC 13	Jointly Controlled Entities—Nonmonetary Contributions by Venturers
SIC 15	Operating Leases—Incentives
SIC 21	Income Taxes—Recovery of Revalued Nondepreciable Assets
SIC 25	Income Taxes—Changes in the Tax Status of an Enterprise or Its Shareholders
SIC 27	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
SIC 29	Disclosure—Service Concession Arrangements
SIC 31	Revenue—Barter Transactions Involving Advertising Services
SIC 32	Intangible Assets—Web Site Costs
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Cooperative Entities and Similar Instruments
IFRIC 4	Determining Whether an Arrangement Contains a Lease
IFRIC 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, *Financial Reporting in Hyperinflationary Economies*
IFRIC 8	Scope of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 11	IFRS 2: Group and Treasury Share Transactions
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programs
IFRIC 14	IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and Their Interaction
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation

APPENDIX B: REVISED IAS 1, *PRESENTATION OF FINANCIAL STATEMENTS*

As noted in the body of the chapter, IASB has been pursuing a multiphase project dealing with financial statement presentation. The issuance of revised IAS 1, *Presentation of Financial Statements*, represented the culmination of the first stage of this undertaking. Later phases will address more fundamental issues for presenting information on the face of the financial statements, including: consistent principles for aggregating information in each financial statement; the totals and subtotals that should be reported in each financial statement; whether components of other recognized income and expense should be reclassified to profit and loss; and whether the direct or the indirect method of presenting operating cash flows provides more useful information. The IASB and FASB have decided that financial statements should present information in a manner that reflects a cohesive financial picture of an entity and which separates an entity's financing activities from its business and other activities as well as from its transactions with owners. Additionally, financing activities should be separated into transactions with owners and all other financing activities. Yet another phase of the project will deal with interim financial reporting.

The revised IAS 1 is largely into line with the corresponding US GAAP standard—FAS 130, *Reporting Comprehensive Income.* The FASB decided that it would not publish a separate Exposure Draft on this phase of the project but will expose issues pertinent to this and the next phase together in the future.

Revised IAS 1 is effective for annual periods beginning on or after January 1, 2009, with early application permitted.

Objective of revised IAS 1. IAS 1 prescribes the basis for presentation of general-purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure, and minimum requirements for their content. In revising IAS 1, IASB's main objective was to aggregate information in the financial statements on the basis of shared characteristics. Other sources of guidance on the financial statement presentation can be found in IAS 7, 8, 10, 12, 18, 24, 27, 34, and IFRS 5.

Scope of IAS 1. IAS 1 applies to all entities, including profit-oriented and not-for-profit entities. Non-for-profit entities in both the private and public sectors can apply this standard, however they may need to change the descriptions used for particular line items within their financial statements and for the financial statements themselves. This standard applies to those entities that present consolidated financial statements and those that present financial statements as defined in IAS 27, *Consolidated and Separate Financial Statements.* It does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34, *Interim Financial Reporting.*

Purpose of financial statements. IAS 1, which previously had been substantially revised in 2003, and which received further amendments in 2005 and 2007, refers to financial statements as "a structured representation of the financial position and financial performance of an entity" and elaborates that the objective of financial statements is to provide information about an entity's financial position, its financial performance, and its cash flows, which is then utilized by a wide spectrum of end users in making economic decisions. In addition, financial statements also show the results of the management's stewardship of the resources entrusted to it. All this information is communicated through a complete set of financial statements.

Presentation of financial statements. IAS 1 defines a complete set of financial statements to be comprised of the following:

1. A statement of financial position as at the end of the period:

    a. The previous version of IAS 1 used the title "balance sheet." The revised standard uses the title "statement of financial position."

2. A statement of comprehensive income for the period:

    a. Components of profit or loss may be presented either as part of a single statement of comprehensive income or in a separate income statement.
    b. When an income statement is presented, it becomes part of a complete set of financial statements.
    c. The income statement should be displayed immediately before the statement of comprehensive income.

3. A statement of changes in equity for the period;
4. A statement of cash flows for the period;

    a. The previous version of IAS 1 used the title "cash flow statement." The revised standard uses the title "statement of cash flows."

5. Notes, comprising a summary of significant accounting policies and other explanatory information; and
6. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

    a. This requirement is part of the revised IAS 1.

Financial statements, except for cash flow information, are to be prepared using accrual basis of accounting.

Fairness exception under IAS 1. There is a subtle difference between US GAAP and what was required by many European countries regarding the use of an override to assure a fair presentation of the company's financial position and results of operations. US auditing standards require a *fair presentation in accordance with GAAP,* while the European Fourth Directive requires that statements offer a *true and fair view* of the company's financial situation. If following the literal financial reporting requirements does not provide this result, then the entity should first consider the salutary effects of providing supplementary disclosures. However, if that is not seen as being sufficient to achieve a true and fair view, the entity may conclude that it must override (that is, ignore or contravene) the applicable accounting standard. US standards contain a rarely invoked exception that permits departure from GAAP if compliance would not result in financial reporting that was deemed appropriate to communicate financial position and results of operations.

IAS 1 has a similar approach. It states the expectation that the use of IFRS will result, *in virtually all circumstances,* in financial statements that achieve a fair presentation. However, in extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework,* the entity can depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure, and the entity discloses all of the following:

1. Management has concluded that the financial statements present fairly the entity's financial position, financial performance, and cash flows;
2. The entity has complied with all applicable IFRS, except that it has departed from a particular requirement to achieve a fair presentation;
3. The title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Framework,* and the treatment adopted; and
4. For each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

When an entity has departed from a requirement of an IFRS in a prior period, and that departure affects the amounts recognized in the current period, it shall make the disclosures as in 3. and 4. above.

The standard notes that deliberately departing from IFRS might not be permissible in some jurisdictions, in which case the entity should comply with the standard in question and disclose in the notes that it believes this to be misleading, and show the adjustments that would be necessary to avoid this distorted result. In extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework,* but the relevant regulatory framework prohibits departure from the requirement, to the maximum extent possible, the entity is required to reduce the perceived misleading aspects of compliance by disclosing all of the following:

1. The title of the IFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the *Framework,* and
2. For each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

When assessing whether complying with a specific requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework,* management should consider the following:

1. Why the objective of financial statements is not achieved in the particular circumstances; and
2. How the entity's circumstances differ from those of other entities that comply with the requirement.

   a. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the *Framework.*

Going concern. When preparing financial statements, management makes an assessment regarding the entity's ability to continue as a going concern. If the result of the assessment casts significant doubt upon the entity's ability to continue as a going concern, management is required to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

Accrual basis of accounting. Financial statements, except for cash flow information, are to be prepared using accrual basis of accounting.

Materiality and aggregation. An entity should present separately each material class of similar items as well as present separately material items of dissimilar nature or function. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. It is not necessary for an entity to provide a specific disclosure required by an IFRS if the information is not material.

Offsetting. Assets and liabilities, or income and expenses, may not be offset against each other, unless required or permitted by an IFRS. However, the reduction of accounts receivable by the allowance for doubtful accounts, or of property, plant, and equipment by the accumulated depreciation, are acts that reduce these assets by the appropriate valuation accounts and are not considered to be offsetting assets and liabilities.

Frequency of reporting. An entity should present a complete set of financial statements (including comparative information) at least annually. If the reporting period changes such that the financial statements are for a period longer or shorter than one year, the entity should disclose the reason for the longer or shorter period and the fact that the amounts presented are not entirely comparable.

Comparative information. An entity is required to include a statement of financial position as at the beginning of the earliest comparative period whenever and entity retrospectively applies an accounting policy, or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. In those limited circumstances, an entity is required to present, as a minimum, three statements of financial position and related notes, as at

1. The end of the current period;
2. The end of the previous period (which is the same as the beginning of the current period); and
3. The beginning of the earliest comparative period.

When the entity changes the presentation or classification of items in its financial statements, the entity should reclassify the comparative amounts, unless reclassification is impractical. In reclassifying comparative amounts, the required disclosure includes (1) the nature of the reclassification; (2) the amount of each item or class of items that is reclassified; and (3) the reason for the reclassification. In situations where it is impracticable to reclassify comparative amounts, an entity should disclose (1) the reason for not reclassifying the amounts and (2) the nature of the adjustments that would have been made if the amounts had been reclassified.

Consistency of presentation. The presentation and classification of items in the financial statements should be consistent from one period to the next. A change in presentation and classification of items in the financial statements may be required when there is a significant change in the nature of the entity's operations, another presentation or classification is more appropriate (having considered the criteria of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*), or when an IFRS requires a change in presentation. When making such changes in presentation, an entity should reclassify its comparative information and present adequate disclosures (see comparable information above).

The revised IAS 1 is effective for annual periods beginning on or after January 1, 2009, with early application permitted.

APPENDIX C: CASE STUDY

GOING PRIVATE AND IMPLEMENTING IFRS

Background

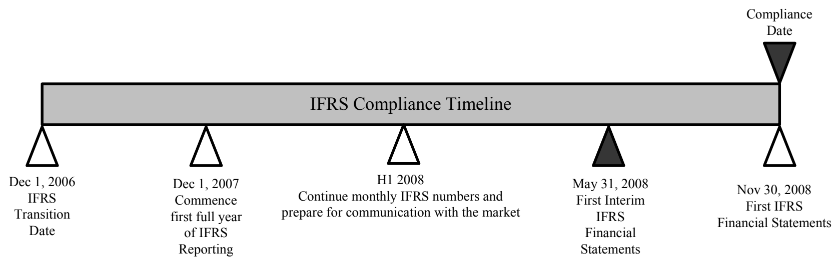
Stolt-Nielsen S.A. (SNSA or the "Company") is one of the world's leading providers of transportation services for bulk liquid chemicals, edible oils, acids, and other specialty liquids. The Company, through the parcel tanker, tank container, terminal, rail and barge services of its wholly-owned subsidiary Stolt Tankers & Terminals and Stolt Tank Containers, provides integrated transportation solutions for its customers. Stolt Sea Farm, wholly owned by the Company, produces and markets high-quality turbot, sole, sturgeon, and caviar. SNSA is currently listed on the Oslo Stock Exchange under the ticker SNI, and was previously also traded in the US on NASDAQ.

On April 19, 2007, the Company announced its intention to voluntarily delist from the NASDAQ Global Select Market and this was effected from May 21, 2007, and it is no longer subject to the registration and reporting obligations under the Securities Exchange Act. The Company has maintained its listing in Norway on the Oslo Børs. Accordingly, the Company is required to present its financial statements under International Financial Reporting Standards ("IFRS") for the financial year ending November 30, 2008, and thereafter.

Legal Structure and Impact on IFRS Transition

SNSA, a Luxembourg registered company, will have a "primary" listing on the Oslo Børs following its delisting from NASDAQ and deregistration from the SEC. Since its flotation on the NASDAQ in 1987, SNSA had been preparing its financial statements in accordance with generally accepted accounting principles in the United States ("US GAAP").

European Union Directive 1606/2002 required all listed companies in the European Union[1] to apply IFRS for accounting periods beginning on or after January 1, 2005, along with comparatives for 2004, for annual consolidated financial statements. Article 9 of the Directive provides an exemption to defer preparation of IFRS financial statements for periods beginning on or after January 1, 2007, for companies that prepare financial statements under US GAAP. Luxembourg incorporated this exemption in its commercial legislation. Accordingly, SNSA was required to publish its first audited IFRS financial statements for the year ending November 30, 2008, with prior year comparatives under IFRS for the year ending November 30, 2007. In addition, quarterly financial statements under IFRS will be required for each quarter of the years ending November 30, 2007 and 2008. Based on this discussion, the implementation timeline is summarized below.



[1] *At the time of the issue of this Directive, the European Union comprised 15 nations, which has since grown to 27 nations as of 1 January 2007.*

Key Dates

IFRS 1 defines specific milestones in the preparation of the first financial statements of a company. The important areas to note while considering the transition date are discussed in the following paragraphs.

Most stock exchanges around the world, including the Oslo Børs, require that the interim or quarterly financial information released to the market should conform to the same accounting standards applied in the presentation of the annual financial statements. For SNSA, this meant that though the first audited IFRS financial statements were only due for the year ending November 30, 2008, the first interim unaudited financial information to be released under IFRS was for the quarter ended February 29, 2008! In effect, this is nine months less than what would appear required under IFRS 1. Of course, this also means that the comparative quarterly financial statements for February 28, 2007 must also be prepared in accordance with IFRS.

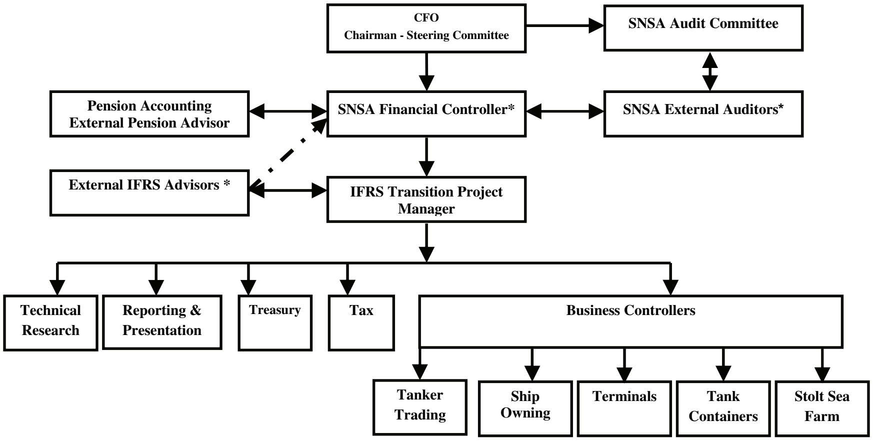
Another important aspect to bear in mind is that IFRS should be applied in full to the financial statements for all the periods presented.

The key dates in accordance with IFRS for SNSA were as follows:

Dec 1, 2006	Opening IFRS balance sheet (date of transition) ❖ Select policies ❖ Recognize and measure all items using IFRS ❖ Not published
May 31, 2007	First unaudited Interim Financial Statements ❖ Only balance sheet and income statement ❖ Required for comparative information for 2008
Nov 30, 2007	IFRS comparatives ❖ For 2008 full year audited IFRS financial
Nov 30, 2008	First IFRS Reporting Date ❖ Use Standards in force at this date ❖ First full audited IFRS financial statements published along with 2007 comparatives

Project Structure and Implementation Approach

One of the key determinants of the success of the implementation was tight project management and a project structure that ensured clear reporting lines and accountability for each step. The project team structure is summarized below.



Overall, the implementation approach involved a mixed team of external advisors, external auditors and a strong in-house team at the Corporate Office to provide project management support and technical accounting support. In addition, the implementation approach involved each of the business controllers along with an external firm to provide hands-on support and technical expertise, both locally and at Corporate, to support the transition process. This ensured that the ultimate ownership of an IFRS issue would rest with the business unit, but with strong support from the Corporate Team. The business controllers were required to provide resource, input and accept responsibility for the IFRS financial statements but were given extensive support both from the Corporate Team and involvement from the external firm. SNSA did not have sufficient resources in the business to implement a project of this scale, complexity, and risk. Further, a number of steps in the transition were "one-off" in nature, and support from an external firm enabled the company to meet its objectives.

To project manage this effectively, a detailed project plan was developed, with week-by-week targets for achievement and responsibilities assigned for deliverables. While there were slippages, no issue was allowed to remain open for over two weeks. The project plan and the implementation were monitored through weekly conference calls of the core team members, including auditors and advisors.

External Auditor Involvement

SNSA's external auditors were integrally involved with the transition project to confirm technical accounting issues and agree treatment upfront. There are a number of areas where the external audit firm was able to assist management as an advisor in the IFRS Transition project. However, in order to maintain the requisite independence as auditors, the auditors would not assist management with preparation of financial statements and detailed accounting advice. This independence requirement, while understandable, did make it more difficult for both external auditors and management to achieve the key tasks within the IFRS transition project.

Training

Management conducted five IFRS Transition Training Workshops, including one for the Audit Committee, where the CEO was present. This was critical to establish buy-in and commitment from the top at the early stage of the project. Each of the workshops was targeted a different audience so there was a significant amount of customization to the training program. The importance of this phase cannot be overemphasized: it is vitally important to plan this in advance. In addition to the training there were a significant element of change management issues surrounding knowledge transfer and the ability of accounting staff to come to a new understanding of the building blocks (or DNA) of SNSA's financial statements.

So Where Did SNSA's IFRS Project Team Start?

After SNSA launched the IFRS Transition Project as noted above, its first step was to understand how different the then-current US GAAP accounting treatments were when compared to IFRS. This was again a critical success factor in our transition. A detailed comparison of IFRS and US GAAP was prepared, with assistance from both external advisors and external auditors. This list of similarities and differences was then applied to each of SNSA's four different businesses.

When IFRS implementation commences, a frequent lament may be heard – "IFRS is similar but not the same." The devil of the differences was in the detailed comparison of IFRS and US GAAP. The insight gained was this: the better and more detailed the comparison diagnostic, the better and smoother will be the IFRS transition. In most cases, SNSA's transition team continued with the US GAAP accounting treatment, albeit with some enhanced disclosures being added. Where IFRS offered an accounting treatment similar to US GAAP, SNSA adopted that method. This minimized the final list of differences when transitioning to IFRS to the following:

1. Areas of significant impact under IFRS 1:
   - Business combinations;
   - Actuarial gains and losses;
   - Reset of cumulative translation adjustment.
   - Significant differences from US GAAP which may impact SNSA's financial statements:
   - Property, Plant, and Equipment—component accounting, residual values;
   - Lease accounting;
   - Consolidation of entities;
   - Equity Accounting and FIN 46[R] compared to SIC 12;
   - Fair valuation of inventories of biological assets at Stolt Sea Farm;
2. Other possible areas which could result in a difference from US GAAP on implementation:
   - Impairment—two-step impairment evaluation process under US GAAP and only a single-step discounted cash flow process under IFRS.
   - Provisions—midpoint of an estimate under IFRS not the "best estimate" under US GAAP.
   - Probabilistic evaluation of provisions—higher threshold of "probable" under US GAAP than under IFRS.
   - Business Combinations.
   - Employee Benefits—Defined benefit pension schemes.
   - Financial instruments, including onerous disclosure requirements under IFRS 7.
   - Deferred Tax assets—classification and measurement.
   - Stock options—under IFRS, graded vesting of options must be accounted for using the accelerated attribution method not straight-line method.

When each and every accounting policy, treatment or disclosure is carefully considered as the transition to IFRS progresses, there will still be some risk that there may have been errors in the implementation of IFRS.

SNSA also ran the comparative diagnostic on its equity method investees and joint ventures. One significant change from US GAAP noted during transition was that the equity method investees and joint ventures not only had to comply with IFRS, but had to have IFRS accounting policies which were consistent with those of the rest of the company. In addition, the accounting period had to be coterminous to the year-end of the parent. This also raised a number of IFRS 1 issues in relation to when a subsidiary adopts IFRS and how the change to IFRS could affect the dividend distribution ability of that subsidiary. This matter is particularly important if there is a local legal requirement to have sufficient distributable reserves, which under IFRS could be lower than under current local accounting standards.

After completing the comparison diagnostic, we identified four additional areas to consider when transitioning to IFRS.

- Corporate Finance—if key numbers on which certain debt covenants are based change due to the transition to IFRS then early discussion and negotiation with the banks is critical.
- Tax—involvement of the tax team at the early stages so that they are aware of the transition differences and the impact on tax.
- Human Resources—impact of transition to IFRS on key metrics and incentive plans.
- Technology—changes required in the consolidation systems and in the general ledger accounting systems.
- Internal controls—IFRS requires a higher level of judgement and estimation than US GAAP. This means the controls and process surrounding accounting judgements and estimate must be robust since it will be challenged by the internal controls testing process.
- Investor Relations—it is never to early to start thinking about how the message of transitioning to IFRS will be communicated to the market. There are a number of excellent examples of European Companies that made detailed presentations to investors in 2005 and 2006 to show how they moved from their local GAAP to IFRS.

Materiality

When the GAAP comparison diagnostic is completed, it is extremely important to consider those areas where the measurement differences between US GAAP and IFRS might be "not material." The difficulty with ignoring some differences on the grounds of "materiality" is that the external audit firms will continue to collect these differences on their schedule of passed audit adjustments. Such "not material" differences could become material under the guidance of SAB 99 and SAB 108.

Treatment of Significant Accounting Differences on Transition Opening Balance Sheet under IFRS

An IFRS Transition generally has two kinds of difference—the first one is the difference only on transition and then does not occur each year. The second difference is the one that is a recurring difference. Both these differences need to be recorded in the accounting ledgers in the respective entities.

SNSA's reconciliation of shareholders' equity from US GAAP to IFRS at each of its key transition dates is summarized below.

In millions		*Dec. 1, 2006*	*May 31, 2007*	*Nov. 30, 2007*
Consolidated US GAAP equity		**$1,172.6**	**$1,295.2**	**$1,354.5**
IAS 37 – Record provision in accordance with IFRS	(a)	(1.9)	--	--
IFRS 1/IAS 19 – Pension and Other Postretirement Employee Benefits ("OPEB") adjustment	(b)	(19.3)	(14.4)	(0.7)
IAS 41 – Fair value of biological assets	(c)	22.9	10.8	12.4
IAS 16 – Componentization of Tankers' ships	(d)	(8.1)	(8.2)	(8.4)
IAS 16 – Adjustment to residual value of tank containers	(e)	5.6	6.0	6.7
Reclassification of minority interest to equity		0.3	2.3	10.9
Other items		(0.8)	(0.2)	(5.6)
Net changes		**(1.3)**	**(3.7)**	**15.3**
Consolidated equity under IFRS		**$1,171.3**	**$1,291.5**	**$1,369.8**

* *Full year financial statements under IFRS for the year ended November 30, 2008 had not been published at the time of the publication of this book.*

(a) *Measurement of Provisions in accordance with IFRS*

Under US GAAP, if a range of estimates is present and no amount in the range is more likely than any other amount in the range, the provision should be measured at the minimum of the range. However, in these circumstances, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, requires the midpoint in the range to be used if all outcomes are equally likely. At December 1, 2006, SNSA had entered into negotiations with certain customers with regard to their claims in which the lower range of possible settlements was recognized under US GAAP. The use of the mid-point in the range had resulted in a $1.9 million reduction in retained earnings under IFRS at December 1, 2006 and an increase in revenue of the same amount for the year ended November 30, 2007, as this amount was recognized in the quarters ended February 28, 2007 and May 31, 2007 under US GAAP.

(b) *Recognition of Previously Unrecognized Actuarial Losses on Pension and Other Postretirement Employee Benefits*

Under US GAAP, the SNSA applied the "corridor" method in relation to the recognition of actuarial gains and losses through the profit and loss. Under this approach, only actuarial gains and losses that fall outside 10% of the projected benefit obligation or, if greater, pension assets are recognized through the profit and loss over the expected average remaining working lives of employees participating in the plan. In accordance with IFRS 1, SNSA recognized all cumulative actuarial gains and losses at December 1, 2006, resulting in a reduction of $23.3 million to retained earnings.

In addition, US GAAP allows the amortization of prior service costs over the expected service life of the employees involved, while IFRS requires prior service costs to be recognized immediately, if they are already vested. IFRS also requires that all plans have the same measurement date as the SNSA's year-end, which resulted in a change in the present value of the funded obligations for one plan. Both of these items have resulted in a $4.0 million credit to retained earnings at December 1, 2006. SNSA had adopted FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* for the year ended November 30, 2007. FAS 158 requires an employer to recognize the funded status of a defined benefit plan, measured as the difference between plan assets and the projected benefit obligation, in its consolidated balance sheet.

For this reason, the net change between the numbers previously reported under US GAAP and those reported under IFRS was only about $0.7 million at November 30, 2007, and $0.8 million for the six months ended May 31, 2007.

(c) Fair Value of Biological Assets

Under US GAAP, SNSA reported its biological assets at cost and classified them as part of inventories. Under IAS 41, *Agriculture*, biological assets are required to be recorded at fair value and separately disclosed on the balance sheet. This resulted in an increase in current assets of $17.2 million and $13.0 million (with a deferred tax effect of $5.0 million and $4.5 million) at November 30, 2007, and December 1, 2006, respectively. For the six months ended May 31, 2007, this resulted in a $13.7 million decrease in net profit. Similarly, there was a $14.4 million increase to Investment in and Loans to Marine Harvest at December 1, 2006. This represents SNSA's 25% share of the fair value of biological assets in respect of Marine Harvest. This adjustment also reduced the gain recorded under IFRS on sale of investment in discontinued operations for the year ended November 30, 2007, from $21.8 million to $7.4 million.

(d) Componentization of Ships

Under IAS 16, *Property, Plant, and Equipment*, each component of an asset that has an expected useful life that is significantly different in relation to the total cost of the asset must be depreciated separately, while US GAAP does not explicitly require this treatment (although widely practiced). Following this policy for Tankers' ship components (including ships held by unconsolidated joint ventures) resulted in a decrease in retained earnings of $8.1 million at December 1, 2006. The effect of this adjustment for the six months ended May 31, 2007, was an increase in depreciation expense of approximately $0.1 million.

(e) Residual Value of Tank Containers

Under US GAAP, estimates of residual value of assets are reviewed only when events or changes in circumstances indicate that the current estimates are no longer appropriate, while IFRS requires that estimates of residual values are reviewed at least at each annual reporting date. Applying this policy and assessing the current expected residual value of the SNSA's tank containers at December 1, 2006, resulted in an increase in retained earnings of $5.6 million at transition date, $6.0 million at May 31, 2007, and $6.7 million at November 30, 2007. The effect for the six months ended May 31, 2007, of this adjustment is approximately $0.5 million decrease in depreciation expense.

Reconciliations of the consolidated balance sheets as of December 1, 2006, and November 30, 2007, and consolidated income statements for the four quarters and year ended November 30, 2007, from US GAAP to IFRS are included at the Company's Web site (www.stolt-nielsen.com/Investor-Relations/Accounting-Policies.aspx).

(f) Application of IFRS 1 Exemption to Adjust Currency Translation Reserve to Zero

Under US GAAP, on consolidation, assets and liabilities of subsidiaries are translated into US dollars from their functional currencies at the exchange rates in effect at the balance sheet date while revenues and expenses are translated at the average rate prevailing during the year. The resulting translation adjustments are recorded in a separate component of "Accumulated Other Comprehensive Income (Loss), net." While this is not different from IFRS, the Company has utilized an exemption in IFRS 1, which allows the cumulative translation reserve to be set to zero at the date of transition for all its foreign operations. Consequently, subsequent to the date of transition, amounts previously recognized in net income under US GAAP as a result of the sale of foreign operations of $3.1 million, have been reversed under IFRS.

Other significant accounting differences on transition.

Additional share option expense in relation to stock options with graded vesting features.

The Company grants several share options to its employees that contain graded vesting conditions. Graded vesting conditions exist whereby options granted vest in equal annual installments over a specified period, equal installments of 25% of the options granted each year over a four-year period.

Under US GAAP, the compensation cost of stock options with graded vesting features is amortized on a straight-line basis over the longest vesting period for the entire share option grant.

Under IFRS 2, each of the installments must be treated as a separate option grant and the compensation cost is recognized as the options vest for each installment. Therefore, the IFRS approach accelerates the compensation cost amortization to earlier periods in the overall vesting period. As a result, an adjustment has been recorded to retained earnings as of December 1, 2006, for $3.6 million of additional stock option compensation costs for options granted since 2000, and a further $1.0 million expense recorded for the year-end November 30, 2007.

Impairment of goodwill. Under US GAAP, goodwill is tested for impairment at the reporting unit level, which is an operating segment or one step below while under IAS 36, *Impairment of Assets*, goodwill is tested at the cash generating unit level that represents the lowest level at which goodwill is monitored by management. The use of the cash generating unit level has resulted in the full impairment of goodwill for one cash-generating unit at the date of transition.

Adjustment to equity investment for gain on ship sale. Under US GAAP, when a company sells an asset and immediately leases it back under an operating lease, a proportion of the gain is deferred on the balance sheet when certain conditions are met. The deferred amount is amortized in proportion to the method through which the related gross rental is charged to expense over the lease life.

Under IFRS, if the asset was sold at fair value, any gain or loss is recognized immediately. In the fourth quarter of 2007, the Company's 50% owned joint venture, NYK Stolt Tankers S.A. ("NST"), sold the Stolt Alliance at fair value and immediately leased it back. This resulted in a $5.8 million gain of which $3.8 million was deferred on the balance sheet under US GAAP.

Under IFRS, this amount, $3.8 million, of which the Company's share is $1.9 million, has been recognized in Other Income.

Severance accrual. Under US GAAP, if employees are required to render services beyond a minimum period until they are terminated in order to receive a termination payment, a liability for terminated benefits is measured initially at the date of communication to the relevant employees, based on the fair value of the liability as of the termination date. The liability is then recognized ratably over the future service period. Under IFRS, the liability is recorded immediately. Adoption of this policy resulted in a decrease in retained earnings at November 30, 2007, of $0.8 million and a decrease in net profit for 2007 of $0.7 million.

Balance sheet and income statement reclassifications. The following represents additional balance sheet and income statement reclassifications required by IFRS.

Deconsolidation of Lingang Terminal. The Company has a 65% ownership in Tianjin Stolthaven Lingang Terminal Co. ("Lingang Terminal") which is a development stage entity and in the process of building a terminal facility. Under US GAAP, the Company is required to consolidate this entity as it was considered to be a variable interest entity under FIN 46(R), *Consolidation of Variable Interest Entities*, and the Company was the primary beneficiary.

However, under IFRS the Lingang Terminal meets the definition of a joint venture as there is joint control over the entity, and so the entity has been accounted for under equity accounting.

Reclassification of minority interest to equity. Under US GAAP, minority interest is displayed as a long-term liability. IAS 1, *Presentation of Financial Statements*, and IAS 27, *Consolidated and Separate Financial Statements*, require minority interests to be presented within equity.

Reclassification of software to intangible assets. Under US GAAP, computer software is included in property, plant and equipment. In accordance with IAS 38, *Intangible Assets*, when the software is not an integral part of the related hardware, computer software should be classified as an intangible asset. Accordingly, $3.3 million and $3.1 million of computer software that is not integral to any associated hardware were reclassified from property, plant and equipment to intangible assets on transition to IFRS at November 30, 2007 and December 1, 2006, respectively.

Reclassification of drydocking asset to property, plant, and equipment. Capitalized costs related to the drydocking of ships are treated as a separate component of tankers under IAS 16, Property, Plant and Equipment. Accordingly they are classified as property, plant and equipment under IFRS while they are recorded as an Other Long-Term Asset under US GAAP.

Reclassification of short-term deferred tax assets and liabilities. Under US GAAP, deferred tax assets and liabilities are classified as either current or noncurrent based upon the classification of the related asset or liability.

A deferred tax liability or asset that is not related to an asset or liability recognised in the balance sheet such as losses carryforwards, is classified according to the expected reversal date of the temporary difference. Under IAS 12, *Income Taxes*, all deferred tax assets and liabilities are classified as noncurrent regardless of the classification of the related asset or liability and regardless of the expected timing of reversal of the temporary difference.

Reclassification of debt issuance costs against current portion of long-term debt and long-term debt. Under IAS 39, Financial Instruments: Recognition and Measurement, transaction costs directly attributable to a debt are recorded against the debt on initial recognition. Under US GAAP, debt issuance costs are recognized as Other Assets. This has required a reclassification of $5.1 million and $6.1 million from Other Assets to both the Current Portion of Long-Term Debt and to Long-Term Debt at November 30, 2007, and December 1, 2006, respectively.

Transfer of minimum pension liability adjustments to retained earnings. Under US GAAP, if the accumulated benefit obligation is greater than the value of the plan assets, a minimum liability must be recognized in the balance sheet for the unfunded accumulated pension liability. In cases where an additional minimum liability is required, a portion is recognized as a component of other comprehensive income.

There is no concept of an additional minimum pension liability under IAS 19, *Employee Benefits*. Therefore, amounts recognized in other comprehensive income under US GAAP have been reclassified to retained earnings on adoption of IFRS.

More detailed information on SNSA's IFRS Transition, including accounting policies, reconciliations of the consolidated balance sheets as of December 1, 2006, and November 30, 2007, and consolidated income statements for the four quarters and year ended November 30, 2007, from US GAAP to IFRS are included in the Company's Web site: http://www.stolt-nielsen.com/Investor-Relations/Accounting-Policies.aspx.

APPENDIX D

US GAAP RECONCILIATION AND RESTATEMENT—CASE STUDY

While the US SEC has now ended the requirement that foreign private issuers filing in the US reconcile their non-US GAAP financial statements to US GAAP, this waiver is applicable only if "full IFRS" is employed by the registrant in preparing its financial statements. Those preparing financial statements under non-US GAAP, including any national or other variations of IFRS (including "Euro-IFRS"), will not be permitted to enjoy this exception to SEC rules. To illustrate the process of reconciliation to US GAAP, the example of Finnish company Nokia Oy's 2005 filing with the SEC is hereby presented.

Nokia Oy prepares its financial statement in accordance with IFRS but also files in the US, where is must reconcile certain financial statement captions to the US GAAP basis. The following is taken from Nokia's 2005 financial statements.

			Year ended December 31,			
	2001 (EUR)	*2002 (EUR)*	*2003* (EUR)*	*2004* (EUR)*	*2005 (EUR)*	*2005 (EUR)*
			(In millions, except per share data)			
Profit and Loss Account Data						
Amounts in accordance with IFRS						
Net sales	31,191	30,016	29,533	29,371	34,191	40,489
Operating profit	3,362	4,780	4,960	4,326	4,639	5,494
Profit before tax	3,475	4,917	5,294	4,705	4,971	5,887
Profit attributable to equity holders of the parent	2,200	3,381	3,543	3,192	3,616	4,282
Earnings per share (for profit attributable to equity holders of the parent)						
Basic earnings per share	0.47	0.71	0.74	0.69	0.83	0.98
Diluted earnings per share	0.46	0.71	0.74	0.69	0.83	0.98
Cash dividends per share [(1)]	0.27	0.28	0.30	0.33	0.37	0.44
Average number of shares (millions of shares)						
Basic	4,703	4,751	4,761	4,593	4,366	4,366
Diluted	4,787	4,788	4,761	4,600	4,371	4,371
Amounts in accordance with US GAAP						
Net income	1,903	3,603	4,097	3,343	3,582	4,242
Earnings per share (net income)						
Basic earnings per share	0.40	0.76	0.86	0.73	0.82	0.97
Diluted earnings per share	0.40	0.75	0.86	0.73	0.82	0.97
Statement of Financial Position Data						
Amounts in accordance with IFRS						
Fixed assets and other noncurrent assets	6,912	5,742	3,837	3,161	3,347	3,964
Cash and other liquid assets [(2)]	6,125	9,351	11,296	11,542	9,910	11,735
Other current assets	9,390	8,234	8,787	7,966	9,041	10,706
Total assets	22,427	23,327	23,920	22,669	22,298	26,405
Capital and reserves attributable to equity holders of the parent	12,205	14,281	15,148	14,231	12,155	14,394
Minority interests	196	173	164	168	205	243
Long-term interest-bearing liabilities	207	187	20	19	21	25
Other long term liabilities	253	274	308	275	247	292
Borrowing due within one year	831	377	471	215	377	446
Other current liabilities	8,735	8,035	7,809	7,761	9,293	11,005
Total shareholders' equity and liabilities	22,427	23,327	23,920	22,669	22,298	26,405
Net interest-bearing debt [(3)]	(5,087)	(8,787)	(10,805)	(11,308)	(9,512)	(11,264)
Share capital	284	287	288	280	266	315

	Year ended December 31,					
	2001	*2002*	*2003**	*2004**	*2005*	*2005*
	(EUR)	*(EUR)*	*(EUR)*	*(EUR)*	*(EUR)*	*(EUR)*
	(In millions, except per share data)					
Amounts in accordance with US GAAP						
Total assets	22,038	22,977	24,045	22,921	22,661	26,835
Shareholders' equity	12,021	14,150	15,437	14,576	12,558	14,871

* *2003 and 2004 financial accounts reflect the retrospective implementations of IFRS 2 and IAS 39(R). 2001 and 2002 data has not been adjusted from that reported in prior years, and therefore is not always comparable with data for years 2003 to 2005.*

(1) *The cash dividend for 2005 is what the Board of Directors will propose for approval at the Annual General Meeting convening on March 30, 2006.*

(2) *Cash and other liquid assets consist of the following captions from our consolidated statements of financial position: (1) bank and cash, (2) available-for-sale investments, cash equivalents and (3) available-for-sale investments, liquid assets.*

(3) *Net interest-bearing debt consists of borrowings due within one year and long-term interest-bearing liabilities, less cash and other liquid assets.*

APPENDIX E

USE OF PRESENT VALUE IN ACCOUNTING

Present value is a pervasive concept that has many applications in accounting. Most significantly, present value of future cash flows is widely recognized and accepted as one approach to the assessment of fair value, which is commonly invoked in various accounting standards. Currently, IFRS does not provide specific guidance to this subject matter, but in recognition of its importance, guidance drawn from US GAAP's Concepts Statement 7 (CON 7) is summarized on the following pages.

CON 7 provides a framework for using estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently remeasured at fair value (fresh-start measurements). It also provides a framework for using the interest method of amortization. It provides the principles that govern measurement using present value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and events should be valued using present value measures or when fresh-start measurements are appropriate.

Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be fair value, absent evidence to the contrary. For fresh-start measurements, a price that is observed in the marketplace for an essentially similar asset or liability is fair value. If purchase prices and market prices are available, there is no need to use alternative measurement techniques to approximate fair value. However, if alternative measurement techniques must be used for initial recognition and for fresh-start measurements, those techniques should attempt to capture the elements that when taken together would comprise a market price if one existed. The objective is to estimate the price likely to exist in the marketplace if there were a marketplace—fair value.

CON 7 states that the only objective of using present value in accounting measurements is fair value. It is necessary to capture, to the extent possible, the economic differences in the marketplace between sets of estimated future cash flows. A present value measurement that fully captures those differences must include the following elements:

1. An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times
2. Expectations about possible variations in the amount or timing of those cash flows
3. The time value of money, represented by the risk-free rate of interest
4. The risk premium—the price for bearing the uncertainty inherent in the asset or liability
5. Other factors, including illiquidity and market imperfections

How CON 7 measures differ from previously utilized present value techniques. Previously employed present value techniques typically used a single set of estimated cash flows and a single discount (interest) rate. In applying those techniques, adjustments for factors 2. through 5. described in the previous paragraph are incorporated in the selection of the discount rate. In the CON 7 approach, only the third factor listed (the time value of money) is included in the discount rate; the other factors cause adjustments in arriving at risk-adjusted expected cash flows. CON 7 introduces the probability-weighted, expected cash flow approach, which focuses on the range of possible estimated cash flows and estimates of their respective probabilities of occurrence.

Previous techniques used to compute present value used estimates of the cash flows most likely to occur. CON 7 refines and enhances the precision of this model by weighting different cash flow scenarios (regarding the amounts and timing of cash flows) by their estimated probabilities of occurrence and factoring these scenarios into the ultimate determination of fair value. The difference is that values are assigned to the cash flows other than the most likely one. To illustrate, a cash flow might be €100, €200, or €300 with probabilities of 10%, 50% and 40%, respectively. The most likely cash flow is the one with 50% probability, or €200. The expected cash flow is €230 (= €100 × .1) + (€200 × .5) + (€300 × .4).

The CON 7 method, unlike previous present value techniques, can also accommodate uncertainty in the timing of cash flows. For example, a cash flow of €10,000 may be received in one year, two years, or three years with probabilities of 15%, 60%, and 25%, respectively. Traditional present value techniques would compute the present value using the most likely timing of the payment—two years. The example below shows the computation of present value using the CON 7 method. Again, the expected present value of €9,030 differs from the traditional notion of a best estimate of €9,070 (the 60% probability) in this example.

Present value of €10,000 in one year discounted at 5%	€9,523	
Multiplied by 15% probability		€1,428
Present value of €10,000 in two years discounted at 5%	9,070	
Multiplied by 60% probability		5,442
Present value of €10,000 in three years discounted at 5%	8,638	
Multiplied by 25% probability		2,160
Probability weighted expected present value		€9,030

Measuring liabilities. The measurement of liabilities involves different problems from the measurement of assets; however, the underlying objective is the same. When using present value techniques to estimate the fair value of a liability, the objective is to estimate the value of the assets required currently to (1) settle the liability with the holder or (2) transfer the liability to an entity of comparable credit standing. To estimate the fair value of an entity's notes or bonds payable, accountants look to the price at which other entities are willing to hold the entity's liabilities as assets. For example, the proceeds of a loan are the price that a lender paid to hold the borrower's promise of future cash flows as an asset.

The most relevant measurement of an entity's liabilities should always reflect the credit standing of the entity. An entity with a good credit standing will receive more cash for its promise to pay than an entity with a poor credit standing. For example, if two entities both promise to pay €750 in three years with no stated interest payable in the interim, Entity A, with a good credit standing, might receive about €630 (a 6% interest rate). Entity B, with a poor credit standing, might receive about €533 (a 12% interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity's credit standing.

Present value techniques can also be used to value a guarantee of a liability. Assume that Entity B in the above example owes Entity C. If Entity A were to assume the debt, it would want to be compensated €630—the amount that it could get in the marketplace for its promise to pay €750 in three years. The difference between what Entity A would want to take the place of Entity B (€630) and the amount that Entity B receives (€533) is the value of the guarantee (€97).

Interest method of allocation. CON 7 describes the factors that suggest that an interest method of allocation should be used. It states that the interest method of allocation is more relevant than other methods of cost allocation when it is applied to assets and liabilities that exhibit one or more of the following characteristics:

1. The transaction is, in substance, a borrowing and lending transaction.
2. Period-to-period allocation of similar assets or liabilities employs an interest method.
3. A particular set of estimated future cash flows is closely associated with the asset or liability.
4. The measurement at initial recognition was based on present value.

Accounting for changes in expected cash flows. If the timing or amount of estimated cash flows changes and the asset or liability is not remeasured at a fresh-start measure, the interest method of allocation should be altered by a catch-up approach. That approach adjusts the carrying amount to the present value of the revised estimated future cash flows, discounted at the original effective interest rate.

Application of present value tables and formulas.

Present value of a single future amount. To take the present value of a single amount that will be paid in the future, apply the following formula; where *PV* is the present value of €1 paid in the future, *r* is the interest rate per period, and *n* is the number of periods between the current date and the future date when the amount will be realized.

$$PV = \frac{1}{(1+r)^n}$$

In many cases the results of this formula are summarized in a present value factor table.

(n) *Periods*	*2%*	*3%*	*4%*	*5%*	*6%*	*7%*	*8%*	*9%*	*10%*
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	0.9612	0.9426	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8265
3	0.9423	0.9151	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513
4	0.9239	0.8885	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830
5	0.9057	0.8626	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209

Example

Suppose one wishes to determine how much would need to be invested today to have €10,000 in five years if the sum invested would earn 8%. Looking across the row with n = 5 and finding the present value factor for the r = 8% column, the factor of 0.6806 would be identified. Multiplying €10,000 by 0.6806 results in €6,806, the amount that would need to be invested today to have €10,000 at the end of five years. Alternatively, using a calculator and applying the present value of a single sum formula, one could multiply €10,000 by $1/(1 + .08)^5$, which would also give the same answer—€6,806.

Present value of a series of equal payments (an annuity). Many times in business situations a series of equal payments paid at equal time intervals is required. Examples of these include payments of semiannual bond interest and principal or lease payments. The present value of each of these payments could be added up to find the present value of this annuity, or alternatively a much simpler approach is available. The formula for calculating the present value of an annuity of €1 payments over *n* periodic payments, at a periodic interest rate of *r* is

$$\text{PV Annuity} = \left(1 - \frac{1}{(1+r)^n} \right)$$

The results of this formula are summarized in an annuity present value factor table.

(n) Periods	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	1.9416	1.9135	1.8861	1.8594	1.8334	1.8080	1.7833	1.7591	1.7355
3	2.8839	2.8286	2.7751	2.7233	2.6730	2.6243	2.5771	2.5313	2.4869
4	3.8077	3.7171	3.6299	3.5460	3.4651	3.3872	3.3121	3.2397	3.1699
5	4.7135	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908

Example

Suppose four annual payments of €1,000 will be needed to satisfy an agreement with a supplier. What would be the amount of the liability today if the interest rate the supplier is charging is 6% per year? Using the table to get the present value factor, then n = 4 periods row, and the 6% column, gives you a factor of 3.4651. Multiply this by €1,000 and you get a liability of €3,465.10 that should be recorded. Using the formula would also give you the same answer with r = 6% and n = 4.

Caution must be exercised when payments are not to be made on an annual basis. If payments are on a semiannual basis n = 8, but r is now 3%. This is because r is the periodic interest rate, and the semiannual rate would not be 6%, but half of the 6% annual rate. Note that this is somewhat simplified, since due to the effect of compound interest 3% semiannually is slightly more than a 6% annual rate.

Example of the relevance of present values

A measurement based on the present value of estimated future cash flows provides more relevant information than a measurement based on the undiscounted sum of those cash flows. For example, consider the following four future cash flows, all of which have an undiscounted value of €100,000:

1. Asset A has a fixed contractual cash flow of €100,000 due tomorrow. The cash flow is certain of receipt.
2. Asset B has a fixed contractual cash flow of €100,000 due in twenty years. The cash flow is certain of receipt.
3. Asset C has a fixed contractual cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is an 80% probability that the entire €100,000 will be received. There is a 20% probability that €80,000 will be received.
4. Asset D has an *expected* cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is a 25% probability that €120,000 will be received. There is a 50% probability that €100,000 will be received. There is a 25% probability that €80,000 will be received.

Assuming a 5% risk-free rate of return, the present values of the assets are

1. Asset A has a present value of €99,986. The time value of money assigned to the one-day period is €14(€100,000 × .05/365 days).
2. Asset B has a present value of €37,689 [€100,000/$(1 + .05)^{20}$].
3. Asset C has a present value of €36,181 [(€100,000 × .8 + 80,000 × .2)/$(1 + .05)^{20}$].
4. Asset D has a present value of €37,689 [€120,000 × .25 + 100,000 × .5 + 80,000 × .25)/$(1 + .05)^{20}$].

Although each of these assets has the same undiscounted cash flows, few would argue that they are economically the same or that a rational investor would pay the same price for each. Investors require compensation for the time value of money. They also require a risk premium. That is, given a choice between Asset B with expected cash flows that are certain and Asset D with cash flows of the same expected amount that are uncertain, investors will place a higher value on Asset B, even though they have the same expected present value. CON 7 says that the risk premium should be subtracted from the expected cash flows before applying the discount rate.

Thus, if the risk premium for Asset D was €500, the risk-adjusted present values would be €37,500 {[(€120,000 × .25 + 100,000 × .5 + 80,000 × .25) – 500]/(1 + .05)^{20}}.

Practical matters. Like any accounting measurement, the application of an expected cash flow approach is subject to a cost-benefit constraint. The cost of obtaining additional information must be weighed against the additional reliability that information will bring to the measurement. As a practical matter, an entity that uses present value measurements often has little or no information about some or all of the assumptions that investors would use in assessing the fair value of an asset or a liability. Instead, the entity must use the information that is available to it without undue cost and effort when it develops cash flow estimates. The entity's own assumptions about future cash flows can be used to estimate fair value using present value techniques, as long as there are no contrary data indicating that investors would use different assumptions. However, if contrary data exist, the entity must adjust its assumptions to incorporate that market information.

APPENDIX F

USE OF FAIR VALUE IN ACCOUNTING MEASUREMENTS

The use of fair value measurements, sometimes also called *market values* or *fair market values,* has expanded in financial reporting over the decades, for two major reasons. First, it has become ever more obvious to preparers and users alike that fair value measures provide the most relevant information for use by decision makers, particularly when compared to the traditional alternative measure, amortized historical cost. And second, the availability of valid, relevant fair value data has greatly increased as information technology has provided most preparers, auditors, and users with access that previous generations could not even imagine.

The use of fair value (or equivalent) measures for financial reporting purposes is hardly a new development. During certain periods in the past (e.g., when inflation caused historical cost data to become particularly obsolete over short time horizons) a number of experiments have been pursued to make financial reporting more relevant by using current cost, replacement cost, fair market value, or other surrogates for pure fair value. Many accounting standards, under various national GAAP regimes as well as IFRS, have always made use of fair values as the appropriate measurement for financial statement representations. Common examples include net realizable value for accounts receivable, lower of cost or market (or realizable value) for inventories, and amortized cost less impairments for many categories of long-lived assets. While the goal of fair value reporting was only partially met by using such surrogates, given the limitations of information availability and the unease many accountants have felt when departing from the absolute verifiability of historical cost measures, these were reasonable and reasonably successful efforts.

During the great inflationary period of the late 1960s to the early mid-1980s, there was a particular concern with developing income measurement strategies that at least partially obviated the inflation effect of matching older, lower costs for goods sold and depreciation charges against more recent product prices, the impact of which was to overstate economic earnings and, inadvertently, encourage such destructive practices as paying excessive dividends, granting excessive wage increases, and failing to post selling price increases to the extent the market would allow them. The illusion of profits caused by the mismatching of costs and revenues led many managers to take actions that thus left the entities unable to maintain their physical capital (e.g., not being able to replace inventory sold at a nominal profit because the replacement cost thereof exceeded the proceeds of the goods already sold).

In reaction, a number of nations, including the US and the UK, implemented supplementary financial reporting requirements (using the very similar but not identical current values, current costs, or replacement costs) to more meaningfully measure results of operations. These were, at best, partial efforts, focusing only on key cost components (cost of goods sold and depreciation, in general), in an attempt to ease the burdens and make the extra effort palatable. Once inflation was generally brought under control by the mid-1980s, interest in these supplementary reporting methodologies largely waned and most requirements were revoked.

Subsequently, however, new attention was directed at the use of fair value measures for monetary assets and liabilities. Compared to the concerns of the 1970s and early 1980s, which were directed exclusively toward the current value measurement of nonmonetary assets (inventory and long-lived assets, primarily), the move to address fair value reporting of monetary items has been greatly facilitated by the fact that information is much more readily available. For many monetary assets, such as marketable securities, data is easily obtained from (previously) daily newspapers and (now) online quotation services. Thus, at least superficially, the practicality issue has been rendered moot.

Market values for only a limited class of assets are immediately obtainable and highly reliable, however. For many of the assets and liabilities for which fair value measurement has been increasingly mandated over recent decades, it is necessary to analogize from market values for similar, but not identical, assets; and for a fraction of these, no close analogies exist at all, a situation which then necessitates the use of "models" to approximate a fair value measurement. During the period of expanded, large-scale financial reporting frauds in the late 1990s and early 2000s, the use of certain variants on the fair value theme (notably, Enron's "mark to model" approach to energy futures contract valuation) contributed to catastrophic corporate abuses and bankruptcies. While the abusive practices were never GAAP-compliant and implicated audit failures, perhaps more than poor GAP standards, the popular perception was that these failures, in part, sprang from such liberalizations as the move away from eminently verifiable historical costs.

After at most a brief pause, the trend to wider use of fair value measures continued, notwithstanding these experiences. A watershed event occurred when the US standard setter, FASB, issued FAS 157, *Fair Value Measurements*, in 2006. This standard—which did not mandate any wider use of fair value measures than already existed—established a three-level hierarchy of methodologies, coupled with expanded disclosure requirement. By late 2006, IASB had issued a Discussion Paper addressing the same topic, and in fact essentially "wrapped around" FAS 157 some additional considerations. If an Exposure Draft of a final standard is released (promised for mid-2009), ultimately to be followed by a final standard (now anticipated for sometime in 2010), based on this Discussion Paper, the standard will closely parallel FAS 157 and may even fully replicate it.

While FAS 157 and the international financial reporting standard that will eventually address the same issues are intended to guide users attempting to apply fair value measurements, without dictating broader application of fair value, both FASB and IASB have also made clear their respective intentions to expand the use of fair value measures in financial reporting. Thus far, these intentions have been limited to financial instruments and other monetary items, with fair value reporting of monetary liabilities being among the more prominently noted expansion targets. The "fair value option" rules propounded under IFRS, at first (via an amendment to IAS 39), and later under US GAAP (FAS 159), have been the most notable of these efforts thus far.

A detour of sorts on the road to expanded use of fair values has recently occurred, as a by-product of the worldwide financial institutions crisis precipitated by the sudden deflation in residential real estate values, followed by concerns about poor credit quality (the so-called subprime lending issue), a growing reluctance to lend by banks and thrifts, and the resultant economy-wide credit crunch that now (as of late 2008) threatens a major and protracted recession, and which has triggered the most far-reaching restructurings of the financial institution segments of major world economies seen since the 1930s, at least. Fair value accounting has become, oddly enough, the scapegoat of choice by bankers, politicians and others seeking an explanation other than the obvious collapse of the housing bubble that had been widely observed and forecast for over a decade.

The coincidence of expanded fair value reporting and the real estate collapse has facilitated this particular spate of blame-shifting. While it is certainly true that fair value-based reporting may result in greater volatility in reported earnings, this only occurs if and when the underlying economic performances of the reporting entities are indeed volatile. An entity enjoying stable performance will report stable earnings, absent such extraneous actions and events as the holding of large, passive investment portfolios which become buffeted by market forces unrelated to the reporting entity's central business activities (and few companies have the luxury of being able to hold large investment portfolios, other than financial institutions, for which such portfolios are a central aspect of their operations).

As with all generalizations, however, there is a large kernel of truth in the observation that fair value accounting has contributed to the near-panic situation that developed by mid-2008, with the collapse of venerable banks and investment banks and the near-elimination of an entire industry segment (the large, formerly private but more recently publicly held investment banks, of which all the only surviving independent US members have sought the shelter of commercial bank charters). With the collapse of the subprime mortgage lending business, resulting from rapidly growing defaults by debtors willing to walk away from "underwater" properties, entities (not limited to banks, although these have been among the major victims) were required to recognize "mark-to-market" adjustments and huge losses which decimated many banks' capital, prompting seizures by regulatory authorities, forced mergers with healthier institutions, and some outright failures. As some institutions failed, the ripple effect on others holding debt or other instruments of those banks, or holding the same or other similar investments as were held by failing institutions, grew apace.

All dramatic declines in value lend themselves to exaggerated claims and explanations, and the current one is no exception. In the present situation, the claim being made is that banks and other (mostly regulated) institutions, faced with holdings of mortgage-backed and other debt securities that suddenly have become "illiquid" due to temporary market anomalies and the so-called "flight to safety" previously also experienced during, for example, the Asian credit crisis of the late 1990s, have been forced to essentially write-down all such holdings to zero, under the fair value accounting rules that, arguably, offer no alternatives when markets seize up at the end of the reporting period. A closer look at the fair value hierarchy under FAS 157 (the best guidance presently extant, even for those reporting under IFRS), however, reveals a greater degree of flexibility than is being publicly acknowledged. This will be further explained later in this appendix.

The increasingly widely held view by late 2008 was that, absent the twin evils of (1) the need to "mark-to-market" these investments at all, and (2) the dramatic declines in fair values caused by the downward price spiral precipitated by declining residential property values and its follow-on effects (loan defaults, foreclosures, the market-dampening effects of the surfeit of for-sale foreclosed and other properties, etc.), which triggered round after round of write-downs and further failures, this crisis would not have occurred. Many interested groups, including preparers and users of financial statements, have begun to agitate for suspension, relaxation or outright repeal of "mark-to-market" accounting by banks and other financial institutions, and possible revision or rescission of the fair value hierarchy established by FAS 157 and in the process of being developed or mimicked by IASB. While leaders including the chairs of both FASB and IASB have publicly identified the fallacies of placing responsibility for the residential real estate and subprime lending bubble burst on the fair value accounting rules, the ultimate outcome cannot be forecast at this early date.

One feature distinguishes the current standard-setting and standard-revising concerns in the US from what may take place under IFRS. US GAAP more generously allowed the use of "off-statement of financial position" vehicles, much (but not all) of which was designed to facilitate the securitization of debt obligations so that the ultimate investors in the debt (which had been divided into so-called *tranches* having varying credit qualities and cash flow properties) were far removed from the actual credit granting process and often had little idea of the actual underlying composition of the investments they held. These vehicles, originally known as SPEs (special-purposes entities), and later as SPVs (special-purpose vehicles) and QSPEs (qualified special-purpose entities), and most recently as VIEs (variable interest entities), were designed to accomplish specific financial objectives, for example, making diversified pools of underlying loans available for investments by investors of only modest means; providing a more liquid secondary market for previously rather illiquid investments (e.g., residential mortgages) and specific financial reporting objectives (removing assets and related debt obligations from the reporting entities' statements of financial position, thereby improving the entities' apparent debt/equity ratios and making further lending activities more feasible). Largely in reaction to certain abuses and the fallout from the residential real estate market declines and subsequent epidemic of loan defaults, FASB is deliberating rule changes that would likely put back on sponsors' statements of financial position some or all of the previously derecognized assets and liabilities.

The IFRS requirements have always been less accommodating, however, with fewer opportunities available for reporting entities to remove assets and liabilities from their statements of financial position. In contrast to the corresponding requirements under US GAAP, which makes use of complex determinations of primary beneficiaries of variable interest entities established by reporting entities, the IFRS approach has been to effectively require consolidation of most such financing structures. Utilizing a much simpler concept of *control*, IFRS require consolidation (and hence, no derecognition) of QSPE-like entities. While there can be very important reasons for employing such structures (most importantly, to isolate certain financial assets so that less risk attaches to the cash flows associated with them, which facilitates using these assets as collateral for further borrowings), the *accounting* result of derecognition will not necessarily follow.

The remainder of this Appendix will explain the IASB's discussion paper on *Fair Value Measurements*, as well as FASB's FAS 157, *Fair Value Measurements*. The authors believe that the move toward greater application of fair value measurements will continue (possible after another brief pause), particularly for financial instruments and other monetary items such as receivables and payables, and that this guidance will be necessary and useful.

The IASB Discussion Paper on Fair Value Measurements

The November 2006 IASB Discussion Paper, *Fair Value Measurements*, essentially wrapped a series of questions around the FASB's then-new standard, FAS 157 (discussed below). It challenges users to consider whether IASB should issue guidance identical or very similar to that standard, which would then provide the sole source for authoritative guidance on this topic. In soliciting these observations, the DP notes the many differences (both substantive and terminological) between US GAAP and IFRS, and invites comments relative to how these differences would, or would not, demand an alternative approach to the hierarchy of fair value measurements set forth by FAS 157. For example, FAS 157 adopts an "exit price" definition of fair value, which was a notable departure from much existing guidance under US GAAP, and would likewise be a deviation from at least certain of the current requirements of IFRS. This issue is particularly acute with regard to the fair value measurement of liabilities.

As of late 2008, IASB is anticipating that an Exposure Draft will be issued in the first half of 2009, and that a final standard will appear the following year. If IASB decides to essentially embrace FAS 157 in its totality, this project can move forward as planned. However, if IASB (based on constituent feedback received by the April 2007 deadline, as well as input from an Expert Advisory Panel appointed in June, 2008) determines that it must create a unique standard to provide for the needs of IFRS users, then even this leisurely pace may be further extended.

FASB FAS 157, *Fair Value Measurements*—The Mixed Attribute Model

Under longstanding US GAAP, mirrored to a greater or lesser extent by other national GAAP and IFRS, assets, liabilities, and equity have been measured and presented in a reporting entity's statement of financial position by applying a disjointed, inconsistent assortment of accounting methods. This is sometimes characterized as the "mixed attribute model." The following table summarizes the current state of the mixed-attribute model as exhibited by US GAAP and the effects of FAS 157 and FAS 159 (if any) on specified assets and liabilities of reporting entities that are not financial institutions, investment companies, or insurance companies.

Assets			**Liabilities and Equity**		
*Key**	*Caption*	*Customary measurement attribute*	*Key**	*Caption*	*Customary measurement attribute*
A	Cash and cash equivalents	Cost, approximating fair value	E	Notes and bonds payable	Unpaid principal adjusted for accrued interest, unamortized premium or discount, unamortized debt issue costs
E	Accounts receivable (with terms not exceeding one year)	Estimated net realizable value	A	Accounts payable	Contractual price agreed upon by the parties; depending on the contractual terms, often will approximate fair value
E	Notes, loans and accounts receivable with terms exceeding one year	Unamortized principal due less allowance for credit losses; also subject to evaluation for impairment when holder considers it probable that it will be unable to collect all amounts due in accordance with the contractual terms	A	Payroll taxes withheld and accrued; sales taxes payable	Amounts due to taxing authorities; due to short periods during which these amounts are outstanding, they usually approximate fair value without being discounted to their present value
N	Inventory	Lower of cost or market using FIFO, LIFO, average cost, or specific identification	N	Income tax liabilities currently payable	Amounts due to taxing authorities based on positions claimed on income tax returns filed or to be filed
N	Deposits	Cost less portion applied by the holder or for which no future benefits are expected	N	Unrecognized income tax positions	Amounts due to taxing authorities for income tax positions claimed or to be claimed on tax returns that exceed the maximum amount that is more than 50% probable of being sustained upon audit
E	Investments in debt and marketable equity securities including those held by a not-for-profit organization	Trading and available-for-sale securities at fair value; held-to-maturity securities at amortized cost subject to evaluation for other-than-temporary impairment	N	Deferred income taxes	Future taxable temporary differences multiplied by the effective tax rate expected to apply upon their future reversal

Assets			**Liabilities and Equity**		
*Key**	*Caption*	*Customary measurement attribute*	*Key**	*Caption*	*Customary measurement attribute*
E	Investments, cost method	Historical cost less dividends received by the investor in excess of the investee's net accumulated earnings since the date of acquisition by the investor, and subject to evaluation for other-than-temporary impairment	N	Accrued expenses	Expenses incurred or allocated to operations that have not yet been invoiced by the supplier or provider and are not yet currently payable
E	Investments, equity method	Historical cost adjusted to recognize the investor's share of investee income and losses, dividend distributions, and amortization of difference between investor cost and underlying net assets of the investee ("equity method goodwill"); subject to evaluation for other-than-temporary impairment	E	Warranty obligations	Estimated costs expected to be incurred over the warranty period
A	Derivatives	Fair value (depending on the measurement, the derivative can be an asset in one period and a liability in another period)	N	Deferred compensation arrangements, pensions, other postemployment benefits	Subject to highly complex GAAP that, in general, accrues the cost of the benefits to be provided in the future in a manner that results in compensation cost being recognized in the periods benefiting from the services provided, including factors for the time value of money, various actuarial assumptions relevant to the measurement, and when the arrangement is funded and based on assumptions regarding future investment returns
N	Prepaid expenses	Cost less amounts consumed in operations or allocated to operations based on the passage of time	E	Guarantee liabilities	Initially recognized at fair value; reduced during the life of the guarantee as the guarantor is discharged from the obligation to stand ready to perform
N	Deferred income taxes	Future deductible temporary differences and carryforwards multiplied by the effective tax rate expected to apply upon their future reversal and less a valuation allowance for the portion, if any, that is not more than 50% probable of being realized.	N	Asset retirement obligations	Initially recognized as the expected present value of the future cost associated with a legal obligation to retire an asset or group of assets; generally increased in subsequent periods for accretion of interest on the obligation

Assets

Key*	Caption	Customary measurement attribute
N	Property and equipment held and used	Cost less accumulated depreciation subject to evaluation for impairment upon the occurrence of certain events and circumstances
N	Property and equipment held for sale	Fair value less cost to sell
N	Cash surrender value of life insurance	Amount realizable under the contract at the end of the reporting period net of outstanding policy loans
N	Goodwill	Arises in business combinations: FAS 141: The excess of the purchase price over the fair values of identifiable tangible and intangible net assets acquired; subject to annual impairment tests; FAS 141(R): The excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired; In both cases, goodwill is subject to annual impairment testing
N	Other intangible assets	Fair value at initial recognition; subject to considerations as to whether the intangible is amortizable and whether impaired; Under FAS 141(R) this category includes in-process research and development assets acquired in a business combination

Liabilities and Equity

Key*	Caption	Customary measurement attribute
N	Contingencies	If probable that a liability has been incurred and amount is reasonably estimable, the estimated settlement amount

**ABBREVIATION KEY:*

E—Generally eligible for fair value election under FAS 159
A—Already stated at fair value or an amount that approximates fair value
N—Not eligible for fair value election or to be measured at fair value on a recurring basis

Further complicating this state of affairs under US GAAP is the current state of specialized industry accounting rules. A commercial bank holding a debt instrument is subject to FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, and thus would consider whether the debt instrument is held for trading purposes, is available for sale, or is expected to be held to maturity. Depending on how the instrument is classified, the bank would report the security at either fair value or at amortized cost. Furthermore, if the instrument is classified as available-for-sale or held-to-maturity, changes in fair value will not be recognized in the statement of comprehensive income while the bank holds the instrument, unless it becomes impaired and that impairment is considered "other-than-temporary."

An investment banking entity, however, that holds the same security would measure the security at fair value and recognize all changes in fair value, whether increases or decreases, in net income in the period they occur.

Objectives of FAS 157. Since the late 1980s, FASB has pursued a stated goal that would require all financial instruments and many other assets and liabilities to be stated at the end of each reporting period at fair value, with changes from period to period recognized as gains or losses in profit or loss. The pursuit of this goal has resulted in a succession of standards that increased the number of fair value measurements required and, to provide more transparency to users, increased the scope and complexity of the related disclosures required.

In December 1991, with the issuance of FAS 107, *Disclosures about Fair Value of Financial Instruments,* the term "fair value" was coined to replace the previously popular term "market value" (for which the term "fair market value" was sometimes substituted). This change was made to emphasize the fact that, even in the absence of active primary markets for an asset or liability, assets and liabilities could be valued by reference to prices and rates from secondary markets discounted. Over time, this concept was expanded further to include the application of various fair value estimation models, such as the probability-weighted expected cash flow model first introduced by FASB Concepts Statement 7 (CON 7).

As these broader fair value concepts were evolving, the preexisting "market-based" literature had not been revised. Further, the concepts and definitions of fair value were not consistently understood or applied in similar situations by similar reporting entities. The need for comprehensive guidance to identifying and applying valid fair value measurement strategies became ever more evident as time progressed.

FAS 157 was issued in September 2006 in order to

- Establish a single, consistent GAAP definition of fair value
- Provide uniform, consistent guidance on how to measure fair value including the establishment of a hierarchical fair value measurement framework that classifies measurement inputs based on their level of market observability
- Expand the information required to be provided to financial statement users about fair value measurements

FAS 157 did not mandate new fair value measurements, but rather only provided "clarification" regarding the application of these measurements in the existing literature. While technically accurate, this understates the major impact that FAS 157 would be destined to have.

Definition of fair value. Fair value is defined in FAS 157 as the *price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.* An "orderly transaction" is explained as being a hypothetical transaction assumed to take place on the measurement date with the item being valued having been exposed to the market for the usual and customary period of time for transactions involving such assets or liabilities in order to provide sufficient time for marketing activities. Further, an orderly transaction is not a sale where the seller is under duress (e.g., a forced liquidation or distress sale).

Fair value measurements are to be considered from the perspective of a market participant that holds the asset or owes the liability. Thus, the objective of measuring fair value is to determine an exit price: the price that would be received to sell an asset or the price that would be paid to transfer the liability. This concept will be explained and illustrated later in this appendix.

Scope of the standard. In pursuing an incremental approach, FAS 157 contained scope exceptions for certain, highly complex specialized applications.

1. Share-based payments (FAS 123 [R])
2. Measurement models that are based on vendor-specific objective evidence (VSOE) such as
   a. Multiple-deliverable arrangements
   b. Software revenue recognition
   c. Software stored on another entity's hardware
3. Market value of inventory for the purposes of applying the lower of cost or market model to measure inventory realizability.

In addition to the scope exceptions listed above, FAS 157 retains the exceptions included in GAAP that tacitly acknowledge that it is sometimes not practical to estimate fair value without "undue cost or effort." When this is the case, however, management is required to inform the users of the financial statements that it has invoked this exception, as well as the reasons that it believes making fair value measurements would be impractical.

This exception applies to certain measurements made in connection with matters such as advertising barter transactions; asset retirement obligations; business combinations; contributions made and received; exit and disposal activities; financial instrument disclosures; guarantees; nonmonetary transactions; not-for-profit organizations; pensions; postemployment benefits other than pensions; puttable marketable securities; and transfers of financial assets.

Measurement principles and methodologies under FAS 157. It is helpful to break down the measurement process under FAS 157 into a series of discrete steps. Although not necessarily performed in a linear manner, the following procedures and decisions need to be applied and made, in order to value an asset or liability at fair value under FAS 157. Each of the steps will be discussed in greater detail in the following pages.

1. *Identify the item to be valued and the unit of account.* Specifically identify the asset or liability, including the unit of account to be used for the measurement.
2. *Determine the principal or most advantageous market and the relevant market participants.* From the reporting entity's perspective, determine the principal market in which it would sell the asset or transfer the liability. In the absence of a principal market, consider the most advantageous market for the asset or the liability. Once the principal or most advantageous market is identified, determine the characteristics of the market participants. It is not necessary that specifically named individuals or entities be identified for this purpose.
3. S*elect the valuation premise to be used for asset measurements*. If the item being measured is an asset, determine the valuation premise to be used by evaluating whether marketplace participants would judge the highest and best use of the asset utilizing an "in-use" valuation premise or an "in-exchange" valuation premise.
4. *Consider the risk assumptions applicable to liability measurements*. If the item being measured is a liability, identify the key assumptions that market participants would make regarding nonperformance risk including, but not limited to, the reporting entity's own credit risk (credit standing).
5. *Identify available inputs.* Identify the key assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. In identifying these assumptions, referred to as "inputs" by FAS 157, maximize the inputs that are observable (i.e., that are based on market data available from sources independent of the reporting entity). In so doing, assess the availability of relevant, reliable market data for each input that significantly affects the valuation, and identify the level of the new fair value input hierarchy in which it is to be categorized.

6. *Select the appropriate valuation technique(s).* Based on the nature of the asset or liability being valued, and the types and reliability of inputs available, determine the appropriate valuation technique or combination of techniques to use in valuing the asset or liability. The three broad categories of techniques are the market approach, the income approach, and the cost approach.
7. *Make the measurement.* Measure the asset or liability.
8. *Determine amounts to be recognized and information to be disclosed.* Determine the amounts and information to be recorded, classified, and disclosed in interim and annual financial statements

Item identification and unit of account. In general, the same unit of account at which the asset or liability is aggregated or disaggregated by applying other applicable US GAAP pronouncements is to be used for fair value measurement purposes. FAS 157 prohibits adjustment to the valuation for a "blockage factor," which is an adjustment made to a valuation that takes into account the fact that the investor holds a large quantity (block) of shares relative to the market trading volume in those shares. The prohibition applies even if the quantity held by the reporting entity exceeds the market's normal trading volume—and that, if the reporting entity were, hypothetically, to place an order to sell its entire position in a single transaction, that transaction could affect the quoted price.

Principal or most advantageous market and market participants. FAS 157 requires those performing valuations to maximize the use of assumptions (inputs) that are observable from market data obtained from sources independent of the reporting entity. In making a fair value measurement, management is to assume that the asset or liability is exchanged in a hypothetical, orderly transaction between market participants at the measurement date. To characterize the exchange as orderly, it is assumed that the asset or liability will have been exposed to the market for a sufficient period of time prior to the measurement date to enable marketing activities to occur that are usual and customary with respect to transactions involving such assets or liabilities. It is also to be assumed that the transaction is not a forced transaction (e.g., a forced liquidation or distress sale).

FASB had tentatively concluded that fair value should be measured by reference to the most advantageous market for the asset or liability being measured. For practical reasons, however, it concluded that if there is a principal market for an asset or liability, the measure of fair value is to be the price in that market (whether directly observable or determined indirectly using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

Management is to identify the *principal market* for the asset or liability, if such a market exists. If the entity has access to more than one market, the principal market is the market in which the reporting entity would sell the asset or transfer the liability that has the greatest volume and activity level for the asset or liability. The greater volume of activity ensures that the measurement is based on multiple transactions potentially between multiple counterparties, and is thus more representative of fair value than if the measurement were based on less extensive data.

Note that the determination of the principal market is made from the perspective of the reporting entity. Thus, different reporting entities engaging in different specialized industries, or with access to different markets, might not have the same principal market for an identical asset or liability. Inputs from the principal market are to be used irrespective of whether the price is directly observable or determined through the use of a valuation technique.

If there is no principal market for an asset or liability from the perspective of the reporting entity, then management is to use the most advantageous market for the measurement.

The most advantageous market is the market that the reporting entity has the ability to access at the measurement date, in which it would maximize the price it receives from the sale of an asset or would minimize the price it pays to transfer a liability. In determining the most advantageous market, management considers transaction costs. However, once the most advantageous market had been identified, transaction costs are *not* used to adjust the market price used for the purposes of the fair value measurement.

FAS 157 provides a typology of markets that potentially exist for assets or liabilities.

1. *Active exchange market*. A market in which closing prices are readily available and that generally represent fair value (e.g., NYSE Euronext, Toronto Stock Exchange, London Stock Exchange, Hong Kong Stock Exchange).
2. *Dealer market*. A market in which parties (dealers referred to as market makers) stand ready to buy or sell a particular investment for their own account at bid and ask prices that they quote. The bid price is the price the dealer is willing to pay to purchase the investment and the ask price is the price at which the dealer is willing to sell the investment. In these markets, these bid and ask prices are typically more readily available than closing prices characteristic of active exchange markets. By using their own capital to finance and hold an inventory of the items for which they "make a market," these dealers provide the market with liquidity. Examples of dealer markets in the US are "over-the-counter" markets that publicly report prices through the National Association of Securities Dealers Automated Quotations Systems (NASDAQ) or Pink Sheets LLC, and the market for US Treasury securities. Dealer markets also exist for various financial and nonfinancial assets and liabilities, including commodities and used equipment.
3. *Brokered market.* These markets use "brokers" or intermediaries to match buyers with sellers. Brokers do not trade for their own account and do not hold an inventory in the security. The broker knows the bid and asked prices of the potential counterparties to the transaction but the counterparties are unaware of each other's price requirements. Prices of consummated transactions are sometimes available privately or as a matter of public record. Brokered markets include electronic communication networks that match buy and sell orders, as well as commercial and residential real estate markets. In some cases, each of the counterparties is aware of the other's identity, while in other cases, their identities are not disclosed by the broker.
4. *Principal-to-principal market*. A market in which the counterparties negotiate directly and independently without an intermediary. Because no intermediary or exchange is involved, little if any information about these transactions is released to the public.

Market participants in the principal or most advantageous market are buyers and sellers that

1. Are unrelated third parties
2. Have the ability to enter into a transaction for the asset or liability
3. Have the motivation to voluntarily enter into a transaction for the asset or liability without being forced to do so under duress
4. Are knowledgeable about the asset or liability since they would possess a reasonable understanding of the asset or liability and the terms of the transaction based on all available information including information obtainable through the performance of usual and customary due diligence procedures

Those determining the measurement are not required to identify specific individuals or entities that would potentially be market participants. Instead, it is important to identify the distinguishing characteristics of participants in the particular market by considering factors specific to the asset or liability being measured, the market identified, and the participants in that market with whom the reporting entity would enter into a transaction for the asset or liability.

Measurement considerations when markets become illiquid or less liquid. At the time many entities were in the process of implementing FAS 157, those same entities were experiencing the effects of a tumultuous credit market in the US and abroad. The previously active markets for certain types of securities became illiquid or less liquid. Questions arose regarding whether transactions occurring in less liquid markets with less frequent trades might cause those market transactions to be considered forced or distress sales, thus rendering valuations made using those prices not indicative of the actual fair value of the securities. In order to respond to these concerns, the Center for Audit Quality (CAQ), a nonprofit group based in Washington, DC, closely affiliated with the AICPA, issued a white paper on October 3, 2007, entitled, "Measurements of Fair Value in Illiquid (or Less Liquid) Markets."[2]

The white paper indicates that an imbalance between supply and demand can occur when there are more sellers than buyers for a particular instrument and that imbalance can result in "forcing prices down." Transactions in markets affected by this situation—where there is a lack of equilibrium between buyers and sellers—are not considered to be forced or distressed transactions as contemplated by FAS 157 (or, for that matter, by the standards that preceded FAS 157). The white paper cites a 2004 SEC Accounting and Auditing Enforcement Release[3] in which the Commission imposed a cease-and-desist order on a registrant because the registrant departed from using established market-based valuation methods when it believed that supply and demand were not "in reasonable balance." For obvious reasons, granting financial statement preparers *carte blanche* to define markets as disorderly to avoid having to use market prices would be a dangerous precedent.

One of the practices covered by the cease-and-desist order involved the valuation of bonds, primarily in the telecommunications industry, that were contained in a high-yield bond portfolio near the end of 2000 when the telecommunications industry was experiencing significant turmoil (liquidations, reorganizations, and bankruptcy filings resulting from factors such as overexpansion of capacity in anticipation of business growth that never materialized). The registrant, a financial services firm, believed that market conditions rendered third-party price quotations unreliable and, rather than use such quotations in its fair value measurements, decided to take a "longer view of the market" and use management's own subjective opinion regarding the value of the bonds.

According to the SEC, the registrant in effect, "valued its positions at the price at which it thought a willing buyer and seller *should* enter into an exchange, rather than at the price at which a willing buyer and a willing seller *would* enter into a current exchange." (Emphasis added.) The situation cited in the release was exacerbated by the fact that the registrant had valued some of the same high-yield bonds held in the portfolios of its own mutual funds using a lower valuation.

Under FAS 157, orderly transactions are occurring in the marketplace for an asset or liability when knowledgeable buyers and sellers independent of the reporting entity are willing and able to transact, and are motivated to transact without being forced to do so. If orderly transactions are occurring in a manner that is usual and customary for the asset or liability, then the transactions are not to be characterized as forced or distress sales. Just because

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[2] *http://www.aicpa.org/caq/download/WP_Measurements_of_FV_in_Illiquid_Markets.pdf*

[3] *AAER No. 2132; US Securities and Exchange Commission; November 4, 2004; http://sec.gov/litigation/admin/34-50632.htm*

transaction volume in a market drops significantly from prior periods does not necessarily mean that the market is no longer active. The white paper asserts that persuasive evidence would be required to establish that an observable transaction is a forced or distressed transaction and, furthermore, it is inappropriate to assume that all transactions in a relatively illiquid market are forced or distressed transactions.

Selection of the valuation premise for asset measurements. The measurement of the fair value of an asset is to assume the *highest and best use* of that asset by market participants. Generally, the highest and best use is the way that market participants would be expected to deploy the asset (or a group of assets within which they would use the asset) that would maximize the value of the asset (or group). This highest and best use assumption might differ from the way that the reporting entity is currently using the asset or group of assets or its future plans for using it (them).

At the measurement date, the highest and best use must be physically possible, legally permissible, and financially feasible. Determination of the highest and best use of the asset will establish which of the two valuation premises to use in measuring the asset's fair value, the in-use valuation premise, or the in-exchange valuation premise.

***Strategic buyers and financial buyers*.** FAS 157 differentiates between two broad categories of market participants that would potentially buy an asset or group of assets.

1. *Strategic buyers* are market participants whose acquisition objectives are to use the asset or group of assets (the "target") to enhance the performance of their existing business by achieving benefits such as additional capacity, improved technology, managerial, marketing, or technical expertise, access to new markets, improved market share, or enhanced market positioning. Thus, a strategic buyer views the purchase as a component of a broader business plan and, as a result, a strategic buyer may be willing to pay a premium to consummate the acquisition and may, in fact, be the only type of buyer available with an interest in acquiring the target. Ideally, from the standpoint of the seller, more than one strategic buyer would be interested in the acquisition, which would create a bidding situation that further increases the selling price.
2. *Financial buyers* are market participants who seek to acquire the target based on its merits as a stand-alone investment. A financial buyer is interested in a return on its investment over a shorter time horizon, often three to five years, after which time their objective would typically be to sell the target. An attractive target is one that offers high growth potential in a short period of time resulting in a selling price substantially higher than the original acquisition price. Therefore, even at acquisition, a financial buyer is concerned with a viable exit strategy. A financial buyer, unlike a strategic buyer, typically does not possess a high level of industry or managerial expertise in the target's industry. Transactions involving financial buyers are often highly leveraged when the economic environment is such that the cost of debt is lower than the cost of equity.

***The in-use valuation premise*.** This premise assumes that the maximum fair value to market participants is the price that would be received by the reporting entity (seller) assuming the asset would be used by the buyer with other assets as a group and further, that the other assets in the group would be available to potential buyers. The target might continue to be used as presently installed or may be configured in a different manner by the buyer. The assumptions regarding the level of aggregation (or disaggregation) of the asset and other associated assets may be different than the level used in applying other accounting pronouncements. Thus, in considering highest and best use and the resulting level of aggregation, the evaluator is not constrained by how the asset may be assigned by the reporting entity to a reportable or operating segment under FAS 131, a business under EITF 98-3,[4] a reporting unit under FAS 142, or an asset or disposal group under FAS 144. The assumptions regarding the highest and best use of the target should normally be consistent for all of the assets included in the group within which it would be used. Generally, the market participants whose highest and best use of an asset or group of assets would be "in-use" are characterized as strategic buyers, as previously described.

The in-exchange valuation premise. This premise assumes that the maximum fair value to market participants is the price that would be received by the reporting entity (seller) assuming the asset would be sold principally on a stand-alone basis. Generally, the market participants whose highest and best use of an asset or group of assets would be "in-use" are characterized as strategic buyers, as previously described.

Risk assumptions when valuing a liability. Many accountants, analysts, and others find the concept of computing fair value of liabilities and recognizing changes in fair value as they occur to be counterintuitive. Consider the case when a reporting entity's own credit standing declines (a "bad thing"). A fair value measurement that incorporates the effect of this decline in credit rating would result in a decline in the fair value of the liability and a resultant increase in stockholders' equity (a "good thing"). The justification provided in FAS 157 (and by quoting from CON 7) is that

> *A change in credit standing represents a change in the relative positions of the two classes of claimants (shareholders and creditors) to an entity's assets. If the credit standing diminishes, the fair value of creditors' claims diminishes. The amount of shareholders' residual claims to the entity's assets may appear to increase but that increase is probably offset by losses that may have occasioned the decline in credit standing. Because shareholders usually cannot be called on to pay a corporation's liabilities, the amount of their residual claims approaches, and is limited by zero. Thus a change in the position of borrowers necessarily alters the position of shareholders, and vice versa.*

As FAS 157 was originally drafted and issued, fair value measurements of liabilities assume that a hypothetical transfer to a market participant occurs on the measurement date. In measuring the fair value of a liability, the evaluator is to assume that the reporting entity's obligation to its creditor (i.e., the counterparty to the obligation) will continue at and after the measurement date (i.e., the obligation will not be repaid or settled prior to its contractual maturity). This being the case, this hypothetical transfer price would most likely represent the price that the current creditor (holder of the debt instrument) could obtain from a marketplace participant willing to purchase the debt instrument in a transaction involving the original creditor assigning its rights to the purchaser. In effect, the hypothetical market participant that purchased the instrument would be in the same position as the current creditor with respect to expected future cash flows (or expected future performance, if the liability is not settleable in cash) from the reporting entity.

The evaluator is to further assume that the nonperformance risk related to the obligation would be the same before and after the hypothetical transfer occurs. *Nonperformance risk* is the risk that the obligation will not be fulfilled. It is an all-encompassing concept that includes the reporting entity's own credit standing but also includes other risks associated with the nonfulfillment of the obligation. For example, a liability to deliver goods and/or perform services may bear nonperformance risk associated with the ability of the debtor to fulfill the obligation in accordance with the timing and specifications of the contract. Further, nonper-

[4] *EITF 98-3 was nullified by FAS 141(R) effective at the beginning of the first annual reporting period beginning on or after December 15, 2008. FAS 141(R) simplified the definition of a business, which will result in more asset acquisitions being characterized as business combinations, including entities that are in the development stage.*

formance risk increases or decreases as a result of changes in the fair value of credit enhancements associated with the liability (e.g., collateral, credit insurance, and/or guarantees).

Reporting entities have reported to the FASB staff that they have experienced various operational difficulties in applying FAS 157 to fair value measurements of liabilities. Many businesses do not issue bonds in public debt markets and are not privy to the amounts that would be realized by their creditors for transferring or securitizing their debt to other market participants. It has been asserted that the price that one investor pays another investor to purchase a debt instrument held as an asset would not be indicative of an exit price that the debtor would be required to pay to induce another party to assume the debt in a hypothetical exit transaction.

To respond to these concerns, the FASB staff issued Proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157,* on January 18, 2008. As of late October 2008, this has not been finalized. Based on the results of the redeliberations to date, the following tentative conclusions were reached:

1. The best measurement of fair value for an entity's liability is the price at which that liability is traded as an asset. Thus, a quoted, unadjusted price for the identical liability (and the identical unit of account) in an active market is the best evidence of fair value for that liability; this measurement would be equally valid for both the obligor of the liability and the asset holder.
2. In the absence of a quoted price for the identical liability in an active market, management of the reporting entity may measure the fair value of a liability at the price it would receive if it were to issue that liability at the measurement date.

   It is important for the reader to note that this valuation concept is not the same as the concept of the incremental borrowing rate used in accounting for leases. The incremental borrowing rate assumes that the borrower is incurring debt in addition to its existing debt. The valuation concept that would be used in the proposed FSP assumes that the borrower either did not owe the liability being measured as of the measurement date or refinanced it with the same repayment terms and remaining number of payments.

Example of measuring a liability absent a quoted market price (based on proposed FSP)

Gladwell Development Inc. (GDI) owed a commercial bank $2,679,824 at December 31, 2009 (the measurement date). When the loan was originated on December 31, 2006, it bore a fixed rate of 9.25% which, at the time, represented the lender's prime rate plus 2%. The original principal amount was $3,000,000 and the loan was to be repaid over a 15-year term with monthly payments of $30,876 of principal and interest.

In order to disclose the fair value of its financial instruments in accordance with FAS 107, it needs to measure the fair value of this debt.

As is usually the case in private lending transactions, there is no available market information at December 31, 2009, the measurement date, regarding the amount that GDI would be required to pay an unrelated counterparty with similar credit standing to assume its debt.

Alternatively, GDI's management contacts local lending institutions and inquires about the availability of terms to refinance its existing debt based on current interest rates and its current credit standing. GDI's management determines (and contemporaneously documents) that based on an improvement in its credit standing, it could obtain $2.7 million of replacement financing at 6% on the measurement date, which represents the lender's prime rate of 5% plus an additional 1%.

Management calculates the fair value of the loan at December 31, 2009, by solving for the present value of 144 remaining payments of $30,876, discounted at 6%, which yields $3,164,010. The logic behind this result from the standpoint of GDI is that, due to a favorable change in interest rates and in its own credit standing, the fair value of its debt has increased. It would be more attractive for a counterparty to purchase the existing debt from the originating lender since the yield on the loan exceeds yields based on December 31, 2009 interest rates for investments with similar risk characteristics.

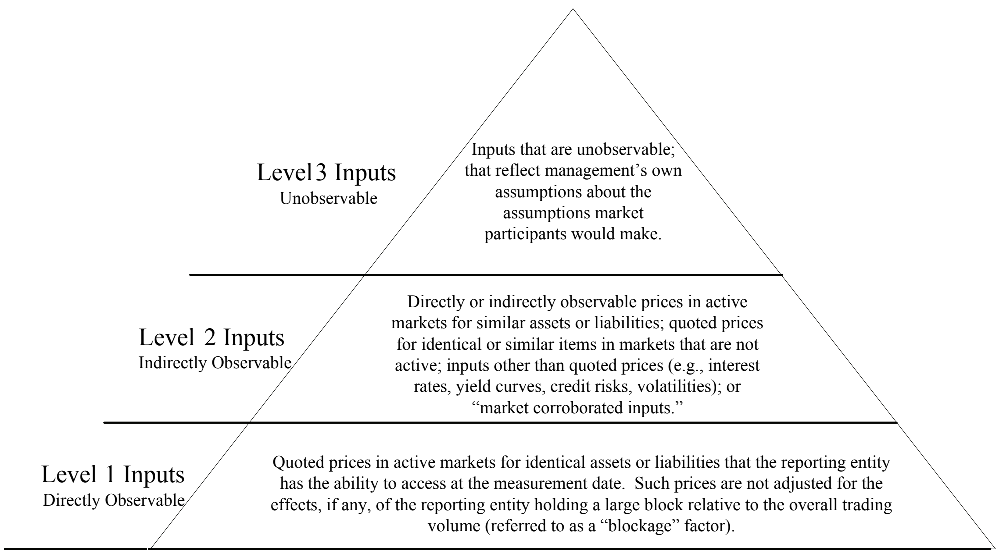
The FASB Staff proposed that the FSP be applied prospectively effective on the later of (1) the beginning of the first reporting period ending after the issuance date of the FSP or (2) the beginning of the period in which an entity initially applies FAS 157. Earlier application would not be permitted. The effect of initial application would be included as a change in fair value in the period of adoption. The authors recommend that readers/researchers monitor the status of this project on the FASB Web site (www.fasb.org) as it progresses to ensure that any effect a final FSP might have on the application of fair value measurement principles to liabilities is fully considered in applying the guidance we provide in this and other affected chapters.

Inputs. For the purpose of fair value measurements, inputs are the assumptions that market participants would use in pricing an asset or liability, including assumptions regarding risk. An input is either observable or unobservable. Observable inputs are either directly observable or indirectly observable. FAS 157 requires the evaluator to maximize the use of observable inputs and minimize the use of unobservable inputs.

An *observable input* is based on market data obtainable from sources independent of the reporting entity. An *unobservable input* reflects assumptions made by management of the reporting entity with respect to assumptions it believes market participants would use to price an asset or liability based on the best information available under the circumstances.

FAS 157 provides a fair value input hierarchy (see diagram below) to serve as a framework for classifying inputs based on the extent to which they are based on observable data.

Hierarchy of Fair Value Inputs



Level 1 inputs. Level 1 inputs are considered the most reliable evidence of fair value and are to be used whenever they are available. These inputs consist of quoted prices in active markets for *identical* assets or liabilities. The active market must be one in which the reporting entity has the ability to access the quoted price at the measurement date. To be considered an active market, transactions for the asset or liability being measured must occur frequently enough and in sufficient volume to provide pricing information on an ongoing basis.

If a market price at the exact measurement date is not readily available, or is available but not representative of fair value because the market is not active or because events occurring after the last available quoted price would have affected fair value at the measurement date,[5] the quoted price is to be adjusted to more accurately reflect fair value. As discussed previously, in order for a market to be considered active, it must have a sufficient volume of transactions to provide quoted market prices that are the most reliable measure of fair value. Markets experiencing reduced transaction volumes are still considered active if transactions are occurring frequently enough on an ongoing basis to provide reliable pricing information. FAS 157 requires that quoted prices from active markets (Level 1 inputs) be used whenever they are available. The use of Level 2 or Level 3 inputs is generally prohibited when Level 1 inputs are available.

Although not fully contemplated when FAS 157 was being drafted, recent (2008) market developments will challenge management to support assertions that market transactions are not valid Level 1 inputs. As discussed above, the burden of proof will be on those making such an assertion, even if market volatility and the virtual collapse of orderly trading of certain classes of securities (such as CDOs of subprime bank debt or mortgages) makes it somewhat suggestive that current market quotes are not truly indicative of underlying values.

Importantly, even if management were to conclude that a reduction in transaction volume in a particular market rendered that market inactive (i.e., the market is unable to provide reliable pricing information) the observable transactions that were occurring in that market would still be considered Level 2 inputs which need to be taken into account by management in its measurements of fair value. Management is required to establish and consistently apply a policy for identifying events that potentially affect its fair value measurements.

If the reporting entity holds a large number of similar assets and liabilities (such as a pool of debt securities), and quoted prices are not accessible with respect to each individual asset and/or liability in a cost-effective manner to enable timely financial reporting, management may choose to substitute, as a practical expedient, an alternative pricing model that does not rely exclusively on quoted prices such as using a matrix pricing model for debt securities. The use of a pricing model as an alternative to directly pricing each asset or liability in the group will require management to characterize the measurement in its entirety as being a level lower than Level 1 in the hierarchy.

Under no circumstances, however, is management to adjust the quoted price for blockage factors. Blockage adjustments arise when an entity holds a position in a single financial instrument that is traded on an active market that is relatively large in relation to the market's daily trading volume. While there is no common agreement as to how large a position would constitute a "block" of a particular instrument, FASB unconditionally prohibits any adjustment as a result of blockage, even if the market's normal daily trading volume is insufficient to absorb the quantity held by the reporting entity and irrespective of whether the placing of an order to sell the position in a single transaction might affect the quoted price.

Level 2 inputs. Level 2 inputs are quoted prices for the asset or liability (other than those included in Level 1) that are either directly or indirectly observable. Level 2 inputs are to be considered when quoted prices for the identical asset or liability are not available. If the asset or liability being measured has a contractual term, a Level 2 input must be observable for substantially the entire term. These inputs include

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[5] *Examples of such events that could occur after the close of a market but prior to the measurement date would include the existence of principal-to-principal transactions or brokered trades about which the evaluator has access to reliable information, or announcements made in press conferences, shareholders meetings, or in regulatory filings.*

1. Quoted prices for *similar* assets or liabilities in active markets
2. Quoted prices for identical or similar assets or liabilities in markets that are *not active*. As discussed in the previous section, these markets may not be considered active because
   a. They have an insufficient volume or frequency of transactions for the asset or liability
   b. Prices are not current
   c. Quotations vary substantially over time
   d. Quotations vary substantially among market makers (e.g., in some brokered markets)
   e. Insufficient information is released publicly (e.g., a principal-to-principal market)
3. Inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates and yield curves observable at commonly quoted intervals; volatilities; prepayment speeds; loss severities; credit risks; and default rates)
4. Inputs that are derived principally from or corroborated by observable market data that, through correlation or other means, are determined to be relevant to the asset or liability being measured (market-corroborated inputs)

Adjustments made to Level 2 inputs necessary to reflect fair value, if any, will vary depending on an analysis of specific factors associated with the asset or liability being measured. These factors include

1. Condition
2. Location
3. Extent to which the inputs relate to items comparable to the asset or liability
4. Volume and level of activity in the markets in which the inputs are observed

Depending on the level of the fair value input hierarchy in which the inputs used to measure the adjustment are classified, an adjustment that is significant to the fair value measurement in its entirety could render the measurement a Level 3 measurement.

During the turmoil experienced in credit markets beginning in early 2008, a holder of collateralized mortgage obligations (CMOs) backed by a pool of subprime mortgages might determine that no active market exists for the CMOs. Management might use an appropriate ABX credit default swap index for subprime mortgage bonds[6] to provide a Level 2 fair value measurement input in measuring the fair value of the CMOs.

***Level 3 inputs*.** Level 3 inputs are unobservable inputs. These are necessary when little, if any, market activity occurs for the asset or liability. Level 3 inputs are to reflect management's own assumptions regarding an exit price that a market participant holding the asset or owing the liability would make, including assumptions about risk. The best information available in the circumstances is to be used to develop the Level 3 inputs. This information might include internal data of the reporting entity. Cost-benefit considerations apply in that management is not required to "undertake all possible efforts" to obtain information about the assumptions that would be made by market participants. Attention is to be paid, however, to information available to management without undue cost and effort and, consequently, management's internal assumptions used to develop unobservable inputs are to be adjusted if such information contradicts those assumptions.

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[6] *ABX indices are disseminated by Markit Group Limited, a London-based consortium of 16 large banks and four hedge funds that provides credit derivative pricing data, valuations, and trade processing services.*

Inputs based on bid and ask prices. Quoted bid prices represent the maximum price at which market participants are willing to buy an asset; quoted ask prices represent the minimum price at which market participants are willing to sell an asset. If available market prices are expressed in terms of bid and ask prices, management is to use the price within the bid-ask spread (the range of values between bid and ask prices) that is most representative of fair value irrespective of where in the fair value hierarchy the input would be classified. FAS 157 permits the use of pricing conventions such as midmarket pricing as a practical alternative for determining fair value measurements within a bid-ask spread.

Classifying inputs. Classification of inputs as to the level of the hierarchy in which they fall serves two purposes. First, it provides the evaluator with a means of prioritizing assumptions used as to their level of objectivity and verifiability in the marketplace. Second, as discussed later in this chapter, the hierarchy provides a framework to provide informative disclosures that enable readers to assess the reliability and market observability of the fair value estimates embedded in the financial statements.

In making a particular measurement of fair value, the inputs used may be classifiable in more than one of the levels of the hierarchy. When this is the case, the inputs used in the fair value measurement in its entirety are to be classified in the level of the hierarchy in which the lowest level input that is significant to the measurement is classified.

It is important to assess available inputs and their relative classification in the hierarchy prior to selecting the valuation technique or techniques to be applied to measure fair value for a particular asset or liability. The objective, in selecting from among alternative calculation techniques, would be to select the technique or combination of techniques that maximizes the use of observable inputs. Note that the intended use of the hierarchy is to prioritize the inputs themselves, not the valuation techniques in which they are used.

Valuation techniques. In measuring fair value, management is to employ one or more valuation techniques consistent with the market approach, the income approach, and/or the cost approach. As previously discussed, the selection of a particular technique (or techniques) to measure fair value is to be based on its appropriateness to the asset or liability being measured as well as the sufficiency and observability of inputs available.

In certain situations, such as when using Level 1 inputs, use of a single valuation technique will be sufficient. In other situations, such as when valuing a reporting unit, management may need to use multiple valuation techniques. When doing so, the results yielded by applying the various techniques are to be evaluated and appropriately weighted based on judgment as to the reasonableness of the range of results. The objective of the weighting is to determine the point within the range that is most representative of fair value.

Management is required to consistently apply the valuation techniques it elects to use to measure fair value. It would be appropriate to change valuation techniques or how they are applied if the change results in fair value measurements that are equally or more representative of fair value. Situations that might give rise to such a change would be when new markets develop, new information becomes available, previously available information ceases to be available, or improved techniques are developed. Revisions that result from either a change in valuation technique or a change in the application of a valuation technique are to be accounted for as changes in accounting estimate, although an exemption was granted for the disclosures that apply to other changes in accounting estimate.

Market approaches. Market approaches to valuation use information generated by actual market transactions for identical or comparable assets or liabilities (including a business in its entirety). Market approach techniques often will use market multiples derived from a set of comparable transactions for the asset or liability or similar items. The evaluator will need to consider both qualitative and quantitative factors in determining the point within the range that is most representative of fair value. An example of a market approach is matrix pricing. This is a mathematical technique used primarily for the purpose of valuing debt securities without relying solely on quoted prices for the specific securities. Matrix pricing uses factors such as the stated interest rate, maturity, credit rating, and quoted prices of similar issues to develop the issue's current market yield.

Income approaches. Techniques classified as income approaches measure fair value based on current market expectations about future amounts (such as cash flows or net income) and discount them to an amount in measurement date dollars. Valuation techniques that follow an income approach include the Black-Scholes-Merton model (a closed-form model) and binomial or lattice models (an open-form model), which use present value techniques, as well as the multiperiod excess earnings method that is used in fair value measurements of certain intangible assets such as in-process research and development.

Cost approaches. Cost approaches are based on quantifying the amount required to replace an asset's remaining service capacity (i.e., the asset's current replacement cost). A valuation technique classified as a cost approach would measure the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence adjustments include factors for physical wear and tear, improvements to technology, and economic (external) obsolescence. Thus, obsolescence is a broader concept than financial statement depreciation which simply represents a cost allocation convention and is not intended to be used as a valuation technique.

Measurement considerations.

Initial recognition. When the reporting entity first acquires an asset or incurs (or assumes) a liability in an exchange transaction, the transaction price represents an entry price—the price paid to acquire the asset and the price received to assume the liability. Fair value measurements are based not on entry prices, but rather on exit prices; the price that would be received to sell the asset or paid to transfer the liability. While entry and exit prices differ conceptually, in many cases they may be identical and can be considered to represent fair value of the asset or liability at initial recognition. This is not always the case, however, and in assessing fair value at initial recognition, management is to consider transaction-specific factors and factors specific to the assets and/or liabilities that are being initially recognized. Examples of situations where transaction price is not representative of fair value at initial recognition include

1. Related-party transactions
2. Transactions occurring under duress such as a forced or liquidation transaction
3. The exchange transaction occurs in a market different from the principal or most advantageous market in which the reporting entity would sell the asset or transfer the liability. An example of this situation is when the reporting entity is a securities dealer that enters into transactions in different markets depending on whether the counterparty is a retail customer or another securities dealer.
4. Different units of account that apply to the transaction price and the assets/liabilities being measured. This can occur, for example, where the transaction price includes other elements besides the assets/liabilities that are being measured such as unstated rights and privileges that are subject to separate measurement or when the transaction price includes transaction costs (see discussion below).

Transaction costs. Transaction costs are the incremental direct costs that would be incurred to sell an asset or transfer a liability. While, as previously discussed, transaction costs are considered in determining the market that is most advantageous, they are not used to adjust the fair value measurement of the asset or liability being measured. FASB excluded them from the measurement because they do not represent an attribute of the asset or liability being measured.

Transportation costs. If an attribute of the asset or liability being measured is its location, the price determined in the principal or most advantageous market is to be adjusted for the costs that would be incurred by the reporting entity to transport it to or from that market.

Fair value disclosures mandated by FAS 157. Substantial disclosures regarding fair value are required by many different pronouncements that comprise authoritative US GAAP literature. In the preparation of the financial statements, these disclosures are often placed in different informative notes including descriptions of the entity's accounting policies, financial instruments, impairment, derivatives, pensions, revenue recognition, share-based compensation, risks and uncertainties, certain significant estimates, etc. FAS 157 requires additional quantitative and qualitative disclosures. FAS 157 encourages, but does not require management to combine its fair value disclosures with other required disclosures. In addition, FAS 157 encourages disclosure of information about other similar measurements that are not intended to represent fair value such as inventories measured at the lower of cost or market. FAS 157 uses a hybrid principles-based approach and rules-based approach to detailing the fair value disclosures it requires. It provides the following high-level disclosure objectives:

1. For assets and liabilities measured at fair value on a recurring basis subsequent to their initial recognition, management is to provide information that will enable financial statement users to assess the inputs used to develop those measurements and, further, for measurements using significant unobservable (Level 3) inputs, the effect of those measurements on earnings for the period.
2. For assets and liabilities measured at fair value on a nonrecurring basis subsequent to their initial recognition, management is to provide information that will enable financial statement users to assess the inputs used to develop those measurements.

To operationalize these objectives, FAS 157 provides the following required disclosures. The quantitative disclosures are required to be presented in a tabular format. Unless otherwise specified, the disclosures are required to be made in each interim and annual period.

Disclosures required to be made with respect to assets and liabilities measured at fair value on a recurring basis in periods subsequent to initial recognition. Disclose separately for each major category of assets and liabilities

1. The amount of the fair value measurements at the reporting date
2. The level within the fair value hierarchy in which the fair value measurements fall in their entirety; separately disclosing the amounts of fair value measurements that use quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
3. For those fair value measurements using significant unobservable (Level 3) inputs, a reconciliation of the beginning and ending balances, separately stating changes during the period attributable to

    a. Total realized and unrealized gains or losses for the period segregating those gains or losses included in income (or changes in net assets of a not-for-profit organization) and a description of where those gains or losses are reported in the statement of income (or statement of activities of a not-for-profit organization)

(1) The unrealized gains or losses included in this disclosure that relate to assets and liabilities still held at the end of the reporting period and
(2) A description of where, in the statement of income, those unrealized gains or losses are reported

b. Purchases, sales, issuances, and settlements (net)
c. Transfers in and/or out of Level 3 (e.g., due to changes in the observability of significant inputs)

Note that, for the purposes of this reconciliation, derivative assets and liabilities are permitted to be presented net.

4. In the first interim period of the fiscal year of adoption and subsequently in annual financial statements, the valuation techniques used to measure fair value and a discussion of changes in valuation techniques, if any, during the period

Disclosures required to be made with respect to assets and liabilities measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (such as impaired assets). Disclose separately for each major category of assets and liabilities

1. Fair value measurements recorded during the period and the reasons for the measurements
2. The level within the fair value hierarchy in which the fair value measurements fall in their entirety; separately disclosing the amounts of fair value measurements that use quoted prices in active markets for identical assets or liabilities (Leve1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
3. For fair value measurements using significant unobservable (Level 3) inputs, a description of the inputs and the information used to develop them
4. In the first interim period of the fiscal year of adoption and subsequently in annual financial statements, the valuation techniques used to measure fair value and discussion of changes in valuation techniques used to measure similar assets and/or liabilities in prior periods

APPENDIX G

IFRS FOR PRIVATE ENTITIES

A long-running debate, which had gathered considerable momentum over the past several years, may be headed for a resolution over the near term. This pertains to the movement to either develop a unique set of financial reporting standards for what many refer to as smaller and medium-sized entities (SMEs), or to extract from existing IFRS a slimmed-down set of requirements to be referenced by such reporting entities as their primary source of guidance. An antecedent for this can be found in UK GAAP, which in late 1997 developed as FRSSE (Financial Reporting Standards for Smaller Entities) a single standard containing excerpts from many, but not all, existing UK GAAP standards. (Revisions have been made to FRSSE, essentially updating the original pronouncement for certain new standards promulgated since its most recent full revision.) The argument took on added urgency when the "principles-based vs. rules-based" debate erupted, stimulated by the flurry of financial reporting frauds in the US in the late 1990s and early 2000s, which some IFRS enthusiasts cited as evidence for the proposition that detailed guidance based on a plethora of mechanical rules actually offered more, not less, opportunity for financial reporting shenanigans. The US standard-setting bodies, FASB and AICPA, subsequently undertook a SME project, as well.

The stimulus for this undertaking seems to center on the perceived complexity of modern financial accounting requirements, which some believe exceed the abilities of financial statement preparers and auditors to fully comprehend, and which arguably serve to make financial statements and accompanying footnote disclosures incomprehensible to both entity management and other, external users. In the authors' view, this is a highly debatable proposition, since it is not the unilateral actions by accounting rule makers but rather the ever-increasing complexity of business transactions that have, for the most part, necessitated the creation of newer and admittedly complex requirements. For one obvious example, the growing use, even by smaller businesses, of "engineered financial instruments" such as forwards and options (e.g., currency forwards used by importers of products to protect against currency fluctuations when purchase obligations are denominated in foreign currencies) has resulted in necessarily complex standards on hedging transactions. (Note that adoption of comprehensive fair value accounting would obviate the need for special hedge accounting, but post–Enron this once widely-stated goal seems to have become less attainable, politically.)

Other complex accounting standards have been the (some would say, unfortunate) result of standard setters' accession to preparers' demands for deferrals and various other smoothing techniques. A prime example: accounting for defined benefit pension and other post-retirement benefit programs. Were market-driven fluctuations in the values of investments, changes in interest rates, and revisions to actuarially determined amounts such as life expectancies fully and immediately reflected, pension accounting would be radically simplified, albeit still subject to estimations that are certain to change over time. The willingness of FASB, IASB and various other national standard setters to countenance various smoothing strategies has resulted in many complex standards—and, not coincidentally, late-blooming recriminations about the broader societal impacts such departures from reporting economic reality have caused or contributed to.

Nonetheless, a popular demand has arisen for "simplified" financial reporting, which often cites the fact that the vast majority of all reporting entities are not large or publicly held companies, suggesting that since most users of financial statements will be management and other "insiders" having access to such details as they may optionally desire to obtain, a stripped-down set of financial reporting rules should suffice, easing the task of preparing and auditing such financial reports. Similar efforts in past decades, often labeled as the debate between "Big GAAP" and "Little GAAP," have (with the exception of the FRSSE standard under UK GAAP) not been successful, since even advocates of differential standards have largely conceded that *recognition* and *measurement* standards cannot vary, if all preparers' financial statements are to be found "fairly presented." The differential disclosures that have been identified even by proponents of "Little GAAP" have been very few, indeed. In short, once it is acknowledged (as it seems destined to have to be) that recognition and measurement cannot logically vary based merely on the entity's size or its status as a private or public company, the effort largely devolves to a debate over the extent of required informative disclosures.

Before addressing the specifics of IASB's Private Entities (PE, formerly SME) project, there are a few final observations to make regarding the wisdom of differentiating accounting standards based upon some criterion concerning the preparers' size or the extent to which it is "publicly accountable" (i.e., reports to outsiders lacking the ability to obtain further information directly from management). In the authors' opinion, the only rational basis for differentiation of GAAP or IFRS is based on the economic transactions and activities engaged in by the reporting entities themselves.

If a reporting entity engages, say, in hedging activities, then the promulgated standards directing how such transactions are to be accounted for need to apply, whether the entity happens to have outside shareholders or not. Leaving aside the question of whether, say, IAS 39 is too complicated, or based on unsound principles (which matters should be addressed directly by revising or amending the standard), it may well be true, and appropriate, that a large, publicly held entity that does not engage in hedging activities could present less complex financial statements than a small, private company that does engage in such activities.

There should be one single set of high-quality global financial reporting standards, and companies should not be permitted choices in selecting their financial reporting standards. The primary objective of the IASB, as set out in its *Constitution* and in the *Preface to International Financial Reporting Standards*, is "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards…" The word "single" implies that the IASB's proposal on PEs conflicts with its constitution. An unfortunate consequence of this approach is that some IASB constitutions may defend the need for another accounting treatment in their particular circumstances, as occurred with European banking interests with regard to IAS 39. If, in addition, PEs are permitted to choose to follow PE standards or IFRS or a combination of the two, this may result in PE financial statements that are not comparable to those of non-PEs and possibly not even comparable to other PEs, potentially impairing the usefulness of financial information.

Furthermore, the parallel existence of what will be widely viewed as two sets of financial reporting standards will contribute to the creation of a two-tiered accounting profession, with some practitioners seen as being qualified for PEs but not for "real" IFRS. This could even have impacts on the educational system, perhaps with an abbreviated course of study for those who will become qualified for the PE level of work, versus a longer program for those aspiring to be expert at "full" IFRS. The problem with this is that it will artificially isolate some, probably smaller, practitioners, who may come to find their credibility (say, with bankers) has become attenuated as a result.

The possibly most deleterious consequence, although likely the least obvious one, will be the higher cost of capital to be borne by smaller entities—those using "second class" IFRS and being audited or reviewed by "second tier" accountants. Cost of capital (bank loans, trade credit, equity infusions) reflects the perceived riskiness of the investment, which in turn is directly impacted by the quality of information made available to investors and creditors.

The poorer or more incomplete such information is, the higher the perceived risk and hence the higher the cost of capital, which diminishes the expected residual return to the owners. In short, the capital markets will punish companies that opt for less than "full" IFRS, even as (according to the standard setters' survey data) they support the abstract idea of "simplified GAAP."

In the authors' view, this is an unnecessary and ill-advised risk. To the extent that promulgated IFRS (or national GAAP) is wrong, fix it. To the extent that preparers struggle with complex rules, independent accountants should help them gain the needed understanding. If lenders and other users of the financial statements cannot cope with the increasing profusion of complex standards, then perhaps the education system is inadequate to the task, or a more rigorous set of requirements for the continuing education of practicing professionals needs imposition. None of these symptoms, however, necessarily imply that certain standards are inappropriate for *certain* classes of preparers.

With this background in mind, and with the authors' view clearly stated, however, note that standard setters (both in the US and the IASB) seem determined, this time, to produce a stand-alone standard (or compendium of rules) that would appease advocates for simplified GAAP or IFRS. The goal appears to be to at least eliminate some, perhaps much, of the verbiage now found in the full text of existing standards, perhaps also dropping examples and other less essential guidance, so that at least the aura of responsiveness to a perceived public demand can be created. This may be as much a "political" undertaking as a technical one, but given the precarious position of the private-sector standard setters—particularly in the US, where the quasi-official but nominally private Public Company Accounting Oversight Board (PCAOB), established under mandate of the Sarbanes-Oxley Act (which itself was a response to the shocking epidemic of financial reporting frauds largely, but not entirely, committed by US-based publicly held companies) could expand its mandate to set accounting, as well as auditing, standards—it is understandable.

It seems that there is significant support by accounting standard setters and preparers of financial statements around the world for a separate set of internationally accepted accounting standards for PEs, giving consideration to the different needs of users and costs of compliance faced by these entities. This support stems from the fact that in most countries in the world, unlike the US, all or most companies are legally required to prepare financial statements that conform to accounting principles that are generally accepted in their home country (national GAAP), and the vast majority of those companies are PEs. For instance, the Accounting Law and *plan compatible* in France apply to financial statements of all legal entities, including PEs. We note that significant differences exist in the regulation of financial reporting in the US and in IASB countries. In the US, market forces influence private company financial reporting in response to user needs and cost-benefit trade-offs. Since in several IASB countries market forces are restricted, a separate set of IASB Standards may appear to be justified.

On a more positive note, in the EU, IASB Standards are now required for consolidated financial statements of approximately 7,000 listed companies, while more than 7,000,000 unlisted PEs will most likely continue to follow diverse national standards, based on the EU's directives, at least for the near term. Thus, there may not be a satisfactory level of comparability across national boundaries, or even within a country. Within the EU, PEs have considerable economic significance. Thus a set of global standards for PEs could ease the transition to a full set of financial reporting requirements for entities that are growing and wish to enter the public capital markets as well as play an important role with respect to developing countries, in helping them attract foreign investment. These countries, often with limited accountancy resources, have numerous PEs and special difficulty in applying the full set of IFRS. Consequently, this PE project may prove to be important politically for the acceptance of IASB around the world.

The IASB PE effort actually began as early as 2001. As de facto standard setter for many developing nations, some of which have fewer cadres of trained accountants and thus, perhaps, greater challenges in implementing the more complex standards, it was sensitive to charges that its rules were more responsive to needs of the more industrialized and developed nations, which (before the recent surge of interest in *converging* national GAAP with IFRS) in fact were not the major users of IFRS. Following the lead of the UK standard setter, the initial, albeit short-lived, stated objective was to develop standards for small and medium-sized entities. Currently, the objectives of the PE project, as stated by the IASB, include the development of high-quality, understandable and enforceable accounting standards suitable for PEs globally, to reduce the financial reporting burden on PEs that want to use global standards, and meet the needs of users of PE financial statements. As early as 2003, the IASB agreed to a four-step plan to

1. Extract from all existing IFRS and Interpretations the *basic principles* in those standards. Given the then-practice of setting forth major principles in "black letter" (i.e., bold-face) text, with explanatory materials in "grey letter" (nonbold) text, it would have been rather simple to thus excerpt the principles in the "black letter" paragraphs of those standards, plus key elements of the *Framework*, plus some principles in IASB and IFRIC EDs that were not yet finalized.
2. Reorganize those excerpts topically (perhaps in financial statement order) if it was concluded that this would make the presentation of the principles more user friendly.
3. Review those for principles or guidance that had been omitted in the original extraction but that, on review, might be deemed to be essential to operationalize the standards for PEs, and add those to the principles already extracted.
4. Review the results with a view to identifying helpful simplifications for PEs, and then present those potential simplifications to an Advisory Group and the IASB for deliberation.

This action plan quickly ran up against the reality of the fact that even a superficially simple goal of assisting "small" businesses would have to address the difficulty of defining "small" and "medium"—and that even if this could be done, it could not be presumed that such entities were not engaging in relatively complex economic transactions. It short order, IASB concluded that a size-based test was not advisable, and that another threshold criterion would be preferable. The fact of "public accountability" by the reporting entity was seen as being a more meaningful distinction, where public accountability soon was defined, subject to determinations ultimately to be made by national regulatory authorities, in terms such as public stock ownership and plans to "go public" in the near term. It was also concluded in 2003 that no changes would be made to recognition or measurement concepts established by the full set of IFRS.

As work progressed, it soon evolved that the ultimate PE version of IFRS would incorporate some, but not all, of the fundamental requirements of IFRS, with a prescription that financial statement preparers using the new standard would, in the absence of complete guidance in the new PE standard, be required to look to standard ("full") IFRS for direction. In other words, the PE version of IFRS would hopefully contain enough guidance for many, perhaps most, of the reporting entities meeting the to-be-developed qualifications for its use (i.e., those not having "public accountability"), but if such preparers were engaged in economic activities of greater complexity, they would have to refer to the original standards and be bound to comply with them. The PE guidance could thus be seen as providing a handy compendium, but not as a distinct set of financial reporting rules.

IASB later expanded on the concept of "public accountability" as follows:

The "public accountability" principle implies that an entity is publicly accountable if

1. There is a high degree of outside interest in the entity, from investors or other stakeholders;
2. The entity may have a social responsibility because of the nature of its operations; and
3. The substantial majority of stakeholders depend on external financial reporting, as they have no other way of obtaining financial information about the entity.

IASB also agreed to adopt presumptive indicators of public accountability. A business entity would be regarded as having public accountability if it meets any one of the following criteria:

1. It has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.
2. It holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities brokerage, pension fund, mutual fund, or investment banking entity.
3. It is a public utility or similar entity that provides an essential public service.
4. It is of economic significance in the jurisdiction in which it is domiciled.
5. One or more of its owners has expressed objection to the entity's decision to use PE standards rather than full IFRSs (all owners, including those not otherwise entitled to vote, having been informed of that decision).

It is interesting to note that IASB discussed a number of possible situations where PE requirements could have been "simplified" versus full IFRS. For example, it considered the alternative classification of expenses permitted in the statement of comprehensive income, the optional use of classified or nonclassified statements of financial position, and the provision of illustrative examples, all found in the original IFRS, and determined that all these attributes were to be preserved in the PE version. IASB was apparently discovering, as had others before it, that actual differentiation of PE from full-blown standards is more difficult to achieve than is apparent when first embracing the concept of "slimmed down" guidance.

In 2004 IASB published a Discussion Paper on the Board's Preliminary Views on Accounting Standards for Small and Medium-Sized Entities. The Discussion Paper focused on issues relating to IASB's approach to the project, but did not include proposals for specific financial reporting standards for PEs, which were promised for a later discussion document. Among other basic concepts this document set forth, it stated that a subsidiary, joint venture, or associate of a publicly accountable entity should use full IFRS in any stand-alone financial reporting it engaged in, as well.

Subsequently, IASB addressed the possible PE versions of a number of standards, and it was clearly established that these would exclude many details, and that users would be directed back to the underlying standards for further guidance, should they encounter the need for such. For example, the PE version of IAS 16 was to exclude discussion of the revaluation model, which would, nevertheless, be available to PE adherents, who would have to refer to IAS 16 itself for instructions. Likewise, the PE version of IAS 23 would permit either interest capitalization (where warranted) or immediate expensing, but would only discuss expensing, with readers directed to the parent standard for guidance on capitalization. (This has probably been rendered moot by the 2007 revision to IAS 23, which made capitalization of borrowing costs, under defined circumstances, mandatory.)

Despite earlier rejection of differential recognition or measurement, in April 2005, IASB published a staff questionnaire on possible modifications of the recognition and measurement principles in IFRS for use in IASB standards for small and medium-sized entities. To date, however, the idea of differentiating recognition or measurement has not gained traction, and almost all attention has been directed at disclosures and, especially, at the level of detail to be included in a compendium of standards for PEs.

IASB claims there is wide support for it to issue global PE standards, and indeed wide support for simplifications apart from those affecting recognition and measurement (e.g., eliminating difficult options, scope exceptions that require calculations or complex judgments, and eliminating guidance not relevant to PEs). IASB has also found wide support for recognition and measurement simplifications, but posing difficulties is the fact that different constituents support different recognition and measurements simplifications, for a variety of different reasons. These likely are irreconcilable and, in any event, of dubious validity.

On February 15, 2006, the International Accounting Standards Board (IASB) issued for public comment the Exposure Draft of its International Financial Reporting Standard (IFRS) for Small and Medium-Sized Entities (SME, now renamed Private Entities, or PE). The stated aim of the proposed standard is to provide a simplified, self-contained set of accounting principles derived from the full IFRS to be used by smaller, nonlisted companies. If this proposal is adopted, as appears quite likely as of late 2008, the full IFRS would become primarily of interest for listed companies, although PEs could make reference to the more expansive set of standards as necessary or desirable.

The perceived need for a stand-alone set of simplified standards has become increasingly manifest in recent years, and FASB is also weighing development of such a streamlined group of financial reporting requirements. This latest development follows by about a decade a similar undertaking in the United Kingdom, where Financial Reporting Standards for Smaller Entities (FRSSE) have been successfully implemented. The IASB changed the name of the standard to IFRS for Private Entities in May 2008 as part of its redeliberations replacing "small and medium-sized entities" with "private entities" in order to more accurately describe the target preparers.

The support for the IASB's project from national accounting standards setters throughout the world stems mostly from the widely perceived complexity of the full IFRS, and from the different statutory requirements for financial reporting in many countries, compared to the United States. The complexity of the full IFRS (or, for that matter, full US GAAP) imposes a high cost of implementing and applying these standards. In addition, in most countries, in contrast with the United States, PEs are legally required to file statutory financial statements prepared in accordance with national GAAP, and to make them available to all users. For example, in the European Union about 7,000 listed companies were implementing the IFRS in 2005, but more than 5 million PEs have to prepare their financial statements in accordance with national GAAP (resulting in a lack of comparability). Additionally, many believe that the IFRS for PEs would allow companies as well as countries an easier transition to the full IFRS.

Some commentators do not support the approach taken in the development of the IFRS for PEs. They argue that, rather than simply streamlining existing standards, the IASB should have taken a user-based, more conceptual approach in creating "differential accounting" for PEs. They insist that fundamental differences exist between the objectives of financial reporting for PEs (being primarily focused on the role of stewardship) and those of reporting by large public companies, and that these differences should be incorporated into the conceptual framework. The ultimate success of the IFRS for PEs will depend on the extent to which users, preparers, and their auditors believe the standards meet their needs.

Opponents of a separate set of standards for PEs believe that all entities should follow the same basic accounting principles for the preparation of general-purpose financial statements, whether the IFRS or US GAAP. Some have noted that complexity in accounting is merely a symptom—the inevitable result of the ever-increasing complexity of transactional structures, such as the widespread use of "engineered" financial products. Based on observations of the difficulties faced by companies implementing and applying the full IFRS, others have concluded that the problem is not that PEs need simpler accounting, but that all entities need reporting requirements that are less complex and more principles-based. In addition, some opponents note that PE standards would adversely affect accounting education, by shifting the focus from preparing professionals to choose the best means of reporting the economic effects of any given transaction or event, to merely following what the "single solution" rulebook says. A worst-case scenario result would be a two-tiered accounting profession, wherein some practitioners would be seen as capable of handling only "little GAAP" assignments. Because the IASB lacks the power to require any company to use its standards, the adoption of the IFRS for PEs will be a matter for each country to decide; that is, a country's government legislators and regulators, an independent standards setter, or a professional accountancy body. Each country will have to set criteria to determine eligibility.

Definition of PEs. After debate over the appropriate threshold criteria, the IASB determined that the proposed standard should be intended for entities that do not have public accountability. An entity has public accountability—and therefore should use the full IFRS—if it meets the following conditions:

1. It has issued debt or equity securities in a public market; or
2. It holds assets in a fiduciary capacity for a broad group of outsiders.

The latter category of entity would include banks, insurance companies, securities broker/dealers, pension funds, mutual funds, and investment banks. The proposed standard does not impose a size test in defining PEs, notwithstanding the nomenclature used.

Modifications of full IFRS. Compared to the full IFRS, the length of this proposed standard has been reduced by more than 85%. This was achieved by eliminating topics deemed to be not generally relevant to PEs, by eliminating certain choices of accounting treatments, and by simplifying methods for recognition and measurement. These three sets of modifications to the content of the full IFRS, discussed below, respond to both the needs of users of PEs' financial statements and to cost-benefit concerns. According to the IASB, the set of standards in the proposed IFRS for PEs would be suitable for a typical entity having fifty employees, but would also be valid for so-called microentities having only a single employee or a few employees.

Omitted topics. Certain topics covered in the full IFRS were viewed as not relevant to typical PEs (e.g., pertaining to transactions thought unlikely to occur in an PE context), and have been omitted in the Exposure Draft. Because PEs would have the option of applying a cross-reference to the relevant IFRS if needed, PEs would not be precluded from applying any of the financial reporting standards and methods currently found in the IFRS. In other words, use of the IFRS for PEs would effectively be optional.

Topics addressed in the full IFRS that are omitted from the proposed IFRS for PEs, with cross-references to the full IFRSs if needed, are as follows:

- General price-level-adjusted reporting in hyperinflationary environment;
- Equity-settled share-based payment;
- Determining the fair value of agricultural assets;

- Extractive industries;
- Interim reporting;
- Lessor accounting finance leases (finance lessors are likely to be financial institutions, which would be ineligible to use the IFRS for PEs);
- Recoverable amount of goodwill (PEs would test goodwill for impairment much less frequently, but if a PE is required to perform such a test it must follow IAS 38, *Intangible Assets*); and
- Earnings per share, segment reporting, and insurance contracts (insurers would not be eligible to use the IFRS for PEs, because they hold assets in a fiduciary capacity for a broad group of outsiders).

Inclusion of only the simpler option. Where the full IFRS provides an accounting policy choice, only the simpler option is included in the IFRS for PEs. PEs would be permitted to use the other options, obtaining needed guidance by cross-reference to the relevant IFRS. Because most of the underlying principles incorporated into the full IFRS would be retained, the same interpretation and application issues are likely to arise when applying these standards.

The simpler options selected for inclusion in the IFRS for PEs are as follows:

- The cost-depreciation model for investment property (fair value through profit or loss is permitted by reference to IAS 40, *Investment Property*).
- The cost-amortization-impairment model for property, plant, equipment, and intangibles (the revaluation model is allowed by references to IAS 16, *Property, Plant and Equipment;* and IAS 38*, Intangible Assets*).
- Expensing of borrowing costs (capitalization allowed by reference to IAS 23, *Borrowing Costs*). Note that this may have been made inapplicable by the late 2007 revision to IAS 23, making capitalization of qualifying borrowing costs mandatory.
- The indirect method for reporting operating cash flows (the direct method permitted via reference to IAS 7, *Statement of Cash Flows*).
- One method (based on that set forth under IAS 41) of accounting for all government grants (the use any of the alternatives in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* is allowed).

Note that, even if this draft standard is adopted, it would remain up to each jurisdiction to mandate what financial reporting methods would be permitted. Thus, in adopting the IFRS for PEs, an individual jurisdiction could decide to proscribe an option that is cross-referenced in the full IFRS.

Recognition and measurement simplifications. The IASB proposed significant simplifications to the recognition and measurement principles included in the full IFRS. This area is perhaps the most controversial aspect of the proposal, because earlier attempts at simplification (e.g., omitting earnings per share and segment data for private reporting entities under both the IASB and FASB standards) have been directed only at differential disclosures.

Examples of the proposed simplifications to the recognition and measurement principles found in the IFRS are as follows:

- Financial instruments.
- Classification of financial instruments. Only two categories of financial assets are provided, rather than the four found in the full IFRS. Because available-for-sale and held-to-maturity classifications under IAS 39 would not be available, there would be no need to deal with all of the "intent-driven" held-to-maturity rules or related "taint-

ing" concerns, and no need for an available-for-sale option, among other simplifications.

- Derecognition. In general, the principle to be applied would be that, if the transferor has any significant continuing involvement, derecognition would not be permitted. The IASB believes that the complex "pass-through testing" and "control retention testing" of IAS 39, *Financial Instruments: Recognition and Measurement,* relate to transactions in which PEs are typically not engaged, and thus can be omitted.
- Simplified hedge accounting. The Exposure Draft includes simplified hedge accounting and less strict requirements for periodic recognition and measurement of hedge effectiveness than IAS 39.
- Goodwill impairment. An indicator approach would supersede the mandatory annual impairment calculations in IFRS 3, *Business Combinations.*
- R&D. All research and development costs would be expensed as incurred. IAS 38 requires capitalization after commercial viability has been assessed.
- Joint ventures. The cost method of accounting for associates and joint ventures would be used, rather than the equity method or proportionate consolidation.
- Simplified accounting for deferred taxes. The "temporary difference approach" for recognition of deferred taxes under IAS 12, *Income Taxes,* is proposed.
- Agriculture. The Exposure Draft would not require the use of fair value for agriculture unless it were readily determinable without undue cost or effort.
- Defined benefit plans. Only one option of the four available under IAS 19, *Employee Benefits,* would be used: the recognition of actuarial gains and losses in full in the profit and loss statement when they occur. The complex "corridor approach" would be omitted.
- Share-based payment. The intrinsic value method is prescribed.
- Finance leases. Simplified measurement of a lessee's rights and obligations.
- First-time adoption. Less prior-period data would have to be restated than under the IFRS 1, *First-Time Adoption of International Financial Reporting Standards.*

Because under the IFRS for PEs draft, the proposed default accounting treatment for financial instruments would be fair value through the statement of income, some users of PE standards might actually be required to apply more fair-value measurements than those reporting under the full IFRS.

Other issues. In addition to the explanations of PE reporting requirements in the body of the Exposure Draft, disclosure requirements have been comprehensively set forth in the Draft Implementation Guidance: Illustrative Financial Statements and Disclosure Checklist.

PEs have expressed concerns not only over the complexity of the IFRS, but also about the frequency of changes to standards. To respond to these issues, the IASB intends to update the IFRS for PEs approximately once every two years via an omnibus standard. Users are thus being assured of having a moderately stable platform of requirements.

The ED posed 12 questions and invited comments to be submitted to the IASB in writing. During the exposure period, the IASB conducted roundtable meetings with PEs and small firms of auditors to discuss the proposals. It also conducted field tests and field visits on the proposals in the Exposure Draft. Enactment of the standard is now expected in early or mid-2009.

Implications of IFRS for PEs. The Exposure Draft of IFRS for PEs is a significant development that may have a real impact on the future accounting and auditing standards issued by organizations participating in the standards-setting process.

In early 2007, FASB and the AICPA announced that a newly established Private Company Financial Reporting Committee (PCFRC) will address the financial reporting needs of private companies and the users of their financial statements. The primary objective of the PCFRC will be to help FASB determine whether and where there should be specific differences in prospective and existing accounting standards for private companies.

The International Federation of Accountants (IFAC) strongly supports the IASB's project on PEs. The IFAC board has agreed to assist the IASB in obtaining feedback on its proposed IFRS for PEs through field testing and other means. The Australian Accounting Standards Board (AASB), the Institute of Certified Public Accountants of Ireland, and the UK Accounting Standards Board have strongly supported the IASB publication of the Exposure Draft on the IFRS for PEs. The AASB tentatively decided that Australia should adopt a two-tiered approach in relation to Australian corporate entities, as follows:

- Australian equivalents to the IFRS will be required for corporations that are publicly accountable; and
- An Australian version of the IFRS for PEs will be adopted by corporations that are not publicly accountable but that prepare general-purpose financial reports. In many European countries, a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of PE standards would require breaking the mandatory link between the financial statements and the income tax return, and would also trigger a need to amend the country's applicable law.

Because it is imperative that international convergence of accounting standards be accompanied by international convergence of audit standards, differential accounting for PEs would affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the SEC. The success of the IFRS for PEs will depend on the extent to which users, preparers, and their auditors believe the standards meet their needs.