

## U.S. Incorporation of IFRS Is a National Imperative

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### Overview.

This afternoon, I am going to explain what I see as the compelling need for the SEC to make a firm, affirmative IFRS incorporation decision in the next period of months. I have titled my remarks: “U.S. Incorporation of IFRS Is a National Imperative.”

The words “National Imperative” are not hyperbole. This is a critical moment. The future path of financial reporting - - and of investor protection and effective financial markets on a global scale - - may well be determined in the next few months. In my time as General Counsel of the SEC (1998-99), I heard Chairman Arthur Levitt say many times: “I never thought that I would be passionate about accounting, but I am.” Somewhat to my surprise, I am passionate too.

If all goes well, accounting standards provide unbiased and transparent information about the economic performance and financial condition of business entities. This information is, of course, of great importance to investors and other market participants. The Trustees of the IFRS Foundation recently concluded: “The confidence of all users of financial statements in the transparency and

integrity of financial reporting is critically important in the effective functioning of capital markets....”<sup>1</sup>

I will analyze at some length this afternoon why the goal of a single set of high quality global accounting standards - - which realistically can only be IFRS standards - - is so important, and why it has been endorsed several times by the U.S. government and the G-20. But I must emphasize, in this area it is the SEC, a proud independent agency, and not the Treasury or White House, that truly counts. The SEC’s incorporation decision is the key to the future. As is already obvious, I am now urging my favorite Commission to act affirmatively and soon.

Let me stop here for a moment to indicate what your program discloses. I am not an entirely unbiased observer; I am one of 22 global Trustees of the IFRS Foundation. Today, particularly if I say something with which my Trustee colleagues disagree, I am speaking only for myself. (And I thought that I was done with disclaimers when I left Washington in 2005.)

I expect to speak for about 30 minutes. That should leave plenty of time for questions or comments from all of you.

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<sup>1</sup> Trustees Strategy Review, IFRSs as the Global Standard: Setting a Strategy for the Foundation’s Second Decade 3 (July 25, 2011).

## Two Basic Accounting Standard Lessons to be Learned from the Financial Crisis.

Everyone here understands that the quality and integrity of accounting standards can make a large difference. The Financial Crisis Advisory Group, which I had the great pleasure of co-chairing with Hans Hoogervorst in 2008 and 2009, concluded: “it seems clear that accounting standards were not a root cause of the financial crisis.”<sup>2</sup> This is accurate. But the first lesson to be learned from the financial crisis is that weak or inadequate standards (e.g., pre-crisis U.S. GAAP standards on off-balance sheet financial structures) can do real harm. We must avoid weak, non-transparent standards and eliminate opportunities for regulatory arbitrage.

The second lesson flows from the first. Too often during the financial crisis, and more recently, we have witnessed the danger of arbitrage and unhealthy political interference when the two systems, IFRS and U.S. GAAP, can be played off against each other. Cries of “level playing field” and “unfair competition” (e.g., with respect to financial instruments and fair value reporting) have been used to try to weaken both systems. The lesson to be learned is that incorporation of IFRS into U.S. GAAP - - so that we have only one set of high quality global standards - - will, as the G-20 implicitly recognized, largely eliminate the arbitrage problem.

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<sup>2</sup> Report of the Financial Crisis Advisory Group 3 (July 28, 2009).

## The Key Advantages of Incorporation and Cost Issues.

What are the advantages of U.S. incorporation of IFRS? First, the avoidance of regulatory arbitrage opportunities. Second, for U.S. public corporations, IFRS incorporation would enhance their attractiveness to foreign investors, lower their capital costs, and reduce their long-run accounting costs. Moreover, as Hans Hoogervorst just indicated, incorporation will allow Ford and other large public corporations to efficiently “use the same financial reporting language for both internal management reporting and external financial reporting on a worldwide consolidated basis.” Third, for U.S. investors, one set of high quality global standards will increase transparency, reduce analytical costs, make them less vulnerable to fraud and manipulation, and increase global investment opportunities.

What about the cost of an affirmative SEC incorporation decision? The largest concern I have heard from the U.S. business community is that Dodd-Frank implementation, and other changes caused by the financial crisis and the current economic downturn, “make 2011 and 2012 the wrong years to create new burdens.”

The basic answer to this concern is that an SEC decision to commit to IFRS in the coming months will not be disruptive. The effective date - - when IFRS would be required for the largest U.S. public corporations - - will not come until

2016, at the earliest. (An even later date, in my view, makes sense for small public corporations.) The year 2016 or 2017, for large public corporations, would provide ample time for planning, education, training, and retooling. The SEC is already used to reviewing IFRS filings, which now come from foreign private issuers.

It is an unambiguous SEC commitment to incorporation that is essential in the coming months. That would create the certainty and incentives for our large issuers, investment analysts, accounting firms, and business schools to be ready by a year like 2016.

There will, of course, be transition costs. But, as opposed to continuing year-by-year advantages, transition costs will come during a limited period. Moreover, the IASB and the FASB have already done much to reduce transition difficulties and costs by narrowing differences between the two systems in their convergence projects. I look forward to hearing reports about this Conference's session Friday on what I think has been the relatively smooth recent transitions to IFRS in Canada and Brazil.

Moreover, the SEC, in its planning, has prudently focused on minimizing disruption and cost. The SEC Staff Paper, titled "Exploring a Possible Method of Incorporation," dated May 26, 2011, sets forth a phased approach to adoption of IFRS through an incorporation mechanism. The SEC's framework is realistic and sound. Basically, if I understand the approach correctly, existing IASB/FASB

converged standards would be incorporated into U.S. GAAP. Not yet completed convergence projects (e.g., leasing and revenue recognition) would be completed and incorporated. FASB would stop writing new standards to prevent confusion and divergence. FASB, which would continue to play a critical role as the U.S. national standard setter, would endorse and incorporate remaining, non-converged IFRS standards over five to seven years. Similarly, FASB would continuously evaluate and endorse new IFRS standards. As a result of this process, U.S. public corporations would be complying with both U.S. GAAP and IFRS.

#### Impact of IFRS Adoption on Effective Enforcement and Litigation Exposure.

Would there be effective enforcement if the U.S. adopted IFRS? The short answer is “yes.” Put bluntly, the rigor of U.S. enforcement fundamentally pivots on the leadership at the SEC.

It is now clear to me that principles (with enough specificity to create comparability) can be better applied and enforced than detailed rules with bright lines and multiple exceptions. The modern principle-based approach has been incorporated into IASB/FASB converged standards. It is much harder to defeat - - by financial engineering - - a well-crafted principle than a detailed, specific rule. The last two decades have taught us that financial types find it much too easy to manipulate and structure their ways around “hard and fast” rules.

Please note that even if the U.S. fully incorporates IFRS, it will not lead to perfect worldwide comparability. Auditing standards and enforcement approaches in some nations will not be of the same quality, for some time, as in the U.S. But this quality difference is a limited problem, and in fact, may be a U.S. comparative advantage. The relatively high quality of our auditing standards and enforcement, for example, have reassured investors everywhere and have historically helped create a roughly 15% premium in value for foreign issuers that have listed here.

If the U.S. commits to IFRS incorporation (followed, as seems likely, by Japan, China, and India), a common global financial language would be established. Remember, in what has been a remarkable success story over the past decade, over 100 nations now use IFRS standards. Great, not perfect, global comparability would occur if the U.S. commits to IFRS.

It is true that incorporation of IFRS principle-based standards would require more judgment than has been required in the past. But under Section 10(b) of the Securities Exchange Act of 1934, and other key securities laws, there is plenty of room to reach improper judgments (e.g., when they constitute “extreme departures from standards of ordinary care”), and as importantly, to limit unfair, counterproductive litigation exposure.

A recent (late August 2011) decision by the Second Circuit Court of Appeals, in New York, demonstrates that judgment issues will be sensibly handled

in U.S. courts. In the Fait case,<sup>3</sup> accounting judgments about goodwill and loan loss reserves were challenged by a plaintiff class. The Second Circuit, following much precedent and a classic Supreme Court case,<sup>4</sup> summarily dismissed the claims because to be vulnerable the judgments had to be more than incorrect; they had to be disbelieved by defendants at the time they were made. Plaintiffs' allegations in the case contained inadequate evidence of such disbelief.

### Safeguards Against U.S. Stakeholders Being Neglected or Inadequately Represented.

There are three basic safeguards in the IFRS system that will prevent U.S. interests from being inadequately considered.

1. The Three-Tier Governance Structure. The IFRS three-tier governance model is similar to the process in the U.S. involving FASB, the Financial Accounting Foundation (FAF), and the SEC. This is no accident; Paul Volcker and Arthur Levitt played large roles in shaping the IFRS governing model.

- a. The International Accounting Standards Board, with 15 current members, is the independent, expert standard setting body. During the IASB's first 10 years, it was led by Sir David Tweedie and now by Hans

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<sup>3</sup> Fait v. Regions Financial Corp., \_\_\_ F.3d \_\_\_ (2d Cir. 2011).

<sup>4</sup> See, e.g., Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991); Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124 (2d. Cir. 1994).

Hoogervorst, who just addressed you. These are two extraordinarily talented, decent, and wise men.

b. The Trustees of the IFRS Foundation basically oversee the work of the Board. Trustees are appointed for a term of three years and may be renewed for a second term. There are 22 Trustees in all: 6 from Asia/Oceania; 6 from North America (including 5 from the U.S.); 6 from Europe; 1 from Africa; 1 from South America; 2 from the rest of the world. Trustees, and this is critical for you to understand, are not involved in the technical content of IFRS standards. Substantive technical decisions are solely for the Board.

c. Since 2009, a Monitoring Board made up of 5 securities regulators (which is likely to be expanded soon) - - including Mary Schapiro - - has provided a public accountability mechanism. The basic idea is to balance the need for public accountability and for the independence of the standard setting process. The appointment of only securities regulators to the Monitoring Board represents a determination that transparency, integrity, and investor protection must be the core values of the standard setting process. The faithful presentation of an entity's financial position and performance - - for investors and other users - - is the driving force.

The Monitoring Board participates in the nominating process and approves Trustees. It reviews financing arrangements, the quality of Trustee oversight of the IASB (especially with respect to due process), and similar matters.

2 Due Process. David Sidwell, a U.S. Trustee and Chair of the Trustees' Due Process Oversight Committee (DPOC), recently observed:

“At the heart of reassuring the world that the IASB is acting in a proper manner at all times is the IASB’s due process....”<sup>5</sup>

The IASB’s existing due process system has been recognized as “best practice” throughout the standard setting and regulatory worlds. Yet some stakeholders in the U.S., and elsewhere, are skeptical and worry about their views being heard. The Trustees are now in the process of approving a protocol to assure the most demanding due process compliance throughout a project’s life-cycle - - i.e., from the placement of a matter on the Board’s agenda through the issuance of a standard. The protocol contemplates: considerably enhanced outreach; more transparency throughout the standard setting process; a larger role for the IFRS Advisory Council, the IFRS Interpretations Committee, and national standard setters; more stringent cost-benefit analysis (called “effects analysis”); and post-implementation reviews of the effectiveness of a standard. U.S. stakeholders should be greatly comforted by this new emphasis on due process and by the roles

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<sup>5</sup> Robert Bruce interview with David Sidwell, [www.ifrs.org](http://www.ifrs.org).

that FASB, as the U.S. national standard setter, and the SEC would continue to play.

3. Roles of FASB and the SEC. Consistent with what occurs in most other nations, under the approach of the SEC Staff Paper of May, 2011, FASB would have to evaluate and endorse an IFRS standard before it becomes part of U.S. GAAP. Given the size and importance of the U.S. financial markets, this would give FASB the ability to influence the development of IFRS standards throughout a standard's life-cycle. The trick, if I can be blunt, would be for FASB to use its endorsement power to protect U.S. interests, when consulting with and advising the IASB, but when a standard is finalized by the IASB, to endorse it except in the most "rare" and "unusual circumstances." These are words wisely used in the SEC Staff Paper. For global comparability and other reasons, there is an enormous advantage to avoiding separate, unique national standards or carve outs of any type.

Under the framework established in the SEC Staff Paper, the Commission would retain its ultimate authority, under the securities laws, to protect investors and prescribe accounting standards. The SEC would be actively involved in the international process, and as the SEC Staff Paper puts it, "monitoring of the standard-setting process, including the FASB's role in the process, would be vital."

## The Dark Side.

What if the SEC fails to commit to incorporation in the next period of months or simply says “no”? I see two basic scenarios; one would be bad for the U.S. and the other far worse. My two basic scenarios represent my most honest belief of what I think would happen - - not, I should emphasize, any kind of threat. I cannot, however, hide my belief that a U.S. failure to move forward on IFRS standards would be a tragic mistake.

In my first scenario, the coalition of nations supporting IFRS would break apart. Rather than two sets of accounting standards, IFRS and U.S. GAAP, we would have a number of regional GAAPs, or we would go back to pre-2000 fragmentation. At a minimum, a number of national or regional accounting systems would exist. The cost of fragmentation, in terms of lack of transparency and comparability, higher accounting expenses, inefficiency, etc., would be extremely large.

The second scenario is far worse from a U.S. perspective. The coalition in support of IFRS would hold together, and the U.S. would become isolated in this area. There would be few, if any, U.S. members of the International Accounting Standards Board or U.S. Trustees. The SEC would be removed from the Monitoring Board. The U.S. would no longer play the large and constructive role it now plays in IFRS development and oversight.

I believe that without active U.S. participation the overall quality of the international accounting standards would deteriorate. Remember, there is less concern about transparency and investor protection in some other parts of the world.

I also believe that the U.S. could not remain out of a global system forever. In a year like 2020 or 2030, the U.S. would be forced to adopt international accounting standards, but I predict, it would be adopting weaker IFRS standards than now exist. The U.S. would then - - as opposed to now - - have only a very small seat at IFRS drafting and governance tables.

#### Conclusion.

As is obvious, I believe that the best way to protect U.S. stakeholders - - including investors who are increasingly investing globally - - is for the SEC to make an affirmative incorporation decision. Both IFRS and U.S. GAAP now have strengths and weaknesses. A widely shared view is that both are of high quality. But only one - - IFRS - - has the prospect of global acceptance. The U.S. remaining an integral part of the IFRS process will go far toward assuring the continued high quality of international standards. This is what both U.S. and global investors truly need.

The SEC is expected to make its fateful IFRS incorporation decision in the next period of months. The Commission is still accepting comments on the SEC Staff Paper. This may be the last chance for any of you who haven't communicated with the Commission to urge an affirmative incorporation decision. Such support, in a complex Washington climate, could prove decisive. Let me end where I began: U.S. incorporation of IFRS - - in the near future - - is very much "a National Imperative."