

INDUSTRY NEWS

SEC Adopts Financial Statement Rule Changes for FPIs and Redefines “Smaller Reporting Companies”

November 15, 2007 -- The Securities and Exchange Commission (SEC) adopted rule changes allowing the SEC to accept financial statements, prepared using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), from foreign private issuers (FPIs). The current requirements regarding the reconciliation to U.S. GAAP will not change for FPIs using standards other than IFRS, as issued by the IASB. The rule changes cover fiscal years ended after November 15, 2007.

The SEC will also provide an accommodation allowing European companies to reconcile from IFRS as adopted by the EU to IFRS as issued by IASB for a two-year transition period. This affects EU-based FPIs that have applied the EU carve-out to IAS 39, *Financial Instruments: Recognition and Measurement*.

At the same session, the SEC replaced the “small business issuer” category with the expanded category of “smaller reporting companies.” The expanded category allows companies with public floats of less than \$75 million – up from \$25 million for most entities – or, if a company does not have a calculable public equity float, having revenues of less than \$50 million in the last fiscal year, to qualify for the smaller reporting company disclosure and reporting requirements available under Regulation S-K. The scaled disclosure requirements for smaller companies contained in Regulation S-B will be integrated into Regulation S-K to make them available to smaller reporting companies.

Further information on these two actions appears below.

IFRS to U.S. GAAP Reconciliation

BACKGROUND

By eliminating the reconciliation requirement, the SEC attempted to balance two policy concerns: investors’ need for consistent information when making an investment decision, regardless of whether the issuer is foreign or domestic; and

the public interest, allowing investors to invest in a variety of securities, including foreign securities. In addition, the SEC did not believe that a particular degree of convergence should be a prerequisite for the acceptance of financial statements prepared under IFRS, as issued by the IASB, without reconciliation to U.S. GAAP. The SEC believes the use of the IASB-approved version would encourage the development of IFRS as a uniform global standard, not a divergent set of standards applied differently in every nation. Given that the wide-scale use of IFRS is less than two years old, the SEC will continue to monitor for possible flaws in standards and any issues with the application of those standards as part of its regular financial statement review process.

In addition, the SEC recently finished reviewing comments on a concept release allowing U.S. issuers to prepare financial statements in accordance with IFRS. Comments were due on November 13, 2007, and on December 13 and 17, 2007. The SEC plans to hold roundtables on this topic.

KEY POINTS

According to the proposal, which the SEC adopted substantially unchanged:

- An issuer will be required to prominently footnote in its financial statements and state unreservedly and explicitly that its financial statements are in compliance with IFRS as issued by the IASB. The independent auditor must opine on whether those financial statements comply with IFRS as issued by the IASB.
- The portions of Regulation S-X that do not relate to the form and content of an issuer's financial statements, including for example, auditor qualification and report requirements and financial statement requirements for entities other than the issuer, still continue to apply to FPIs.
- FPIs eligible to omit the U.S. GAAP reconciliation in their audited annual financial statements will likewise be able to omit a reconciliation from their unaudited interim period financial statements.
- When a standard or interpretation of IFRS does not address a matter, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, provides guidance, including looking to the most recent pronouncements of other standard-setting bodies. Without specific guidance, companies can look to various recognition, measurement and presentation practices, including their home country accounting principles, in establishing their accounting policies.
- An IFRS filer that is not required to provide a reconciliation will continue to be required to respond to those items of Form 20-F that refer to U.S. Financial Accounting Standards (FAS), FASB interpretations or other specific pronouncements for definitional purposes. In providing that disclosure, the issuer will apply the corresponding IFRS notion of the principles embodied in the referenced U.S. GAAP pronouncement. In acknowledgement that several countries will be changing national accounting standards to IFRS, the SEC will extend the accommodation to first-time adopters of IFRS contained in General Instruction G to cover financial statements through the 2012 financial year.

IMPACT TO CLIENTS

IFRS has not been uniformly implemented country to country. The most notable example is the European Union's adoption of IFRS with modifications. Jurisdictional implementations of IFRS could minimize the advantages of comparability provided by a global standard. EU-based FPIs will need to evaluate how to apply IFRS as issued by IASB appropriately versus IFRS as adopted by the EU and determine how to cost effectively take advantage of the elimination of the new SEC rules.

FPIs should evaluate their reporting requirements under the new rules and adjust their policies, procedures and disclosure controls to reflect the new requirements. In addition, given that smaller FPIs can now file as smaller reporting companies, FPIs should review all of the updated reporting changes to determine the optimal route for accessing U.S. financial markets.

The United States stands alone as the last major financial market that has not adopted IFRS. Europe, Canada, Japan, China, Australia and over 100 other countries have made a commitment to adopt some form of IFRS. For the United States, the question does not appear to be if it will adopt IFRS, but when and how. Proposals include providing an option to U.S. filers to use IFRS, creating a two-GAAP system (SEC proposal) and an adoption model where FASB adopts IFRS as convergence continues. The United States is likely to adopt one of the two approaches within the next two to five years. Now is the time for U.S. organizations to prepare for this transition.

Smaller Reporting Companies

BACKGROUND

In March 2005, the SEC chartered the Advisory Committee on Smaller Public Companies to review the regulatory environment for micro- and mid-cap issuers. The rule changes creating the "Smaller Reporting Companies" category stem from its recommendations.

KEY POINTS

According to the proposal, which the SEC adopted substantially unchanged:

- The term "smaller reporting company" replaces the term "small business issuer" and covers companies that are "non-accelerated filers" — creating three categories of companies: smaller reporting companies, accelerated filers and large-accelerated filers.
- For most companies, the smaller reporting company definition includes a public float ceiling of \$75 million. Other companies that do not have a public float or are unable to calculate it are eligible for scaled treatment if their revenues are below \$50 million annually for the most recently completed fiscal year for which audited financial statements are available. The public float to establish eligibility for smaller reporting company status will be determined on the last business day of a company's second fiscal quarter or

within 30 days of the date it files the initial registration statement associated with an IPO.

- Smaller reporting companies lose eligibility to claim smaller reporting company status in the first fiscal year following a fiscal year in which the smaller reporting company's public float rises above \$75 million as of the last business day of the second fiscal quarter. Likewise, a reporting company will be required to transition to smaller reporting company status in the next fiscal year if its public float falls below \$50 million as of the last business day of the company's second fiscal quarter. An issuer with no public float may use the scaled disclosure item requirements until it exceeds \$50 million in annual revenue and would remain unqualified unless its annual revenues fall below \$40 million during the previous fiscal year.
- All foreign companies meeting the criteria of a smaller reporting company and filing a form that permits disclosure based on the standards for smaller reporting companies (S-1, S-3, S-4, 10-Q and 10-K), will qualify to take advantage of the scaled accounting and disclosure requirements. FPIs may choose to use the domestic forms so they can disclose based on these standards or use the "F" forms and comply with those requirements.
- The requirements of Item 310 of Regulation S-B are less detailed than the requirements in Regulation S-X, governing the financial statements of larger companies. Regulation S-B also contains a number of disclosure requirements that are scaled to the characteristics of smaller companies, including requirements on executive compensation, related-person transactions, and MD&A and the results or plan of operations. For example, Regulation S-B allows companies to provide an audited income statement for the latest two fiscal years versus three years under regulation S-X.
- Under the new rules, smaller reporting companies will provide only two years of MD&A analysis if the company is presenting only two years of financial statements.
- Companies are allowed to choose, on an item-by-item or "a la carte" basis, to comply with either the scaled disclosure requirements for smaller reporting companies or other companies under Regulation S-K. A smaller reporting company is required to provide its financial statements, based on either Item 310 of Regulation S-K or Regulation S-X, for an entire fiscal year, and would not be permitted to switch back and forth from one to the other in different filings within a single fiscal year.
- The SEC eliminated the forms associated with Regulation S-B — allowing a phase-out period for current small business issuers.
- The Commission adopted amendments to Securities Act Rule 144 to shorten the holding period for the resale of restricted securities of reporting companies.
- The SEC substantially simplified Rule 144 compliance for non-affiliates of both reporting and non-reporting companies.
- The Commission created two new exemptions from Exchange Act registration requirements for compensatory employee stock options.

IMPACT TO CLIENTS

Given the elimination of the S-B family of forms for filing with the SEC and the availability of scaled disclosures, smaller reporting companies should begin to

evaluate their disclosure procedures and controls to reflect the new requirements. While the rule changes should reduce the total effort, companies will need to revise their processes and controls to ensure compliance. This, along with current SOX efforts, provides issuers an opportunity to review and streamline the financial closing and reporting process.

In addition, smaller reporting companies should evaluate the optional reporting requirements to determine which items are relevant to their investors. Issuers in this category have an opportunity to enhance their disclosures, taking advantage of the reduced reporting requirements while maintaining or enhancing disclosures to attract investors and capital.

As a reminder, management is still required to furnish its assessment on internal control over financial reporting for fiscal years ending on or after December 15, 2007, with a related audit report required for fiscal years ending on or after December 15, 2008.

HOW JEFFERSON WELLS CAN HELP

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