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Credit Market Services

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November 13, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via Electronic Mail: rule-comments@sec.gov.

Re: File No. S7-20-07

Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards

Dear Ms. Morris:

Standard & Poor's Ratings Services (Standard & Poor's) appreciates the opportunity to provide the Securities and Exchange Commission (the Commission) with our comments on the Concept Release—*Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* (the Concept Release). The views expressed in this letter represent those of Standard & Poor's, and do not address, nor are they intended to address, the views of The McGraw-Hill Companies. Further, our comments are intended to address the analytical needs and expectations of credit analysts.

We consistently have supported global convergence of financial reporting standards. We view the prospects of a single comprehensive global financial reporting system, to be consistently applied and enforced, as an important facet in maintaining and expanding efficient global financial markets. We appreciate and are encouraged by the Commission's efforts to promote convergence, and to improve the consistency and quality of information provided to users of financial reports.

Global accounting and disclosure standards will be of great value to our analysts, by improving data consistency and enabling enhanced global peer comparisons. This was evident by the recent adoption of International Financial Reporting Standards (IFRS) by many of our rated issuers throughout Europe and in other countries, in lieu of the myriad local standards previously in use. Further, we strongly believe global convergence and an ultimate migration to a single set of international financial reporting standards will promote much-needed improvements to the global financial reporting framework.

We view IFRS as a high quality set of principles-based standards that could be implemented on a global basis. Indeed, it has successfully been implemented in over 100 countries around the world. Accordingly, we are not conceptually opposed to permitting domestic U.S. issuers to report using IFRS.

However, we believe allowing U.S. domestic issuers to report based on IFRS in its current evolutionary state is premature. In our view, the salient issue is not whether to maintain U.S. Generally Accepted Accounting Principles (GAAP) for U.S. issuers, allow them an option to report based on IFRS, or convert entirely to IFRS. Rather, we believe the decision predominantly should rest on whether the selected financial reporting system will improve information flow, which in turn will contribute to greater efficiency of markets and lower costs of capital.

We therefore believe the focus should be on whether, under the discipline chosen, the financial information provided by registrants (as drafted under a mandated set of requirements or standards) ultimately provides investors, creditors, analysts, and other financial-statement users with a clearer understanding of an entity's financial position, results of operations, and cash-flows, and enables more informed investment and credit choices. The information conveyed should include a discussion of how and why past-observed results might change in the future and the material accounting choices made by the issuer that could generate meaningful differences in reported results when contrasted with peers (domestic as well as global). We further note that meaningful differences remain in the quality and content of financial disclosures provided under both systems--IFRS as well as U.S. GAAP¹. Given the complexity of the current business environment, the myriad accounting choices allowable under any accounting system, the considerable reliance on often highly discretionary estimates and assumptions, and the prevalence of 'mixed attributes' in measurement, it would be naïve to imagine that any accounting system now in place is capable of translating such vast complexity into a single number--or set of numbers--that can meaningfully capture the risks and results of a company's transactions, operations, and environment.

In deciding how to move toward an improved state of financial reporting, we cannot overemphasize the need for standard setters and securities regulators to focus on improving the extent and content of disclosures. Much of the discussion thus far has involved the accounting system chosen, but has been significantly lacking in deliberation and evaluation of the accompanying disclosures.

Without passing judgment on the relative merits or deficiencies of either U.S. GAAP or IFRS, we note that neither provides for all (or even substantially all) of the informational needs of analysts and other financial-statement users². Our analysts obtain much additional information

¹ See SEC Staff Observations in the Review of IFRS Financial Statements, July 2, 2007 and Standard & Poor's "How IFRS Transition Affected The Financial Disclosure Of Major Western European Banks", published January 23, 2007 on RatingsDirect.com.

² See also Standard & Poor's comment letter on the Commission's Proposed Rule: *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP* (File No. S7-13-07) submitted on September 24, 2007.

from data contained outside the financial statements (e.g., in the Management Discussion & Analysis for a public company issuer) or supplemental financial information. The importance of disclosures becomes much more evident during periods of transition, when reported financial information may change meaningfully for many, hindering analysts' ability to perform peer and period-over-period comparisons³.

We greatly support the broader move to IFRS, including an eventual migration of U.S. registrants to reporting under IFRS; however, it will be suboptimal if such a move results in less or lower quality information for users, even if only in the short term. Although ultimately desirable, we view an immediate choice for U.S. registrants to report using IFRS as premature, given the current evolutionary state of IFRS development and its limited application experience, the substantially incomplete accompanying disclosure framework, and the lack of readiness of U.S. market participants. As more fully discussed below, we believe certain elements of transitioning to IFRS that we view as critical must be addressed before U.S. registrants are allowed to report using IFRS, and we encourage the Commission to establish a comprehensive plan and timeline for full adoption of IFRS by all U.S. registrants. Underpinning our view is the desire for global convergence and enhancements to the information provided to analysts, rather than a particular preference towards U.S. GAAP⁴.

The remainder of this letter summarizes our responses, further elaborated upon in our article *The Road To Convergence: U.S. GAAP At The Crossroads*, included in the Appendix (also available on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.).

Harmonization of Global Financial Reporting Standards

Financial-statement analysis is central to our rating methodology. The financial statements, including the accompanying footnotes and disclosures, provide our analysts with an abundance of information incorporated in the determination and surveillance of ratings. However, the issuer's financial statements are not necessarily viewed as the optimal or ultimate depiction of the economic reality of the issuer's financial performance and position. We focus our analysis on the underlying economics of companies and the businesses in which they are engaged, and have a longstanding practice of making analytical adjustments to financial statements in order to recast the information to better reflect our view of companies' underlying economic status for purposes of our credit analysis. These adjustments facilitate peer analyses and help us better identify trends in period-over-period comparisons and in making financial projections. Our adjusted financial measures also allow a more transparent, consistent view of companies on a global basis, regardless of the accounting convention applied or the manner in which financial information is reported.

We therefore support the development and implementation of a robust set of globally applicable standards. Even though significant efforts have been made to date, these efforts are far from complete, such that allowing the option to adopt IFRS would simply result in the replacement of one set of standards with another, irrespective of the overarching goal of improving and

³ See "It's Not A Small World, After All: The SEC Goes International", *The Analyst's Accounting Observer*, Jack Ciesielski, published September 24, 2007.

⁴ *Ibid* at 2.

enhancing the information content provided to analysts. In fact, we believe a change from U.S. GAAP to IFRS may meaningfully diminish the information provided to analysts (e.g., for insurers and for companies in the extractive industries, and disclosure requirements under FASB Statement 157 and FIN 46(R)). These examples underpin the need to focus on disclosures, in addition to simply evaluating the accounting choices in deciding on transition. Further, an optional transition merely introduces another discretionary choice in financial reporting, which will be less than helpful for analysts if it leads to less consistency in peer-group reporting.

In considering whether to replace U.S. GAAP, we must also consider the fundamental strengths and weaknesses of IFRS. IFRS has the benefit of reasonably outlined principles, unencumbered by an often entangled, and at times incongruent, set of rules symptomatic of U.S. GAAP. Being principles-based allows IFRS, in many respects, to be more flexible in addressing the complexities of the businesses and capital markets in which they operate. However, this same flexibility also allows for potentially greater subjectivity in the application of accounting choices relative to U.S. GAAP, and, without the information requirements of an improved disclosure framework, may call into question the comparability and potentially the relevance of the financial statements. In that environment, the need to develop a robust disclosure framework to accompany the financial statements becomes very clear.

Furthermore, IFRS is still in its early days in terms of application, interpretation, and oversight by financial market regulators, so, although widely implemented, it remains a work in progress. There currently is scant guidance provided on presentation of financial information, and accounting rules are yet to be developed in certain topical areas.

Ideally, the transition to IFRS would be done concurrently, or near concurrently, for all companies, so the option to adopt would not be open-ended. This would eliminate the creation of additional options beyond those that already exist within the accounting systems. Introducing two systems of financial reporting would significantly complicate our analysis of domestic issuers, and necessitate further analytical adjustments merely to retain the current comparability.

During this transition period, companies should be required to provide a detailed reconciliation from previously reported U.S. GAAP to the newly adopted IFRS-based financial statements. The reconciliation would serve as a bridge, showing how assets and liabilities were adjusted in transition to IFRS, and allow a full understanding of the changes affecting the financial statements.

Further, as discussed in our comment letter addressing the potential elimination of the reconciliation requirements⁵, we also are concerned that efforts to convert prematurely to IFRS risk delaying and discouraging true convergence to an improved global framework. Indeed, the impact of converting to an unimproved IFRS may significantly lower the profile of U.S. GAAP and the Financial Accounting Standards Board (FASB) globally, and hamper the ability to ensure completion of the convergence process to a single improved set of global standards as well as other key projects including the Conceptual Framework and Financial Statement Presentation.

Timing

⁵ Ibid at 2.

We recommend the Commission encourage the International Accounting Standards Board (IASB) and the FASB (collectively, the Boards) to establish an explicit timeframe for the transition, providing sufficient time for necessary improvements, promulgation or adoption of disclosures and accounting rules in certain lacking areas, and allowing for orderly transitional needs to be met for companies, auditors, and users. Adequate time must also be allowed for market participants to become acquainted with the new standards--especially preparers and auditors--to ensure that an adequate transition is achieved and the IFRS financials are well understood.

Although the convergence process established by the Boards is robust and has achieved significant progress in identifying and resolving differences between U.S. GAAP and IFRS, the approach whereby differences are identified, deliberated, exposed for comment, and then implemented “piecemeal” prolongs the convergence process. Under this approach, improvements to specific standards are made and then issued after public debate and comment. The implementation of standards issued at different times, however, results in increased costs of implementation for analysts and other financial-statement users in assessing the guidance, training personnel, and implementing changes based on the new standards. Financial-statement preparers face similar challenges, but in addition must develop and implement new financial reporting procedures and system support. This is repeated each time new guidance is issued, resulting in incomparable results and great difficulty in coping with the vast rate of change.

Accordingly, we prefer implementation of IFRS on a one-time, rather than piecemeal, basis. Indeed, the EU-wide implementation of IFRS was relatively successful, largely because of its one-time implementation, and the planning and transition period that allowed it to occur.

One-time implementation would not necessitate a change in approach for the projects currently underway, in which proposed guidance is deliberated and exposed for public comment. Rather, it merely changes the implementation date of the disparate pieces of guidance to be consistent with the overarching implementation date of the improved IFRS. We believe this approach has the added benefit of reducing costs to all financial-statement constituents, and allows the improvements to be made in a consistent and concurrent fashion.

Transition

Without a plan outlining an explicit timeline with identified milestones, not only will necessary changes likely be delayed, but the likelihood for further delay of migrating to an improved IFRS increases. With an explicit timeline, continued uncertainties regarding how and when the improved IFRS would be resolved, and actual planning to address the transitional needs, could begin. These far-reaching changes would require significant time and resources commitments.

Talent education and availability

Educational standards, curriculums, and training programs will need to undergo significant revisions to support the use of IFRS in the U.S. No less important is the shortage of trained accounting and audit professionals, as demand currently outstrips supply, for business enterprises and auditors alike.

Auditing practices

To sustain confidence in reported amounts and information, high-quality audits are critical. Robust accounting rules (or principles) become largely irrelevant to analysts and financial statement users if they are not supported by a rigorous audit process that fosters confidence in reported information and consistency in application. There is now an inconsistent and fragmented international audit environment. Harmonizing international auditing rules and ensuring consistent compliance with IFRS standards are key to developing confidence in the accounting framework that will be used. Our response in this letter presumes that the Commission, together with other international financial-markets regulators, will continue to enforce high-quality auditing and financial reporting oversight, regardless of the method of accounting used by issuers, so the quality and robustness of financial information will not diminish as a result of the adoption of new standards.

Market acceptance

Auditors and preparers are not the only ones who will need further education. Principles-based accounting provides little bright-line guidance, but focuses on providing financial-statement preparers with broad guidelines, where fewer circumstances will have black-and-white accounting solutions. This approach implicitly acknowledges the inability of accounting standards to address every possible circumstance, particularly as the business environment and structured transactions designed to meet differing needs become increasingly complex. Accordingly, the market must also be educated about accounting choices made and disclosures must be sufficiently instructive to accommodate the application of principles-based accounting and address perceived concerns regarding consistency, quality, and transparency of IFRS reporting.

Cost, and coping with change

Full migration to a single convergent standard will require planning, preparation and significant investments in systems, personnel, new protocols, and new reporting formats. It may also require modification of internal control systems over financial reporting. Significant incremental effort and cost could come in renegotiating contracts, debt covenants, compensation arrangements, and other arrangements tied to U.S. GAAP measures. Similarly, modifications to certain regulatory capital requirements may be necessary. Coming on the heels of the recently adopted Sarbanes-Oxley Act provisions, not all U.S. companies may be willing to embrace an 'optional' version of IFRS, given their perception of benefits. Accordingly, providing an option could result in greater divergence. As such, we prefer a concurrent or near-concurrent transition, pursuant to which a reasonable period of time should be afforded for migration.

Legal and regulatory

The disparate legal and regulatory environments highlight the need to establish the structures, means, and mechanism necessary for global enforcement of reporting and auditing standards. For example, the Commission, while responsible for standard-setting authority in the U.S., delegates much of that authority to the FASB. With full convergence, however, the IASB will effectively have responsibility for standard setting. It is important that a process be established, pursuant to which an adaptation of standards to local flavor or preferences, such as E.U.-endorsed standards, is discouraged and limited. Otherwise, it will lead to an effective divergence of accounting standards and mitigate the benefits achieved from application of a global set of standards. If it is determined that additional information is essential to a particular jurisdiction, it could be

provided in addition to, and not in lieu of, the information required by IFRS. Additionally, the extent and nature of funding for the IASB will need to be addressed to ensure it is truly independent and is capable of maintaining its ambitious goals.

Greater coordination also will be needed among market regulators. Differing enforcement standards could drive a movement toward reporting arbitrage, where strict enforcement of reporting requirements in one jurisdiction may cause companies to prefer listing in a market with less stringent enforcement. Failure to maintain consistency in application and enforcement ultimately would undermine the usefulness and comparability of financial statements between markets, undermining the very principles convergence seeks to achieve.

Developing a Single Comprehensive Disclosure Standard

Regardless of the timeline for achieving accounting convergence, optional accounting methods and significant differences in accounting standards likely will remain for some time. Further, the issues addressed in this letter underscore the need for regulators and standard setters to expand the vision of global accounting standards from merely focusing on achieving accounting harmonization to creating a process for developing a financial reporting framework capable of addressing the needs of the complex and dynamic global capital markets. This entails a review of the content of the financial statements and disclosures, greater integration of information included in the financial statements and the Management Discussion & Analysis (MD&A) section of the regulatory filings, and the provision of better information enabling forward-looking analysis⁵.

As an interim and essential step, we recommend that the Boards promulgate and implement a more robust disclosure framework before full convergence (or convergence to IFRS) takes place. At a minimum, information should be consistently provided regarding accounting policy selections and means of application; the related balances in the financial statements and account composition (given the lack of specificity in IFRS); the significant assumptions on which material account balances are based; the events that could cause these assumptions and balances to change; and incorporate an assessment of the probability/likelihood of such events occurring. We believe efforts can be made in the short term to address these disclosure needs. To that end, we recommend the Commission, in conjunction with its work with IOSCO, CESR, and other regulators, direct the Boards to consider developing a single disclosure standard that would better meet analysts' and financial-statement users' information needs beyond the basic financial reports (including incorporating information provided by issuers in their MD&A section).

In closing, we are encouraged by the prospects of global adoption of IFRS and are very supportive of the Commission's proposal, provided an appropriate process and plan are established and adhered to, and greater emphasis is placed on disclosure content. We believe it will lead to a more robust financial reporting discipline, globally accepted, and consistently applied--a system capable of meeting the information needs of investors and creditors, and of supporting the evolving global capital markets for many years to come.

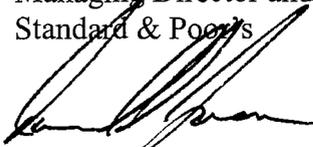
⁵ Appendix – see sidebar “What Do Analysts Expect From A Financial Reporting System?”

We thank you for the opportunity to provide our comments. We would be pleased to discuss our views with any member of the Commission's staff. If you have any questions, or require additional information, please contact Neri Bukspan, Managing Director and Chief Accountant at (212) 438-1792 (neri_bukspan@standardandpoors.com) or Ronald Joas, Director, Financial Reporting at (212) 438-3131 (ron_joas@standardandpoors.com).

Very Truly Yours,



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July 16, 2007

The Road To Convergence: U.S. GAAP At The Crossroads

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The Road To Convergence: U.S. GAAP At The Crossroads

Standard & Poor's Ratings Services has consistently supported global convergence toward a single comprehensive reporting standard, believing the current financial reporting system is inadequate to satisfy analysts' needs. We recognize the hurdles to be overcome, and understand the process may not result in a quick fix: Neither is it likely the ultimate goal of a single accounting standard will be realized in the form of a pure U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) set of accounting standards. Rather, the resulting framework will be an evolution of the accounting systems currently in place.

As long ago as 2002, The U.S. and international accounting standard-setters agreed in principle that merging international and U.S. accounting standards into a single set of standards would be ideal for the global business and investor community. That ideal recently moved one step closer to reality when the U.S. Securities and Exchange Commission released a proposal that would allow foreign companies listed in the U.S. to no longer reconcile their financial statements to U.S. GAAP, possibly as early as 2009. The SEC also indicated that it is willing to explore even giving U.S. companies a choice between IFRS and U.S. GAAP. This may well be interpreted as a not-so-gentle nudge toward a looming exit for U.S. GAAP, and could bring a sea change for the future role of U.S. GAAP and of the Financial Accounting Standards Board (FASB), the U.S. private-sector accounting standard setter.

In early July, the SEC requested comments from market participants on a proposal that would eliminate the requirement for foreign private issuers (non-U.S. companies that list their securities in the U.S.) to provide reconciliation from IFRS to U.S. GAAP, thus allowing foreign registrants a choice in filing financial reports. Allowing this flexibility, however, raises significant questions as to whether all registrants--including U.S. companies--should be able to report using either IFRS or U.S. GAAP, and highlights the issue of converging accounting standards and what this means for Standard & Poor's Ratings Services' analyses. On June 27, in a separate, but not unrelated action, the SEC announced the formation of an advisory committee that will examine the U.S. financial reporting system with a view to reducing unnecessary complexity and making information more useful and understandable for investors. Table 1 illustrates how convergence has evolved over the past decade.

We believe convergence ultimately will lead to significant changes in U.S. GAAP as we know it today, and will result in a set of standards that largely are principles-based. It is naïve to suppose a rules-based system will meet the needs of analysts and other financial-statement users, given repeated attempts to structure around the rules in order to attain a beneficial accounting result. Moreover, there has been a recurring need to create further rules to clarify a particular issue or to close a loophole. This, coupled with the increasingly complex business and finance environment creates a dire need for an accounting system that can more swiftly and effectively respond to the changing business dynamics, without the need to rewrite the rules or to create new ones. That changing dynamic currently is in place, leading to unrealistic presentations of the current and future prospects of companies. These results often require our analysts to make a multitude of adjustments to issuers' financial-statement data as part of our analyses (see table 2).

Table 1

Convergence Timeline

November 1996	U.S. Congress passes the "National Capital Markets Efficiency Act," directing the SEC to respond to the growing internationalization of securities markets by giving "vigorous support" to the development of "high-quality international accounting standards as soon as practicable."
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Table 1

Convergence Timeline (cont.)	
February 2000	The SEC issues a Concept Release soliciting comments on whether the U.S. should consider accepting International Financial Reporting Standards in the United States.
June/July 2002	European Parliament and The Council of the European Union pass a regulation requiring all listed E.U. companies (including banks and insurance companies) to prepare their consolidated financial statements in accordance with IFRS commencing in 2005 (application may be deferred until 2007 for companies listed on regulated markets outside of the E.U.).
October 2002	The "Norwalk Agreement": The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) announce their agreement to work toward making their existing financial standards fully compatible as quickly as possible, and to coordinate future efforts to ensure continued compatibility of the standards.
June 2004	The SEC and the Committee of European Securities Regulators (CESR) announce plans to increase collaboration, focusing in part, on the consistent application, interpretation and enforcement of the use of IFRS.
April 2005	In a speech known as the "Roadmap", then-SEC Chief Accountant Donald Nicholaisen describes the rationale and drivers behind a single globally applied set of accounting standards and the SEC's considerations of the changes necessary in order to eliminate the IFRS/U.S. GAAP reconciliation for foreign filers.
June 2005	The CESR releases its "Technical Advice on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information" concluding that U.S. GAAP (as well as Canadian and Japanese GAAP) was, on the whole, equivalent to IFRS (subject to certain conditions).
February 2006	The FASB and the IASB jointly publish a Memorandum of Understanding (MOU) that outlines a roadmap for developing common accounting standards by 2008.
March 2006	The SEC holds a roundtable on the prospects of the roadmap and eliminating the reconciliation requirement, addressing the effect on the capital raising process in the U.S. and the implications to issuers and investors in the U.S. capital markets.
August 2006	The SEC and the CESR announce a joint work plan focusing on increasing dialogue between the organizations and promoting high quality accounting standards and consistent application of IFRS worldwide, with the ultimate goal of working towards converging standards.
June/July 2007	The SEC votes to issue for comment a proposal to eliminate the requirement that foreign-based companies listed in the U.S. reconcile their IFRS-based reports to U.S. GAAP. The SEC also announced that it is working on a concept release on whether U.S. domestic issuers be allowed the choice to report in either U.S. GAAP or IFRS (issued in July).

A Phased-In Approach Will Strike The Right Balance

We support efforts resulting in financial statements that more clearly present economic reality. Consequently, we strongly believe a phased-in, principles-based approach is the appropriate solution to the financial reporting quandary, because it would--when accompanied by robust disclosures--incorporate the flexibility necessary to address each company's unique strengths, weaknesses, and business and financing approaches. This approach likely would contribute to a lower error rate by financial-statement preparers, who now follow a detailed formula rather than a broader concept, and reduce the number of restatements of financial statements while providing analysts and other users with a more economically based presentation of a company's business model, transactions, risks, and opportunities. The ability of financial statement preparers to use principles to apply their own judgments ultimately would better meet the needs of analysts and other stakeholders.

Clearly this approach does not come without its own potential shortcomings and risks, some of which we believe are transitional in nature, such as creating a better financial reporting framework supported by a robust conceptual framework and adequately training U.S. preparers and auditors. Other risks are more of a permanent nature, such as the degree of non-comparability in financial reporting because of the greater level of discretion and subjectivity allowed under a principles-based approach.

We believe that accounting should match economic reality as much as possible. The current mixed-attribute model, by creating asset/liability mismatches, is not desirable because it masks this reality, and does not provide analysts with the necessary information. A principles-based approach, supported by robust disclosures that indicate the

accounting policies, significant assumptions, and sensitivities of recorded balances would serve as the means for companies to provide much needed information to analysts and other financial statement users.

A principles-based approach undoubtedly will initially result in greater divergence in how financial statements are presented and how accounting principles are applied, which will, in turn, require market regulators and participants to tolerate greater differences as judgment in the application of standards replaces rules in dictating a particular accounting treatment. Ultimately, we believe market forces will impose appropriate discipline on the application of judgment: Where such judgment is deemed to be more aggressive, market forces will require greater risk premium, whether it would be through higher borrowing costs or lower share prices while correspondingly rewarding those companies that employ best reporting practices. In this environment, however, adequately transparent and comprehensive financial statement disclosures will be critical in providing an appropriate understanding on how principles have been applied to a particular situation.

The trends surrounding convergence and continuing improvement to global financial reporting standards clearly are encouraging, but there is much work to do, particularly regarding the creation of a conceptual framework that will serve as the foundation for a comprehensive reporting system.

We hope greater coordination among participants (regulators, accounting standard setters, analysts, companies, their auditors, and others) will lead to a single financial reporting discipline, globally accepted, and consistently applied. It should be a system capable of meeting the information needs of investors and creditors, and of supporting the evolving global capital markets for many years to come.

Eliminating The Reconciliation: An Accident Waiting To Happen?

Although eliminating the reconciliation is part of the natural evolution of convergence, it may also have the counter-intuitive effect of eliminating one of the drivers for converging standards. Some market participants have argued that the SEC's effort to eliminate the reconciliation requirement is premature in light of the current progress towards convergence and the current evolving state of IFRS.

Myriad questions about potential hurdles and perils have been raised, including:

- What information currently provided by the reconciliation will no longer be available?
- Will the information and understanding currently provided by the reconciliation cease to exist, and negatively affect analysts' and other users' understanding of the financial statements?
- Should other disclosures be required to accommodate transition, and given the greater flexibility embedded in IFRS, around particular accounting choices made by the company?
- Is this the right next step, or would it evolve as a natural outcome of convergence, where differences ultimately would be minimized?
- How well is IFRS enforced in the EU member states and elsewhere?
- Is audit quality enhanced through a better understanding of choices made?
- Are U.S. investors adequately educated on the differences between the standards?
- Would analysts' and investors' ability to make peer comparisons be hindered?

Our analysts understand the broad differences that currently exist between the accounting conventions. This is an integral facet of making peer comparisons in assigning ratings to companies operating in many countries around the

globe. In our analysis, we focus on the underlying economics of the business and transactions and use the accounting information often as a starting point to our financial analysis (see table 2, again). While we acknowledge that this is not a basis for retaining a reconciliation requirement, we have found that the reconciliation guides us between the different accounting conventions, and allows us to better appreciate how accounting differences are evident under the varying reporting regimes (all foreign private issuers are required to reconcile their accounts to U.S. GAAP or use U.S. GAAP as the primary basis of accounting). In the absence of full convergence, the reconciliation is a useful tool for aiding comparisons among global peers, particularly as IFRS is still in its infancy in terms of its application and interpretation.

However, we traditionally have rated companies based on their home-country GAAP. To facilitate greater consistency among global rated peers, we make adjustments based on how we view the economic reality of the company and our understanding of the accounting variants, regardless of the particular accounting rules followed. While we consider a reconciliation useful for highlighting the differences in accounting conventions, our rating process is not dependent on it.

Although starting with less complex notions, IFRS has the benefit of reasonably outlined principles, unencumbered by an often entangled, and at times incongruent, set of rules symptomatic of U.S. GAAP. IFRS may well evolve, and has the potential to shed some of its principle-based appeal over time as it attempts to close loopholes, clarify inconsistent application, and respond to intervention by regulators. Further, the application of accounting standards often incorporates the consensus reached by the dominant accounting firms. Looked at in this way, standard setting can be viewed as pushing the rule-making down, so auditors now will have a greater influence in the rules-making process. The evolution of IFRS in this way may continue at a pace different than that of convergence, thereby introducing differences that some would argue should be highlighted as part of a reconciliation.

Without a reconciliation, greater reliance also would be placed on financial statement disclosures, which raises potential issues regarding the robustness of IFRS disclosure requirements in its current state. In a Standard & Poor's study, we noted significant variations in the quality and types of IFRS disclosures, many of which were boilerplate in nature, and lacked the analytical information needed to gain full appreciation of the underlying assumptions and risks (please see *How IFRS Transition Affected The Financial Disclosure Of Major Western European Bank*, published Jan. 23, 2007, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.).

Indeed, results of recent SEC reviews of over 100 reports filed using IFRS echo these concerns:

- **Compliance:** While most companies asserted compliance with IFRS, their auditors only opined on compliance with the company's jurisdictional, or 'home-country', IFRS (i.e., the reports may not be fully IFRS compliant).
- **Presentation:** IFRS provides scant guidance on presentation, leading to inconsistent income statement formats for companies even in the same industry and jurisdiction. Additionally, required disclosures were, in some instances, scattered throughout the filing both within and outside the audited financial statements.
- **Application:** Different accounting treatments were noted for mergers, recapitalizations, reorganizations, acquisitions of minority interest and similar transactions, leading the SEC to require further disclosure and clarification in their footnotes. Additionally, significant variations were noted in accounting for insurance contracts (accounting for which is currently under discussion by the IASB) and extractive industry exploration and evaluation activities, for which there are no extensive standards under IFRS.
- **Topical:** The SEC requested additional information and disclosure on several other topics, including revenue

recognition; intangible assets and goodwill; policies for identifying and evaluating impairments; leases; contingent liabilities; and the significant terms, recognition, measurement, and impact on cash flows of financial instruments.

See Staff Observations in the Review of IFRS Financial Statements at http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm.

The SEC comments may be indicative of the evolving nature of IFRS and the level of compliance with its standards. Clearly, the comments highlight the need for robust and consistent disclosures, which we view as essential in fostering a transparent, principles-based reporting environment.

Table 2

Standard & Poor's Approach To Accounting Analysis

Financial-statement analysis is central to our rating methodology. The financial statements, including the accompanying footnotes and disclosures, provide our analysts with an abundance of information incorporated in the determination and surveillance of ratings. However, the issuer's financial statements (historical or projected) are not necessarily viewed as the optimal or ultimate depiction of the economic reality of the issuer's financial performance and position. We focus our analysis on the underlying economics of companies and the businesses in which they are engaged, and have a longstanding practice of making analytical adjustments to financial statements in order to recast the financial statements to better reflect our view of companies' underlying economic status. These adjustments facilitate peer analyses and help us better identify trends in period-over-period comparisons and in making financial projections. Adjusted financial measures also facilitate a more transparent and consistent view of companies on a global basis, regardless of the accounting convention applied or the manner in which financial information is reported.

Our adjusted financial measures are a baseline for a much broader analytic process, in which we consider myriad qualitative and quantitative financial and nonfinancial factors, including economic, regulatory, and geopolitical influences; management and corporate governance attributes; key performance indicators; competitive trends; product-mix considerations; R&D prospects; intellectual property rights; and labor relations. To that end, supplementary interpretive nonfinancial and trend data, such as the information provided in the Management Discussion and Analysis section of SEC filings (MD&A), as well as data gathered from our discussions with companies, other industry participants, and experts, is essential.

For further information on Standard & Poor's accounting analyses and methodology, please see the following articles published on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis:

Standard & Poor's Encyclopedia Of Analytical Adjustments For Corporate Entities, July 9, 2007

New Risk Based Insurance Capital Model, May 31, 2007

Financial Institutions Group Provides More Transparency Into Adjustments Made to Bank Data, April 26, 2007

IFRS: An Added Twist To The Globalization Of Canada's Capital Markets, Jan. 15, 2007

A Closer Look at Industrials Ratings Methodology: Accounting and Financial Reporting, Nov. 13, 2006

New Reconciliation Table Shows Standard & Poor's Adjustments to Company Reported Amounts, Oct. 3, 2006

Drivers Of Convergence

In many ways, the globalization of capital markets is a primary driver of convergence. Much has been said of a supposed decline in the competitiveness of U.S. capital markets. While some maintain that the Sarbanes-Oxley Act resulted in onerous internal-control reporting and auditing requirements--driving companies to overseas markets--it seems more likely that foreign markets simply have become more realistic and efficient alternatives to raising capital in the U.S. market. Where foreign companies previously had little choice but to access the U.S. markets, they now are more likely to raise capital in their home countries (please see "New Section 404 Guidance Will Increase Efficiencies And Cost-Effectiveness," published June 25, 2007, on RatingsDirect).

The state of the financial reporting arena outside of the U.S must also be considered. The vast majority of developed countries now report based on IFRS (or a variant of IFRS), or have announced plans to do so. Indeed, many U.S. subsidiaries of foreign companies, and U.S.-domiciled companies with foreign subsidiaries, must maintain multiple sets of financial statement records: U.S. GAAP for U.S. shareholders and creditors and often a variant for regulators and taxing authorities; IFRS financial statements for the parent company's external reporting needs; and possibly

other financial statements to meet internal management and business performance metrics.

A poll taken at a May 2007 Financial Services Executives Forum in New York City, sponsored by PricewaterhouseCoopers and attended by several hundred CFOs and other finance professionals, showed that 56% of attendees said IFRS was important to their companies, and 88% believed there should be a single set of global accounting standards; 34% said the new standards should be derived solely from IFRS, while 44% said the final standards should represent a continued convergence of U.S. GAAP and IFRS.

Globalization also affected the investment community, which, in its desire for diversification, continues to expand its reach across borders. To best assess potential investments, however, there is strong preference for financial information and analyses based on a single set of comprehensive and understandable standards, to enable comparisons among global peers.

Although globalization is a significant driver, it is far from the only one. The state of financial reporting often does not meet the evolving informational needs of investors, creditors, analysts, or other financial statements users. U.S. GAAP and IFRS continue to be based on a mixed-attribute model, in which some assets and liabilities are shown in financial statements at historical cost, and others at current market values. Factor in a series of highly complex rules and standards, and suddenly the underlying nature of the economic benefits and costs being realized by the company is obfuscated.

Convergence: Tinkering With, Or Overhauling The Accounting Engine?

The role of the accounting-standard setters (both the FASB and the IASB) has evolved to providing financial reporting, rather than solely accounting information. The current accounting model, regardless of the convention followed, is backward looking and generally does not fully capture the totality of a company's worth and activities. From an analytical perspective, while knowing where a company has been is useful, information that gives a sense as to where the company is going is more helpful. To a greater extent, recent changes in accounting guidance are forcing financial statement presentation to incorporate more forward-looking assumptions and estimates; however, these changes are being incorporated sporadically. Still, backward-looking information is not irrelevant to our analysis: It has great value in enabling us to understand how effectively and efficiently management of the company has--given its attendant risks--employed its resources compared with its stated objectives, communicated plans, or budgets, and given an expected level of risk.

These shortcomings highlight the fact that convergence for the sake of convergence will fall short of the goal, and that this evolution (of accounting and financial reporting) must take place within the context of a comprehensive framework designed to meet the present and ongoing needs of analysts and other users. Convergence should be handled with care and approached with advancement and progress toward meeting those goals in mind.

Consider some fundamental differences between U.S. GAAP and IFRS: U.S. GAAP has become a highly structured, rules-based, set of standards spanning hundreds of pronouncements, interpretations, and practice aids, filling thousands upon thousands of pages. As a result, in the absence of guiding principles or circumstances where certain rules are incongruent with the principles or merely clash with other rules that are applicable to analogous circumstances, U.S. GAAP practitioners struggle to apply the guidance, and readers of the financial statements struggle to understand the results.

Conversely, IFRS is principles-based and unencumbered by a long history of rule-making. It is, however, much more subjective, calling into question the comparability and potentially the relevance of financial statements. Further, IFRS is still a work in progress, and some areas of accounting are not yet fully covered (e.g., insurance accounting). In addition, the principles-based concept may be somewhat misleading--there are many principles governing U.S. GAAP, while there are many rules or rules-based standards under IFRS (e.g., IAS 39 on financial instruments accounting). Broadly, however, IFRS can be characterized as having a much greater principles-based notion embedded in it.

Neither set of standards currently provides all (or even substantially all) of the information needed by analysts and other users. Much information is obtained from data contained outside the financial statements--e.g., in the MD&A. In Europe, a consortium of preparers called the CFO Forum developed a standardized reporting method for evaluating life insurance companies, European Embedded Value (EEV). The method was created in response to shortcomings of accounting guidance and to more properly depict the financial position of industry companies (predominantly as it relates to recognizing the inherent value of the contracts being written and other perceived accounting asset and liability mismatches arising from the mixed-attribute accounting structure currently rooted in both IFRS and U.S. GAAP). The EEV methodology seeks to provide a better economic view of companies' financial position than would be presented under existing guidance. Results based on EEV are an integral part of financial reports of life insurance companies in Europe, and a valuable tool in our analyses.

When presenting key performance indicators and other incremental financial data, there is a concern that the lack of common conventions, audit, and oversight will lead issuers to provide misleading or favorably portrayed data to investors. The SEC rules intended to mitigate these concerns often limit companies' abilities to present non-GAAP financial information in their financial statements, even though this information may better reflect how the company is managed and better represent its economic position. As a result, many companies now provide supplemental financial information to analysts and other users outside of the financial statements or have dropped it altogether. When provided, this information typically is not subjected to the same level of audit rigor as the financial statements themselves.

Of further note is the duplicative nature of many disclosures presented by publicly traded entities. Although this issue may not be solely within the control of the accounting standard-setters (as it relates to disclosures required by the SEC), certain efficiencies in this area could be gained as well in eliminating redundant disclosures, in conjunction with a reconsideration of an accounting and disclosure framework. Further, it also would be beneficial to consider the incorporation of an MD&A-type disclosure standard to complement the generic financial statement disclosures currently required.

It is clear that simply merging various accounting standards, without moving toward better accounting standards that are ultimately harmonized within a conceptual framework, will mean convergence has failed. Indeed, the FASB and the IASB, in the Memorandum of Understanding issued in 2006, recognized that the focus must be on improving standards, rather than just merging the two sets of standards. Despite the value convergence will provide, the obstacles are significant.

Roadblocks To Convergence

Cultural

The greatest roadblock to full acceptance of convergence may be cultural, in the form of market participants' unwillingness to relinquish control over standard-setting. As noted, the Forum poll results showed a vast majority of participants were willing to accept an IFRS-based standard or a converged set of standards, but when asked if they were prepared to give up control of establishing accounting standards, 68% said they would not, and another 7% were unsure. This likely is the U.S. sentiment at large, given the historical strength of U.S. capital markets relative to global markets. It may also reflect a comfort zone: While there are shortcomings with U.S. GAAP, the market may not be ready for a wholesale substitution with a new system of standards that is still evolving, has yet to be tested, and to which the market will have to get accustomed. Many critics have argued the prospective changes would result in financial statements that are harder to understand than before, that lack "bright-line" guidance and clear-cut rules. However, with the increased prominence of financial markets outside the U.S., change within the U.S. is inevitable.

Legal and regulatory

The disparate legal and regulatory environments between nations may also be a barrier to convergence. The U.S. business environment is increasingly litigious, and the judgment of management, boards, and auditors often is second-guessed by plaintiffs, regulators, and other third parties. The desire to avoid the consequences of second-guessing resulted in a penchant for establishing rules and bright lines in accounting standards. Integrating principles-based guidance into an environment ill-equipped to tolerate differences in opinion and judgment will continue to be a significant roadblock that must be addressed.

We believe future legislation or legal action related to the application of accounting standards should interpret the actions of financial statement preparers and auditors from a prudent commercial perspective. This will promote company and auditor adherence to the spirit of the standard and to the broader principles. Accounting methods selected by the company should be assessed in the context of whether they faithfully depict the economics of its business, and determine whether the recognition, measurement, and disclosures made provide sufficient information to discern the nature of significant transactions, risks, and opportunities to the company.

Greater coordination also is needed between market and other regulators. Differing enforcement standards could drive a movement toward reporting arbitrage, where strict enforcement of reporting requirements relative to other markets causes companies to list in a market with lesser enforcement. While the SEC and the Committee of European Securities Regulators (CESR) are working together to ensure consistency in rules and regulations, the SEC regulates publicly traded companies in the U.S., whereas regulation in Europe is left to national regulators in each country. Similarly, auditing standards must also be standardized to support the goals of convergence. Failure on either of these points ultimately would undermine the usefulness and comparability of financial statements between markets, sabotaging the very principles on which convergence would be based.

Structural

The mechanisms and structures designed to address reporting needs also must be addressed, i.e.:

- Will two standard-setting bodies co-exist, or will there be a single, merged standard-setting body?
- How will the standard-setting body (or bodies) be funded, while maintaining their independence from interests seeking to influence the standard-setting process?
- If the dual structure continues, what mechanisms will be implemented to ensure a consistent framework?
- How will standard-setting-process constituents be assured that their views will be heard, and their ongoing needs

met?

Although the FASB and the IASB have made greater efforts toward being more inclusive within their own spheres of influence, a recurring complaint about standard setters is that they are out of touch with the practical applications or impediments of the guidance being issued. The appropriate feedback mechanisms in the standard-setting process will need to be established at the outset to address these concerns.

The appropriate structure also should be geographically diverse and free of local and political influence, thereby enabling it to maintain an unbiased accounting standard-setting posture. Overrides of accounting standards by a particular jurisdiction, in whole or in part, carve-outs, or modifications to address unique local preference or sentiment will undermine convergence trends, and ultimately may lead to a continuing divergent environment.

An international standard-setting forum that should have greater resources at its disposal and support from many local boards can act much more rapidly and comprehensively than in the past. However, some could view the global scope of such a forum, without the ability to cater to local sentiment, as an impediment to convergence.

Lack of consistent auditing standards

To sustain confidence in reported amounts and information, the quality of the audit is critical. Robust accounting rules (or principles) become largely irrelevant to analysts and financial statement users if they are not supported by robust external audit procedures that foster confidence in reported information. There is now an inconsistent and fragmented international audit environment. Harmonizing international auditing rules and ensuring consistent compliance with these standards are key to developing confidence in whatever particular accounting framework will be used.

Talent availability and education

No less important is the shortage of trained accounting and audit professionals, as demand currently outstrips supply. Educational standards, curriculums, and training programs will need to undergo significant revisions to support the movement towards convergence in the U.S. For example, convergence likely will result in accounting standards that rely much more on fair value accounting to assign a value to an asset or liability. There is a real question as to whether preparers and auditors have the necessary training to ensure that companies are making reasonable valuations. Mark Olson, Chairman of the PCAOB, expressed reservations regarding fair value reporting in a recent speech, indicating "...fair value accounting, while presenting the promise of greater relevance, represents an area of potential audit risk. Thus, we are monitoring this area to understand how firms are addressing this potential risk." (Remarks of Mark W. Olson, Chairman, Public Company Accounting Oversight Board, June 7, 2007, see http://www.pcaobus.org/News_and_Events/Events/2007/Speech/06-07_Olson.aspx).

Cost, and coping with the change

Full migration to a single convergent standard, without a reasonable transition time, may result in large costs, inefficient transition, and will encumber management's time, potentially distracting from day-to-day management efforts. Convergence and harmonization at a rapid pace will require investments in systems, personnel, new protocols, new reporting formats, and modification to the internal control system over financial reporting, which may be quite large. Additionally, significant incremental effort and cost could come in the way of having to re-negotiate contracts, debt covenants, compensation arrangements, etc. that are tied to measures of a particular standard. U.S. companies, recuperating from like-sized efforts associated with the implementation of Section 404 and other provisions of the Sarbanes-Oxley Act, may be reluctant to undertake these efforts, barring a large capital cost enhancement (or the avoidance of a penalty) arising from migration to a totally new set of accounting

standards.

Market acceptance

Auditors are not the only ones who will need further education. Principles-based accounting provides little bright-line guidance but focuses on providing financial-statement preparers with broad guidelines, so fewer circumstances will have black-and-white accounting solutions. This approach implicitly acknowledges the inability of accounting standards to address every possible set of circumstances, particularly as the business environment and structured transactions designed to meet disparate needs become increasingly complex. Accordingly, the market must be educated about addressing perceived concerns regarding quality and transparency of financial reporting. The result: Higher risk premiums, in the form of higher borrowing costs or lower share prices, will be assessed for companies not providing the best quality and transparency. In extreme cases, companies may not be able to raise capital in the first place. Shareholders and boards will then drive management to provide better information to reduce these costs. By encouraging a proactive market response, the system would incorporate a self-correcting mechanism that is no longer entirely reliant on regulation for resolution.

Filling In The Potholes

In discussing the evolving nature of global accounting standards and convergence, fundamental questions remain unresolved.

What should the financial statements represent, and for whom?

Some believe the financial statements should reflect management stewardship; others argue they should reflect the risk of the company failing to meet its obligations. Still others say that financials should reflect the potential rewards and risks the company undertakes in maximizing shareholders' value. Similarly, regulators, vendors, taxing authorities, management, or potential merger or acquisition candidates have distinct financial information needs. None of these views are inherently incorrect, but accommodating these different perspectives could result in significantly disparate means of presentation and information provided to users, and must be considered carefully.

For example, regulators in some industries view company financial statements from a solvency perspective to ensure the company, if liquidated, would have the means of paying its obligations. This view is quite distinct from that of equity owners, because it fails to recognize the economic benefits the company realizes as a going concern.

Others contend that financial statements should be prepared to accommodate the equity owners, as they represent the residual equity of the company. This view assumes that equity owners' perspective ensures that the information needs of other users are also met. We however, believe the equity holders' perspective is not necessarily inclusive of the informational needs of all other primary users, particularly the needs of creditors during a period leading up to insolvency. Augmenting the information provided to meet the needs of other primary user groups, such as creditors (e.g., by providing information on liquidity, asset protection, and priority of claims), would not detract from the informational needs of shareholders.

For example, within the drive toward convergence, there has been a distinct movement toward the use of fair value accounting and fair value measurements. Over the past few years, the FASB has released guidance detailing situations where fair value measurements are required (such as FASB Statement No. 133), and where fair value accounting may be chosen (FASB Statements No. 155 or 159). Similarly, the IASB has guidance (IAS 39) that both requires fair value in certain situations and allows for an option in others. While a consistent approach to valuing

and presenting a company's assets and liabilities may be preferable to the current mixed-attribute models, fair value measurements, taken to an extreme, could result in balance sheets reflecting the market capitalization of a public company, and the income statement reflecting changes (period over period) in the value of that market capitalization.

Few would argue that financial statements presented solely on this basis would meet analytical and other needs. Additional information would be required to ensure the financial statements remain relevant for analytical and other user needs, including: disclosures regarding the causes of the changes in value; ranges of values that may ultimately be realized; assumptions underlying the values presented; events that could result in a particular value being realized; management's strategy for addressing the risks in variation, etc. Supplementing the single number shown for a particular account in the financial statements with these types of disclosures would go a long way toward satisfying analytical and other user needs.

Is close enough good enough?

Critics of convergence and principles-based standards point to the potential for greater subjectivity within financial statements and question whether there will be a loss of comparability and reliability. It is true that--as judgment replaces rules--converging on a principles-based environment may result in greater diversity in how financial information is presented. But it is equally true that U.S. GAAP-based financial statements undergo innumerable subjective assessments, including estimates for contingent liabilities; loss reserves; tax liabilities; pension obligations; judgments on residual benefits in assessing consolidations; and even in estimating assets' useful life for depreciation purposes.

This perception highlights the need for greater tolerance of differences in opinions and judgment and significant changes in disclosure requirements. Close enough can be good enough where robust disclosure clearly and concisely explains the underlying assumptions on which management relies in presenting financial information, the risks and consequences should these be incorrect, and the plausible events or circumstances that might cause them to be incorrect.

The Road Ahead

The IASB, the FASB, and the SEC have established a roadmap in the drive towards convergence. While short-term goals may differ in certain respects, the ultimate destination remains the same. Further direction is needed on this journey, and the fundamental questions must be answered so that the framework developed under convergence incorporates the flexibility and conceptual consistency necessary to meet the current and future needs of a variety of financial-statement users in the global community.

Once developed, an orderly transition to the new standards is needed. One potential option is to allow a transition period, during which companies could present financial statements under either accounting convention, but provide--either in the footnote disclosures or directly on the face of the financial statements--a reconciliation of the significant differences during a transition period. This transition-period reconciliation would serve as a bridge between U.S. GAAP and IFRS for the most recent comparable year, show how assets and liabilities were adjusted in transition, and allow a full understanding of the changes affecting the financial statements. This and other transition techniques should be considered to better allow financial-statement preparers and users to fully implement and appreciate the information provided by the converged guidance (see table 3).

Table 3

Analytical Implications Of Changes In Accounting Standards

Evolving accounting standards typically have not resulted in ratings changes, largely because of our longstanding approach to financial statement analysis and because such changes often do not have any direct impact on credit quality. However, accounting changes often reveal new information about a company--information which must be factored into our understanding of the company. It is also possible that accounting standards changes could trigger related effects, such as financial covenant violations; regulatory or tax consequences; or adverse market reactions as a result of changes in market sentiment about the company's leverage, profitability, or capitalization. Pronounced business and financing behavioral shifts as a result of accounting changes (e.g., changes in compensation arrangements or hedging strategies) are cases where changes in accounting standards have influenced our ratings considerations in the past.

As part of our analyses, we have historically adjusted financial statements to reflect pension and other post-retirement plan benefit liabilities within the balance sheet for purposes of measuring a company's leverage (and continue to do so where the financial statements fail to). Because our analyses and adjustments methodology already took these liabilities into account, we were less concerned with the impact of FASB Statement No. 158, which required these obligations to be fully reflected on the balance sheet. Rather, our primary concern was the potential market reaction to the inclusion of these obligations on company balance sheets, and any impact on covenants in debt and other agreements. Ultimately, there was little to no effect on ratings issued by us because of the change in accounting guidance.

Similarly, before IFRS went into effect for European listed companies in 2005, there was some concern about whether new information would be disclosed that might result in changes in credit ratings. This has not been the case, reflecting our efforts to understand the fundamental economics of the company's business and financial statements and engage in a robust dialogue with our affected issuers in the period leading to transition. It is possible, however, that as accounting standards continue to evolve, they will provide analysts with previously unavailable information, or would provide for different ways of evaluating existing information, especially if financial reports evolve to contain better forward-looking information, enabling greater understanding of the reported financial position and results (e.g., risk factors, sensitivity analyses, and key performance indicators). In this sense, ratings actions (which may be favorable or unfavorable) could result from converging or evolving accounting standards. (See also "Transition Without Tears: A Five Point Plan For IFRS Disclosure," published Dec. 6, 2004, on RatingsDirect.)

Even when financial statements may not be directly comparable, the accompanying disclosure (if so mandated) would give analysts and other users the necessary information to fully understand the economic results of the business. Good disclosure does not make up for bad accounting; however, well-applied principles, combined with good disclosure, will go a long way in providing the type of information needed by analysts and other users. There is no trade-off between accounting and disclosures--both are essential. Financial statements alone currently do not provide complete decision-useful information to financial-statement users, as shown by the broad use of non-GAAP measures to highlight financial position and results, and users' on-going call for more information.

We believe current U.S. financial reporting can and should be improved in the short term without waiting for full convergence or the evolution of a joint conceptual framework to financial reporting. The information needs of a wide variety of financial-statement users could be met by instituting a principles-based disclosure standard that would set out a minimum standard of information to be disclosed (in lieu of developing discrete disclosure standards, by topic, the disclosure standard would cover all items reflected in the financial reports).

Some have stressed the potential for diminished usefulness of financial reports associated with incremental disclosures. To mitigate these concerns, that standard might introduce the use of a multi-level disclosure framework. Users could find the areas of most importance to them, and minimize the potential for diminished clarity (i.e., be able to condense financial reports and present only the information needed for their own purposes). For example, Level 1 of the disclosures might consist of the accounting standard and policy applied; Level 2 would provide a roll forward and breakdown of the applicable balances; and Level 3 would provide details of the estimates, assumptions, and the reasons for the potential variation in the amounts disclosed, and incorporate forward-looking information. This would avoid information overload, while satisfying analysts and other users' needs for more comprehensive information. Whether improved in the short or long term, disclosure requirements will have to be addressed on the road to convergence.

Step On The Gas

There is no current consensus on what constitutes an adequate accounting and financial reporting framework, and much of our discussion here leads to the conclusion that no one size fits all. Certain trade-offs must be accepted when aggregating financial information into one report that can deliver sufficient information to analysts and other financial-statement users. We believe that, by harmonizing and converging accounting standards, the standard setters should strive to develop a framework that:

- Is capable of delivering sufficient decision-useful information to financial statement users in a consistent and timely manner;
- generates meaningful financial reports and is responsive to market trends;
- is sufficiently reliable and not prone to abuses;
- is easily understood by reasonably well-informed users; and
- covers a multitude of users needs, including creditors, shareholders, regulators and past and current employees.

(See tables 4 and 5 for further discussion).

We believe the road to convergence presents a unique opportunity for standard setters, preparers, regulators, and the financial-statement user community to revisit existing guidance within the broader context of a more comprehensive framework, unencumbered by the specter of accounting's past. Beyond convergence, the ultimate evolution of global financial markets ideally would lead to a single set of accounting standards that is globally accepted and consistently applied and audited. Developing this framework is essential to supporting the constantly expanding global capital markets. Continued focus and strong commitment by all parties will be necessary to successfully navigate the journey ahead of us.

Table 4

What Do Analysts Expect From A Financial Reporting System?

We believe that accounting should match economic reality as much as possible. The current mixed-attribute model, by creating asset/liability mismatches, is not desirable because it obfuscates this reality, and does not give analysts the information they need. A principles-based approach, supported by robust disclosures that indicate the accounting policies, significant assumptions, and sensitivities of recorded balances would allow companies to provide much-needed information to analysts and other financial statement users.

A financial reporting system should be:	
Reliable And Consistent:	Produce dependable information generated on a consistent basis, that users' can trust and rely on in making financial decisions. Consistency relates both to period-over-period comparisons and how information relates to comparisons among enterprises. It also reflects expectations regarding the consistency of the audit process.
Useful And Timely:	Information provided is useful in financial decision making, and is provided in a timely manner.
Retrospective And Prospective:	Enable historical comparison and evaluation of performance and financial position, and provides sufficient forward-looking information for future projections of predictive value.
Versatile And Dynamic:	Allow for registering, summarizing, and disseminating complex business transactions; responsive to an ever-evolving complex environment, and incorporate varying users' needs.
Precise And Imprecise:	Financial statements reflect precisely measurable items at the measured amount, while giving enough information about uncertain items that let analysts understand the underlying estimates and assumptions supporting the amounts reflected in the current financial statements. Sensitivity analyses and additional information must be provided so that analysts can understand management's views of future performance, and how and why its recorded amounts may differ going forward.

Table 4

What Do Analysts Expect From A Financial Reporting System? (cont.)

Integrated And Understandable:	Both financial and non-financial information should be integrated into the financial statements, including key performance indicators, high-level operating drivers, and evaluations of performance against strategic initiatives. In many cases, this information is provided outside the financial statements, i.e., in the MD & A or supplemental information (and therefore, not subject to the same level of audit scrutiny, or not provided at all). Additional information should be provided where earnings diverge significantly from cash flows, including expectations for future cash flows and the assumptions on which management relies for determining expected cash flow needs.
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Table 5

Tensions And Tradeoffs

Throughout financial reporting, there are tradeoffs between what can and should be reported. Often, either because of the complexity of the transaction or the inherent uncertainties surrounding the event in question, there may be more than one "right" accounting answer, so from an analytical perspective, disclosure of the range of potential results would be more informative. For example, current guidance for contingencies under U.S. GAAP indicates a liability would be recognized when the contingency is probable and estimable. In those cases where the probability of a loss for a contingency does not exceed a "probable" threshold (often estimated at 70% or more) the company does not recognize a liability. Further, if the probability were only 70%, the company would recognize the entire contingent amount (at 100%) unless the amount can only be estimated within a range, in which case the lowest amount within that range would be recognized. This accounting result by itself provides users with little informational value; indeed, failure to disclose further information is misleading to analysts within the context of the future prospects of the company and the risks it faces.

The subjective and uncertain nature of the assumptions underlying the accounting measures mandate a much broader reporting framework. Consider the fair value of a derivative financial instrument on the balance sheet, which signifies its value on a particular date (the reporting date). To be meaningful to analysts, the value must be complemented with further information, such as the risks against which the instrument should protect; the risks to which the company remains vulnerable; the underlying assumptions on which reported figures are based; ranges of potential results, should those assumptions not hold true; and the duration of the risk and potential impact on liquidity (e.g., termination or collateral triggers).

However, it is neither practical nor cost-effective to have a system to create accounting rules that cover every current and anticipated business transaction. The following highlights some of the more significant tradeoffs and challenges that currently exist in financial reporting, and suggests some potential solutions:

Verifiable (Auditable) Vs. Unauditable Information:	Certain information may be tied to a particular transaction, and as so, may be easily audited and attested to by an external auditor. For example, auditing the revenue from an irrevocable sale of merchandise supported by a collection of cash is easily verifiable, whereas the fair value of an investment in a start-up technology company may be more subjective and challenging to verify. Auditors have long held they face challenges in auditing forward-looking statements because of their inherent uncertainties.
Fair Value Vs. Historical Cost:	The mixed-attribute model currently leads to many instances of asset/liability mismatches, causing volatility in the financial statements, obfuscating the actual underlying economics of a company's asset/liability management and hedging programs, and consequently its financial position and operating results. Solving this may not be as easy as it seems. Should an appreciation of assets be reported on a company's balance sheets, and if so, should companies reflect the appreciation (or the value-added) generated to their own inventory produced prior to its sale, assuming its value could be readily determined? Alternatively, should this be limited to only those assets for which a liquid or defined market value exists? Even if the premise is agreed, it raises an issue of comparability, i.e., how the performance of these companies compares with the performance of other companies that own assets with either less-robust valuations, or are supported by less-active markets.
Account Vs. Disclose:	Accounting produces a single number, representing a wide variety of potential outcomes that may result in the realization of a different amount. Disclosures should provide information allowing users to assess what might be realized. Often such disclosures are lacking. In recognizing the significance of disclosures, the fundamental difference between accounting and analysis must be recognized: The accounting method necessarily must find one number to use in presenting financial data in the basic financial statements, whereas the analyst, by definition, picks apart the numbers in order to find the potential and reasons for variability in those numbers. Good analysis looks at multiple perspectives--and uses adjustments and scenario analyses to depict a situation differently for a specific purpose or to gain another vantage point. Disclosures are vital to our ability to analyze information in a meaningful fashion.

Table 5

Tensions And Tradeoffs (cont.)	
Substance Vs. Form:	Legal form often takes precedence over the substance of the transaction. Many questions and issues surrounding the accounting for securitization transactions revolve around these matters. Similarly, form over substance has caused many restatements when dealing with hedge accounting treatment under FASB Statement No. 133.
Realized Vs. Earned:	Unrealized gains/losses from changes in fair value measurements that are reflected in earnings are increasingly significant. Although these fair value changes technically are earned, they may never be realized (i.e., translated to an amount in cash equivalent to the recorded amount) as a usable asset (or payable liability). A prominent example is the gain a company recognizes (if the optional fair value election is made) following the consequential devaluation of its own financial obligations after the deterioration of its own credit worthiness. The point-in-time snapshot perspective inherent in financial statements fails to provide users with critical information. Consequently, we believe the statement of cash flows will become increasingly important to our analysis, allowing analysts to identify actual cash flows and discern the relative quality of issuers' earnings. For a greater relevance to users, further reconsideration by the standard-setters of the presentation of the statement cash flows is needed. Requiring the use of the direct method of cash flow presentation, or ideally, a more comprehensive presentation, will enable better understanding of how earnings and expenditures reflected in the income statement differ from cash realized or paid for these items during the reporting period.
Gross Vs. Net (Aggregated Vs. Disaggregated) Presentations:	Certain balance sheet and income statement items may be reflected on a gross basis, and while others might be presented on a net basis (e.g., sales taxes collected may be reflected as revenue or as an offset against revenue). Presenting these items inconsistently may grossly affect an analyst's view of profitability or top-line revenue growth. An analogous issue arises for certain non-recourse obligations and securitizations, and investments in joint ventures and related parties: Depending on the circumstances or the accounting standard followed, the transaction may be recorded on a gross basis (i.e., on the balance sheet) or a net basis (i.e., as a single line item reflecting equity investment or a residual interest). Differing presentations for what appear to be transactions with very similar economic bases could lead financial statement users to varying conclusions as a result of different optics of capitalization and leverage (hence another prominent reason for the importance of disclosures). Another similar issue relates to segmental information--with the amalgamation of many activities (e.g., a manufacturing company with a finance subsidiary or conglomerates with diversified activities), financial-statement analysis cannot be meaningful without disaggregated segment data.
Aggressive Vs. Conservative:	Accounting should endeavor to be neutral--neither conservative nor aggressive. Conservative accounting in one period could very well translate to being aggressive in the successive period. Differing approaches to accounting may result in significantly different accounting results, and subjectivity plays an increasing role in financial statement preparation. Current accounting under U.S. GAAP and IFRS embeds a bias towards conservatism--prominent examples include the prohibition on recording contingent assets, reflecting inventory at the lower of cost or market, expensing costs of research and development, and the prohibition on the recognition of "self-developed" intangibles. However, the approaches under U.S. GAAP and IFRS are not consistent, and do not follow a conceptually congruent and coherent principle that can guide practitioners in making accounting choices and analysts in deciphering the outcome.

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