

Adoption of IFRSs in Europe

Hong Kong Financial Reporting Standards are identical to International Financial Reporting Standards. While the issues addressed in this Technical Briefing are stated in the context of Europe, they are relevant here in Hong Kong as well.

Is switching to IFRSs a big adjustment for European listed companies?

That will depend both on the individual countries and individual companies. IFRSs are required for nearly 9,000 listed companies in Europe starting in 2005. That actually means 28 countries, including the 25 EU countries and three European Economic Area countries. Plus there is Switzerland, where IFRSs are required for most listed companies starting in 2005. In those 29 countries, the effect of switching to IFRSs depends on what the starting point is – and that, in turn, depends on what the current national GAAP is. In some countries, national GAAP is closer to IFRSs than in other countries. It is my understanding that 50 to 100 EU companies have been reporting under IFRSs in the past, as have many Swiss companies. Reporting by those companies will not be affected. The effect of changing to IFRSs will also depend on the industry in which a company operates, because some IFRSs will affect certain industries more than others. For instance, companies that are heavily involved with financial instruments will be more affected by IAS 32 and IAS 39 than might, say, manufacturing companies. Insurance companies that had been accruing catastrophe provisions or equalisation reserves may be significantly affected by IFRS 4. Another example would be agricultural companies that have been using a cost-based model for their livestock, crops, timberlands, and

produce at the point of harvest. They will have to switch to a fair value model. Furthermore, the effect of adopting IFRSs will also depend on each individual company's circumstances and business practices. For example, companies that do not issue stock options or other forms of share-based payment will not be affected by IFRS 2.

What are the big changes in the reported profits of European listed companies as a result of changing to IFRSs?

IFRSs will require all companies to present both a cash flow statement and an equity statement, in addition to the balance sheet and the income statement. Moreover, IFRSs require specific formats for those statements, and specific line items. In some countries, those will be important changes. Examples of IFRSs that are likely to have a significant affect on profit and loss include:

- Comprehensive recognition of deferred income tax assets and liabilities will be a major change.
- To the extent that national GAAP had continued to allow the pooling of interests method of accounting for business combinations, the switch to IFRSs – under which pooling is prohibited – is likely to result in higher depreciation charges going forward.
- On the other hand, non-amortisation of goodwill and other indefinite-lived intangibles is likely to have a positive affect on reported earnings. The flip side of that is the IFRS requirement

to do an annual impairment test for goodwill – something companies may not have been doing on a regular basis up to now.

- Impairment recognition for all assets and liabilities, either individually or on a cash-generating-unit basis.
- Accrual of pension and other employee benefit obligations, and measurement of related plan assets at fair value.
- The IASB requirements on accrual of provisions (liabilities of uncertain amount or timing, and related expenses) can work in two ways. In some cases, provisions will be required where companies had not done so in the past. On the other hand, some traditional provisions may now be prohibited, things like provisions for future restructurings and accruals of general reserves.
- Of course, financial instruments is likely to be a major area for which profit and loss will be affected. For one thing, nearly all financial instruments will now be on the balance sheet, with many measured at fair values. IFRSs are likely to restrict derecognitions of financial assets, which will mean that fewer gains will be recognised up front. No European country had strict hedge accounting rules in their national GAAP. The rigorous rules under IAS 39 are likely to mean earlier gain and loss recognitions. Also, fairly strict requirements for recognising impairments of financial assets are likely to have an affect on profits.
- Consolidation of all subsidiaries – IFRSs do not allow any exceptions for subsidiaries that are held for disposal or that operate in different industries from the parent or that operate in countries with currency exchange restrictions.
- Non-recognition of most self-created intangible assets may mean, for some companies, more up-front expensing of the costs of intangibles.
- The fair-value-through-profit-and-loss model for investment property ➤

is something that is new to Europe. It is one of two options allowed by IFRSs – the other being the traditional cost-depreciation-impairment model. There is likely to be a significant affect on earnings of companies opting for the fair value model.

- The IASB's fair value through P&L model for agriculture is not an option. It's a requirement.

And it is fair to say that the levels of required disclosures under IFRSs are, in general, considerably higher than under most national GAAPs. So there will be an expansion of the volume of note disclosures.

In your opinion, what are the principal fears of the European companies concerning IFRSs? Which IFRSs are the most troublesome?

First of all, hopefully European companies are viewing the adoption of IFRSs with optimism, as a favourable rather than fearsome development. While human beings are always a bit nervous about change of any kind, because we are comfortable with the 'status quo', there will be a big payback for Europe by moving to IFRSs for all listed companies. A payback in terms of better functioning and more integrated European capital markets. A payback in terms of acceptability of the financial statements of European companies in overseas capital markets. And, of course, a payback in terms of the reduced cost of capital that should result from more credible, understandable, and transparent financial reporting.

That being said, it is understandable that companies are worried. Among the aspects of IFRSs that seem to be of concern are these:

- IFRSs require greater use of fair values in financial reporting, on grounds that values are more relevant to users of financial statements than are historical costs. But the increase in relevance comes, in some cases, with a reduction in measurement precision, and some find that troublesome.

- By requiring greater use of fair values in measuring performance, IFRSs are likely to cause volatility in reported earnings, and some find that a concern. Actually, accounting doesn't cause the volatility. The volatility of asset and liability values is a real world phenomenon. A cost based accounting model hides that volatility – sometimes until it is too late.
- IFRSs are built on a conceptual framework with fairly rigorous definitions of assets and liabilities. Liabilities, for instance, must be present obligations owned by the company to somebody else. Assets must be current rights to future cash inflows. Some European national GAAPs have allowed balance sheets to include deferred debits or deferred credits that would not meet the IASB's asset and liability definitions, sort of as a by-product of a process of measuring or smoothing earnings or as a result of a concept of prudence.
- Standards, by their nature, reduce flexibility. They tell us what to do and how to do it. Where IFRSs deal with areas that simply were not addressed in national GAAPs, or where IFRSs are more specific about what is required than were the national GAAPs, the ability of company managers to 'manage their earnings' is reduced. While some people applaud this, there are others who would rather have continued flexibility.

Are European companies finding it difficult to apply IAS 39?

For a company with only traditional financial instruments, IAS 39 is not difficult at all. Measuring accounts and loans receivable and most debt investments at amortised cost, with appropriate recognition of bad debts, is nothing new or complicated. And debt and equity investments that are held for trading have been measured at fair values for many years. And even when investments were carried at 'lower of cost or market' the company had to know what fair value is in order to measure 'market'. So the IAS 39 principles of

accounting for debt and equity investments are not especially difficult either. People may not agree that the changes in fair value are income or expense, but the accounting is not difficult.

However, when a company enters into complicated financial transactions, or purchases or issues complex financial assets or liabilities, the accounting becomes more complex because the instruments are complex. For example:

- Traditional accounting did not recognise derivative assets and liabilities, whereas IAS 39 does (including embedded derivatives). This means that companies must now measure the fair values of derivatives at each reporting date.
- Traditional accounting had no rules for hedge accounting. Some companies did it, while others did not, and those that did it were not constrained by standards. IAS 39 has fairly rigorous hedge accounting requirements.
- Traditional accounting does not tell you what to do if a company indexes the interest or principal payments on its outstanding debt to the price of its shares or the price of a commodity.
- Traditional accounting does not provide guidance if a company buys a variable rate bond and interest rates rise or fall. Is some accounting required?
- Or what if a company has a right to renew its outstanding debt for another 10 years at a fixed interest rate, and market rates of interest go up? Clearly the ability to borrow at a below-market rate of interest is a big benefit, but that right is completely ignored under traditional accounting.
- Or what if a company sells its receivables but guarantees the first 20 per cent of credit losses – is it appropriate to simply record a sale – and possibly profit on that sale – while ignoring the guarantee?

The complexity in IAS 39 relates directly to the complex world of financial instruments.



What is the IASB's project on standards for small and medium-sized entities all about? Why are IASB SME standards needed?

In most countries in Europe and elsewhere (including Hong Kong), many or even all entities have a legal obligation to prepare financial statements that conform to a required set of accounting principles that are generally accepted in that country (national GAAP). Those statutory financial statements are normally filed with a government agency and thus are available to creditors, suppliers, employees, government and others. The great majority of those entities are small or medium-sized entities (SMEs) – no matter how one might define 'small' or 'medium-sized'. Few countries require these entities to prepare financial statements that comply with the full requirements of the IASB's standards developed primarily for use in international capital markets.

The IASB believes that IFRSs are suitable for all entities, listed and unlisted, large and small. Nonetheless, the Board recognises that in most developed countries where IFRSs are used, the primary adopters are entities whose securities are publicly traded. In Europe, where all listed companies will be adopting IFRSs in 2005, only two or three small EU and EEA member states (out of 28 total) will require IFRSs for SMEs. Most of the others will permit IFRSs, but they will also permit SMEs to follow national GAAP. Many of those countries are moving to align their national GAAPs with IFRSs, but no two are doing it in the same way. And most of those countries already include, either in their national GAAPs or national laws and regulations, accounting exemptions and simplifications for SMEs. In some cases, there is a separate body of accounting standards for SMEs.

There is a real possibility, in Europe alone, that there could be two-dozen or more sets of national standards that purport to be adaptations of IFRSs suitable for SMEs. This is true not only in Europe, of course, but also elsewhere in

the world. The problems that the Board sees in that event include:

- Claims of extraction from, convergence with, alignment with, or similarity with IFRSs are often somewhat exaggerated.
- National standards for SMEs would not necessarily be consistent with the IASB's Framework or Standards.
- National standards for SMEs would not necessarily address the needs of external users of financial statements (which is the IASB's objective).
- Financial statements of SMEs would lack comparability across national boundaries or even within a country.
- National standards for SMEs would not necessarily allow for an easy transition to full IFRSs for entities that wish to enter the public capital markets.

Simply put, in Europe it makes more sense to have one set of accounting standards for SMEs based on IFRSs developed by the IASB rather than 28 different sets. The same is true globally.

What will be the subjects addressed in the next group of IASB standards?

Over the next, say, three or four years we are likely to see IASB standards on the following topics:

- Accounting standards for SMEs (companies that do not have public accountability)
- A standard on how to apply the purchase method of accounting for business combinations – expanding the current IFRS 3.
- More detailed guidance on applying the concept of control, under IAS 27, in deciding whether an investment should be consolidated.

- More detailed guidance on consolidating 'special purpose entities'. These are currently addressed in SIC Interpretation 12.
- Standards that will lead to convergence of IFRSs and US GAAP in the areas of income taxes (IAS 12), segment reporting (IAS 14), pension accounting (IAS 19), and provisions (IAS 37).
- A whole new standard on accounting for government grants, replacing IAS 20.
- A new financial instruments disclosure standard (this will be finished in 2005 but not applicable until perhaps 2007).
- A comprehensive standard on accounting by insurance companies.
- A standard on reporting financial performance that will incorporate the income statement and parts of the traditional equity statement.
- A replacement of IAS 18 on revenue recognition.
- Clearer guidance on what is a liability and what is equity.
- Significant revisions to the IASB's conceptual framework and alignment of the IASB's and the US FASB's frameworks.
- We will see further revisions to IAS 39. Projects on the fair value option, financial guarantees, hedges of forecast transactions, and puttable instruments are already under way.

The IASB also has projects on its research agenda on joint ventures, leases, management discussion and analysis, intangible assets, extractive industries, investment companies, and measurement. Some of these are likely to blossom into standards in the next few years.

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- Director in the global IFRS office of Deloitte Touche Tohmatsu in Hong Kong.

He worked for the IASB's predecessor in London from 1996-2000, where, among other things, he managed the board's project that produced IAS 39 financial instruments: Recognition and measurement.