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Preparing for IFRS - a directors' guide

Countdown to transition

IFRS: COUNTDOWN TO TRANSITION

Letter from the editor

You could be forgiven for thinking that too much is happening too quickly. As a quoted company director, the chances are that you're currently wrestling with the issues raised by the Combined Code, the upcoming Operating Financial Review regulations and possibly even Washington's Sarbanes-Oxley legislation. And of course, there is also the imminent transition from UK GAAP to the new International Financial Reporting Standards, or IFRS.

While it's tempting to think that the implementation of IFRS is something that primarily concerns the financial community within the organisation, the truth is that the new standards have wide-reaching implications that everyone on the board should be aware of and preparing for.

For one thing, the annual profit and loss account could look very different when the consolidated accounts are drawn up under IFRS. Although the impact will vary greatly from company to company, in some cases the new rules on financial instruments and share options could result in a company apparently taking a severe hit on its bottom line. Preparing investors for the change could be a major challenge.

But it's not just your external communications that may need reviewing. Collecting the information required for IFRS compliant accounts will require new systems and procedures to be embedded across the organisation.

But what will this mean in practice? Well, while our latest directors' guide – written by Deloitte on behalf of *PLC Director* – can't address the specific circumstances of your company, it can provide a comprehensive overview of the operational and investor relations issues raised by the IFRS transition. This is an important time for listed companies and we hope that this guide will make some contribution to the preparations that are doubtless well underway within your company at the present time.

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CROSSING THE RUBICON?

Company directors, investors and analysts, auditors and tax advisors are set to experience a revolution in financial reporting, the size and impact of which the world has not previously experienced: the move to International Financial Reporting Standards (IFRS).

The hope of the International Organisation of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB) is that the adoption of IFRS will lead to consistent and comparable financial reporting by companies across the globe. The ultimate goal is an increasingly efficient global financial marketplace, where costs of capital are lower as a consequence of an improved allocation of capital world-wide. In turn, this should lead to better decision-making to enhance shareholder value.

Some countries have already incorporated IFRS into their accounting frameworks, or are in the process of doing so, South Africa and the Russian Federation for example. For EU listed entities, the move to IFRS is effective for periods beginning on or after 1 January 2005.

ARE YOU READY?

Research suggests probably not. Recent surveys conducted by several leading accountancy firms, *Accountancy Age* and the Institute of Chartered Accountants of England and Wales have indicated that many companies do not have an effective and fully comprehensive IFRS transition project in place. For a number of other companies, their project is behind schedule and the 2005 deadline looks challenging.

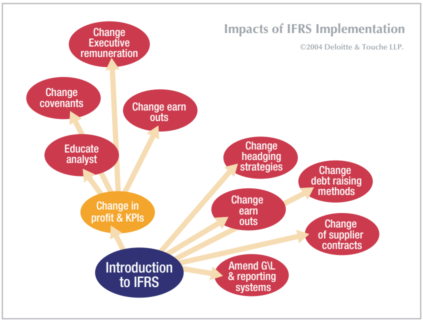
The business implications of an inadequate response to the introduction of IFRS are significant. Adoption of IFRS is not an issue for finance directors alone. The board of directors must be confident that their IFRS implementation project will be successful and that market evaluation of underlying business performance will be unaffected or merely better informed by the change.

This publication discusses first how to manage the communication of IFRS information to ensure that shareholders and the market develop appropriate expectations of what changes IFRS will bring and investors have confidence in their understanding of the figures when they are announced.

Additionally, there is a multitude of other operational and business issues on which the Board must take decisions to ensure that the transition to IFRS is successful. The second part of this publication focuses on more detailed implementation points to help company directors identify outstanding issues.

KEEPING YOUR INVESTORS ON BOARD

Implementing IFRS is not simply a question of changing formats and disclosures. One of the biggest challenges companies face is explaining the impact of IFRS on various performance indicators, and the increased volatility that IFRS will bring. Companies must ensure that investors and other stakeholders are well informed and that unforeseen market adjustments for unexpected restatements under IFRS are avoided.



The Hundred Group of Finance Directors has issued guidelines affirming this message:

"It is essential that companies begin this dialogue with the markets now, to ensure that everyone receives the information they need to avoid damaging speculation on the potential impact of the changes brought about by the implementation of IFRS on individual companies."

PERFORMANCE EVALUATION

- *How much historic data will be converted to IFRS to aid comparison?*

For investors to be able to make an assessment of underlying performance, they will need a basis upon which to compare results. The first set of IFRS accounts will look very different and the usual trends may have shifted. In most cases companies will only restate one year of comparatives. Furthermore, companies may take the exemption from restatement of comparatives for application of IAS 32 and 39, two standards that can radically alter the picture presented. Where the impacts of transition are not transparent or are not effectively communicated, it could make it difficult for stakeholders to assess underlying performance leading to damaging market speculation. This could visibly affect share price and credit ratings.

IMPACT ON KEY PERFORMANCE INDICATORS (KPI)

- *Are the company's KPIs adversely affected by the introduction of IFRS?*
- *Will the market be provided with historical KPIs restated for IFRS?*

The new standards may lead to considerable changes in the KPIs traditionally discussed in the Chairman's statement or the company's Operating and Financial

Review (OFR). For example, earnings' measures such EPS and the P/E ratio will be affected by increased volatility in the income statement, the current ratio by volatility in fair value of derivatives newly recognised on the balance sheet as current items and the debt to equity ratio by changes in classification of certain capital instruments from equity to debt.

Companies will need to explain such impacts and present alternative KPIs where these are more relevant to an understanding of performance reporting under IFRS.

The market may expect KPIs across sectors to be comparable, although the IFRS standards may affect individual companies quite differently. It is essential that any such differences and the reasons for these are intelligible to investors and other stakeholders alike.

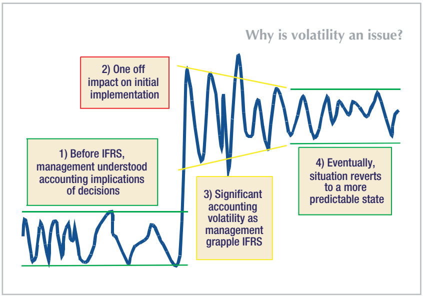
INCREASED VOLATILITY

- *Have the greatest sources of volatility for the company been established and quantified?*

IFRS requires greater use of fair values than other accounting frameworks that are largely based on the historical cost convention. Measurement at fair value will lead to increased volatility in results.

Companies will need to explain this. Some of the additional sources of volatility arising from the introduction of IFRS include:

- *Share-based payments recorded in the income statement as an expense at fair value*
- *Financial derivatives recorded on balance sheet at fair value with gains and losses reported in profit or loss*
- *Volatility in equity for re-measurement of available-for-sale assets and deferral of cash flow hedging gains or losses*



Volatility is not a one-off transition issue. Financial performance is likely to be more volatile under IFRS from one period to the next.

To ensure that readers of the IFRS accounts understand them correctly, early and effective communication of the one-off adjustments on first-time adoption and the continuing sources of volatility is paramount.

COMMUNICATION TIMETABLE

- *Will the release of the quantified effects of IFRS on the company's results differ from competitors?*

Companies must decide on the method and timing of their IFRS communication to the market, and whether they plan to release information with their competitors, to lead the way, or to follow the crowd.

The guidelines issued by the Hundred Group of Finance Directors advise companies to:

- *Consider co-ordinating the timing and detail of communications with other companies in industry and sector groupings to help facilitate better understanding across sectors and avoid unhelpful competition between companies*
- *Set a realistic timetable to release the opening balance sheet and the interim*

comparatives prepared under IFRS
The Committee of European Securities Regulators (CESR) encourages companies to include quantified reconciling information in the final set of financial statements prepared in accordance with previous GAAP. Where this is not possible, CESR recommends narrative disclosure together with a complete explanation of why the company is not in a position to provide quantified information.

Directors will need to decide whether to deliver their UK GAAP and IFRS information for 2004 simultaneously or whether they believe that the market will need time to digest the UK GAAP information before considering the restatement under IFRS.

The recommendation of the Hundred Group of Finance Directors is to publish full 2004 IFRS information and comparative interim data in the period between the preliminary announcement of the 2004 full year results and the first IFRS interim announcement.

Nonetheless, companies should not be hasty in the release of IFRS information. Just as the lack of IFRS communication may damage a company's reputation, the disclosure of misleading or inaccurate information will have the same effect.

A model reporting timetable for a listed company might include release of IFRS information as follows:

2004 Q3 and Q4	Select IFRS accounting policies, IFRS 1 First Time Adoption options and policies under standards optional for adoption in 2005 Prepare 2004 pro forma opening balance sheet under IFRS with reconciliation Prepare comparatives for IFRS interim financial statements for six months to 30 June 2004
2005 Q1	Publish 2004 UK information
2005 Q1/Q2	Publish pro-forma IFRS information with the 2004 UK GAAP financial statements or Publish 2004 comparative IFRS information and interim data separately, post release of the 2004 UK GAAP results
30 June 2005	Release first set of interim financial information under IFRS including comparatives for the period to 30 June 2004, and all reconciliations between UK GAAP and IFRS required by IFRS 1 First-time Adoption
From December 2005	Publish annual IFRS financial statements including comparatives for year to 31 December 2004 and all reconciliations required by IFRS 1, including reconciliation adjustments for application of IAS 32 and IAS 39*

AUDIT IMPLICATIONS OF THE TRANSITION TIMETABLE

- *Will the company's quantified IFRS disclosures be audited before they are released to the market, and if so have the auditors agreed to your timetable?*

Where the IFRS opening balance sheet and 2004 interims and/or full-year comparatives are released to the market prior to the 2005 IFRS interim figures or the first set of annual IFRS financial statements, company directors may decide that an audit of this information is prudent. Restatement of previously published IFRS comparatives for inclusion in the 2005 results could be seriously prejudicial. The time table for such audits will need to be factored into the reporting schedule and agreed with auditors.

STRATEGIES FOR SMOOTHING THE CHANGEOVER

- *Has the implementation project adequately addressed all issues?*

There is a multitude of business and operational issues on which the Board must take decisions to ensure that the transition to IFRS is successful.

The full impact of IFRS on business strategy is considerable. Areas most likely to be affected include: dividend policy and the level of distributable profits, performance related pay awards, treasury policy, budget setting and the preparation of other management information. Directors must be confident that the reporting (and KPI) impacts on business strategy are understood throughout the company and factored into day-to-day business decisions.

In terms of financial reporting, company directors are ultimately responsible for the preparation of financial statements which give a true and fair view. It is essential that the company's IFRS implementation project provides directors with the requisite level of assurance for them to be able to sign the IFRS financial statements.

MANAGEMENT'S GRASP OF IFRS

- *Do decision-makers understand the impacts of IFRS on business strategy?*

The transition to IFRS does not solely affect the finance department and accounting staff. Company directors, senior management, the audit committee and other members of staff (treasury personnel, lawyers and others negotiating contracts) throughout the business must be fully aware of IFRS to be in a position to make informed decisions regarding the company's financial position and its strategies for future performance.

PERFORMANCE RELATED CONTRACTS AND EMPLOYEE REMUNERATION SCHEMES

- *Have performance related contracts based on accounting information been reviewed and re-negotiated to identify the effects of IFRS?*
- *Will performance targets continue to be appropriate under IFRS?*

Performance related contracts such as employee share schemes are usually carefully crafted to ensure they provide an appropriate incentive. Since these contracts are often based on accounting information they may be adversely affected by the introduction of IFRS.

IMPACT OF GEARING AND LIQUIDITY RATIOS ON DEBT COVENANTS

- *What impact will IFRS have on the company's gearing and liquidity ratios?*

Loan covenants based on ratios from audited financial statements may be broken (or at least appear much tighter) leading to uncertainty about the availability of finance. A review of agreements should be performed to identify potential issues and formulate solutions.

TREASURY POLICY

- *Is the necessary hedge accounting documentation in place?*

It is likely that competitive market forces will result in companies needing to adopt the full version of IAS 39. Those companies intending to apply the IFRS hedge accounting rules should continue to invest time in designating and documenting their hedge accounting relationships.

Companies can buy time by using the optional exemption in IFRS 1 First-time adoption from restating the 2004 comparative information for application of IASs 32 and 39, in which case, the requisite documentation must be in place by 1 January 2005.

THE AUDIT COMMITTEE

- *Have Audit Committee members sufficient knowledge of IFRS to be effective in their review and approve the choice of international accounting policies adopted?*
- *Will existing controls over fraud and error be effective during the transition to IFRS where the risk of misstatement is greater?*

The Audit Committee will need to have sufficient awareness of IFRS requirements and to receive appropriate information on progress and decisions taken, to be able to provide effective oversight of the implementation project and to challenge management where necessary.

The ICAEW has produced guidance on auditing the transition to IFRS that includes an insight into what auditors will be expecting of management and Audit Committees in particular. It also warns of increased pressure on auditors to qualify accounts due to misinterpretation of IFRSs, inappropriate selection of accounting policies and inadequate records and audit trails.

SYSTEMS AND CONTROLS

- *Have systems been developed to capture information, which may not have been needed for UK GAAP, in a format compatible for reporting under IFRS?*
- *Has internal audit been involved to test new systems and controls?*

Company directors must be confident that all of the necessary changes to systems and controls for the implementation of IFRS have been made and tested for reliability. Systems will need to capture data which may not have been needed for UK GAAP, in a format compatible for reporting under IFRS. New systems interfaces to track those fair value gains and losses taken directly to equity and subsequently recycled into the income statement will be required. Automatic interfaces for accounts preparation will need to be recoded for changes to the formats of the financial statements.

Other changes to systems and processes that must be accommodated may include changes to consolidation procedures, especially for non-IFRS subsidiary accounts, amendments to budget information and the introduction of new KPIs.

These modifications and system requirements must be identified early to enable implementation and testing before full reporting. Systems will need to be able to produce a clear audit trail back to source data and have sufficient controls embedded within them to ensure the quality of the results they produce.

VALUATIONS METHODOLOGY

- *Has the company developed internal models for determining fair values or sourced external valuations expertise?*

Application of IAS 32 and 39 will require treasury operations to develop models for determining fair value for certain financial instruments, in addition to hedge effectiveness testing methodologies, and systems capability for tracking fair value gains and losses.

IFRS 2 will require options granted over the company's own shares to be fairly valued.

IFRS requires increased use of fair values and companies will need to establish models for determining fair values and develop expertise particularly where valuation is difficult or complex.

US REGISTRANTS

- *Have senior management considered the complex interplay between the adoption of IFRS and the needs of SEC reporting?*
- *Will new IFRS systems and controls meet the requirements of Section 404 of the Sarbanes-Oxley Act?*

US registrants that do not file full US GAAP financial statements will, for the first time, be required to provide a reconciliation of data from IFRS to US GAAP. Systems and controls established during the IFRS implementation project should identify reconciling data readily and accurately.

Furthermore, the adoption of IFRS coincides with the requirement, under Section 404 of the Sarbanes-Oxley Act, for management to report on the effectiveness of their systems of internal control over financial reporting. New internal control systems arising from IFRS implementation must satisfy this requirement. Additional resources and scrutiny of new systems and controls may need to be deployed.

STAFF SKILL SET

- *Have accounting staff been sufficiently trained to identify all transactions, assets and liabilities for recognition under IFRS?*
- *Do other staff members have the necessary understanding of the aspects of IFRS relevant to their operations?*

Accounting staff need to be as comfortable with IFRS as with UK GAAP.

Other members of staff taking operational decisions need to have sufficient knowledge and understanding of the aspects of IFRS relevant to their areas of responsibility.

For example, those negotiating contracts need to understand that unusual terms in purchase or supply contracts may meet the definition of 'embedded derivatives'. Such features are required to be accounted for separately at fair value in the balance sheet, with re-measurement gains or loss recorded in profit or loss. These should be avoided, unless deemed to be essential.

DISTRIBUTIONS AND DIVIDEND POLICY

- *Has the effect of IFRS on reserves available for distribution been gauged?*

Companies need to assess the impact of IFRS on their dividend policy. Where the new standards affect the ability to pay dividends, this will need to be explained to the market. Some of the key changes that may alter the distributable profits figure include reclassifications, for example, some preference shares reclassified as debt instruments (with preference dividends treated as interest) and increased fair value measurements under IFRS which generate volatility in the income statement or equity.

TAXATION

- *Will existing tax structures remain effective under IFRS?*
- *Has the cash flow impact arising from taxation on IFRS profits been assessed?*

The Inland Revenue has announced its intention to make revisions to tax legislation with effect for periods beginning on or after 1 January 2005, to ensure that companies choosing to adopt IFRS in their statutory accounts receive broadly equivalent tax treatment to companies that continue to use UK GAAP. However, these revisions also encompass amendments to the treatment of loan relationships, derivative contracts, intangibles and research and development under both UK GAAP and IFRS.

A fully accurate assessment of these tax implications may be difficult to make until precise details are known, but they are a significant factor in a decision to adopt IFRS for the statutory financial statements.

THE PLATFORM OF IFRS FOR APPLICATION

Although the IASB met its self-imposed March 2004 deadline for the publication of the suite of Standards to be applied on first-time adoption, some uncertainty remains. The standards must be endorsed by the European Commission (EC) before their application is legally required. Some of the standards due to be applied in 2005 have yet to be endorsed.

Companies must monitor and assess the impact of these 11th hour changes and fully accommodate them into their implementation plans.

The controversy surrounding the endorsement of IAS 39 and the fact that a European 'carve-out' version has been endorsed adds to the difficulty in preparing for transition.

In the UK at least, it is likely that competitive market forces will result in companies adopting the full version of IAS 39.

THE 2005 'STABLE' PLATFORM

- *IASs 1-41, IFRSs 1-5 (note that those revised IASs resulting from the IASB's improvements project and IFRSs 2-5 have been recommended for endorsement by the European Financial Reporting Advisory Group (EFRAG) but have not yet been endorsed by the European Commission)*
- *IAS 39 – the carve-out version has been endorsed*

CROSSING THE FINISHING LINE

Simplifying matters for investors, staying ahead of the impacts for the business, avoiding confusion in-house and maintaining shareholder value – the transition to IFRS is no easy task.

HOW WE CAN HELP

We hope that this article has highlighted a number of IFRS issues relevant to your business, and provides an overview of where further action may be required. Additional and useful sources of guidance and advice, some of which have been referred to in the text of this document, are included as an appendix.

For up to date daily news and developments regarding IFRS, the European Commission's progress with endorsement and further detail on the IASB's projects visit the Deloitte IFRS website by logging on to: www.iasplus.com.

Who to Contact

If you would like to talk to us about transition to IFRS, you can speak to our London IAS Centre of Excellence, which forms part of our IAS global expert network.

Please e-mail us at iasplusuk@deloitte.co.uk or contact:

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USEFUL RESOURCES AND GUIDANCE

- *For guidance on the presentation and disclosures that will apply to financial statements of UK listed groups for 2005 and an illustration of a model set of IFRS accounts, Deloitte's recent publication, iGAAP 2005 Financial Statements for UK Listed Groups can be purchased through CCH Online at www.cch.co.uk or by phone on +44 (0) 870 777 2906.*

- *Web-based e-learning modules on each of the IAS Standards, including IAS 32 and 39 are available free of charge at www.iasplus.com.*

- *For a practical guide to applying IAS 32 and 39 on the accounting for financial instruments under IFRS, Deloitte's recent publication, iGAAP 2005 Financial Instruments: IAS 32 and 39 Explained, can be purchased through CCH Online at www.cch.co.uk or by telephone on +44 (0) 870 777 2906.*

- *Downloadable publications providing further information and guidance on various IFRSs and a disclosure checklist for 2005 IFRS accounts are available at the Deloitte IFRS website, www.iasplus.com.*

- *The CESR recommendations and guidance can be accessed and downloaded from www.cesr-eu.org.*

- *The International Federation of Accountants (IFAC) has produced comprehensive guidance for auditors on reporting issues concerning first time adoption of IFRSs. Although designed to assist auditors, this publication provides companies with an insight as to how auditors can be involved in reporting IFRS numbers to the market. This can be downloaded from the 'other' category at http://www.ifac.org/store/.*

- *The IASB has published A Briefing for Chief Executives, Audit Committees and Boards of Directors, which provides a high-level summary of each standard along with the key business implications of their adoption. This can be purchased from their website at www.iasb.org.*

- *The ICAEW's technical release Audit 03/04 sets out expectations of management and audit committees in relation to the adoption of IFRS in their business. This is available for download from www.icaew.co.uk.*

- *The publication, Taking Control – A Comprehensive Guide to Compliance with Section 404 of the Sarbanes Oxley Act is available for download free from the Deloitte IFRS website at www.iasplus.com.*

- *Detailed notes on the tax consequences for companies adopting IFRS are available from the Inland Revenue's website at www.inlandrevenue.gov.uk.*

This guide is one of a series of supplements from PLC Director magazine

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