

Evaluation of the Application of IFRS in the 2006 Financial Statements of EU Companies

Executive Summary

December 2008

Ineum Consulting, a French consultancy company, has prepared this Report "Evaluation of the Application of IFRS in the 2006 Financial Statements of EU Companies" at the request of, and with funding from, the Directorate General for Internal Market and Services of the Commission of the European Communities (the "Commission"). This Report comprises two separate documents - an Executive Summary and a Detailed Report – which together represent the Report as a whole. Readers are advised to refer to the Report as a whole in order to obtain a complete understanding of the contents included and the methodology used.

The preparation of this Report by Ineum Consulting has been performed on a best abilities basis, exercising all due care that can be expected. For any error or omission, please contact Ineum Consulting and/or the Commission.

The source, including the author's name and logos of Ineum Consulting cannot be removed from the Report, except upon written authorisation by Ineum Consulting and the Commission. Moreover, the trademark of Ineum Consulting remains its property.

Any opinions expressed in the report are those of Ineum Consulting and should not be construed as opinions or policy statements of the Commission.

Further copies of this Report may be obtained from the Commission or Ineum Consulting.

Currency Convention:

In order to facilitate comparability between the companies in our sample, all figures presented in tables and in the text of the Report are expressed in Euros, except figures taken as a direct extract of the financial statements and included in the Report as an image or those figures for which a specific reported currency is mentioned. Closing Balance Sheet items have been translated using the closing rate and Profit & Loss Account items have been translated using the average rate.

Table of Contents

INTRODUCTION	4
1. THE APPLICATION OF IFRS IS HEADING TOWARDS MEETING THE OBJECTIVE OF ENHANCING COMPARABILITY	5
2. 2006 DISCLOSURES DEMONSTRATE EFFORTS MADE BY PREPARERS AND AUDITORS	9
3. ISSUES RELATED TO STANDARD SETTING, ENDORSEMENT AND ENFORCEMENT	11
4. APPETITE FOR WIDER APPLICATIONS OF IFRS	17
5. METHODOLOGY	19
6. CONCLUSION	20

Introduction

This Executive Summary presents our overall conclusions on the evaluation of the application of IFRS in the 2006 Financial Statements of EU companies.

The study was commissioned by the European Commission in order to follow the developments of consistent accounting for EU companies covered by the IFRS Regulation, including any evolution compared to the first year of IFRS application¹.

Our work is based on the desktop review of the financial statements of a representative sample of EU companies, the review of reports and statements by some national standard setters, enforcers and auditors, and interviews of some enforcers and members of professional bodies. Although we believe our approach to have taken into account all major facts and issues, the overall opinion that we have formed cannot be construed as being as “all encompassing” as if a wider detailed, more comprehensive study had been performed.

The opinions expressed in this report are those of the authors and do not necessary represent the position of the European Commission on these matters.

We would like to take the opportunity to thank all the people who have contributed to the results of this study, and particularly:

- ▶ The national enforcers and members of professional bodies whom we have interviewed and who have provided us with valuable input.
- ▶ The preparers who responded to the web survey.
- ▶ The European Commission project team members.

¹ A general analysis of the implementation of IFRS in 2005 was presented in “EU Implementation of IFRS and the Fair Value Directive”, a report by the Institute of Chartered Accountants in England and Wales

1. The Application of IFRS is heading towards Meeting the Objective of enhancing Comparability

1.1. The overall quality of IFRS financial statements has improved in 2006 in comparison with 2005

The overall quality of Financial Reporting under IFRS in 2006 appears to be better than the previous year, as illustrated for example by the FRRP² [United Kingdom] – “*The Panel’s experience is that there has been good progress and that the overall quality of financial statements has improved since 2005*” and by the CMVM³ [Portugal] – “*In the accounts for the 2006 financial year, a decrease in the number of qualified opinions was confirmed*”.

Other national bodies that released information on their analysis of the quality of application of IFRS in the 2006 Financial Statements outlined the overall progress towards full compliance compared to 2005 Financial Statements.

Auditors also indicated that the progress made by preparers allowed them to shift their primary focus from ensuring the correctness of accounts in 2005 to paying more attention to the relevance of comments and the overall understandability of the financial statements in 2006.

As one interviewee put it “*The concerns in 2005 were mainly the correct application of measurement and recognition criteria; not the disclosures*”.

Our review of 2006 financial statements also leads us to the same conclusion.

1.2. The application of IFRS by small and medium-sized companies poses specific problems

Most stakeholders recognise that the application of IFRS by small and medium-sized companies poses specific problems because, while their transactions are usually simpler than those of larger groups, they lack the necessary resources to cope with complex standards.

DPR-FREP [Germany] commented⁴ that “the key cause is the enormous scope and high complexity of the IFRS (...) Small and medium-sized companies and their auditors in particular often reach the limits of their abilities here.

While our analysis of financial statements did not highlight accounting errors, we also found that the number missing or incomplete disclosures was higher for small and medium-sized companies than large groups.

- ▶ For example, IAS 39 mandates that non-consolidated financial investments be classified in categories according to intent. : We found 100 % of large groups in our sample to be fully compliant in this respect; whereas only 75% small groups are compliant.

² Review Findings and Recommendations – 2008 (covering Financial Statements from December 2006 to June 2007) Financial Reporting Review Panel [United Kingdom]

³ 2007 Annual Report on the CNVM’s Activity and the Securities Markets, Comissão do Mercado de Valores Mobiliários [Portugal]

⁴ Annual Activity Report 2007, Deutsche Prüfstelle für Rechnungslegung – Financial Reporting Enforcement Panel [Germany]

1.3. Average size of companies is the major driver of differences in compliance between Member States

All large⁵ listed companies are on the markets of 15 of the 25 Member States. On the other 10 markets, even the largest companies qualify as medium or small on a pan-European level. Bearing this in mind, the comparison of the levels of compliance between countries appears more driven by the discrepancies in the average size of companies listed on each market rather than national situations.

1.4. The variety of disclosures between Member States reveals differences in economic and welfare policies across the European Union.

- ▶ For example 13 out of 15 companies under review disclosing the existence of service concessions (arrangements whereby a government or other public sector entity contracts for the supply of public services to private sector entities) are located in France, Spain and Italy, pointing out the tradition of State intervention in utilities.
- ▶ Some New Member States and Mediterranean countries have higher than average occurrence of disclosure of Government Grants under IAS 20, while United Kingdom has the lowest rate of government assistance, reflecting the different levels of grants given in the different countries.
- ▶ Wide differences in disclosures relating to IAS 19 *Post Employment Disclosures* exist. These are partly due to the different ways that the pension mechanisms and obligations are structured in each of the Member States' laws and economic policies.

With the exception of IAS 19 *Post Employment Benefits*, our work on the sample of companies did not show any major problems in terms of comparability across countries.

1.5. The choice of presentation options remains under the influence of national accounting cultures

Our technical analysis of financial statements showed noteworthy continuing areas of local accent in the choice of presentation options:

- ▶ a preference in the choice of Profit & Loss Account format linked to previous GAAP preferences (certain countries preferring the costs by function presentation and others the cost by nature presentation),
- ▶ a format of disclosures in the notes to Financial Statements which tended to reflect prior approaches for either text based disclosures or tabular based analysis of figures.

1.6. Consistency of application across industry sectors is limited by different underlying business models

Comparability across industry sectors is difficult and imperfect as each industry has a different underlying business model. Therefore a number of IFRS requirements apply with a different level of significance depending on the specifics of each industry sector.

We identified areas of specific interest for a limited number of industry sectors, for example:

- ▶ 73% of capitalized borrowing costs originate from two sectors: Oil & Gas (46% of the total) and Basic Resources sectors (27% of the total)

⁵ Defined for the purpose of this study as having a market capitalisation in excess of EUR 15 Billion as of 29th December 2006

- ▶ 52% of share-based payments originate from three sectors: Banks (27% of the total), Insurance (14% of the total) and Oil & Gas (11% of the total)
- ▶ 40% of intangible assets and goodwill originate from two sectors: Telecommunications (26% of the total) and Banks (14% of the total)

In each case, these areas result from the specific business models of the industry.

1.7. No occurrence was found of companies deeming necessary to depart from the requirement of standards to abide by the objectives set in the IASB Framework.

In the rare circumstances in which management concludes that compliance to an IFRS requirement would be misleading, IAS 1 requires an entity to depart from this requirement.

None of the companies surveyed disclosed the use of this Fair Presentation override.

1.8. The underlying use of IFRS options in 2006 Financial Statements are very similar to those in 2005. In the case of certain IFRS, a clear preference of many companies for one particular option exists. In other cases, there is a more varied spread of options selected by companies.

The underlying use of options by companies in our 2006 sample was similar to that in the 2005 ICAEW sample.

Many IFRS offer options, enabling the management to apply financial reporting requirements to the particular circumstances of their company. While enabling this flexibility, this possibility can add complexity and diminished comparability. Without listing all the cases that arise, CESR⁶ pointed out the potential improvement of removing or reducing the number of accounting options available in certain areas.

We summarise below our analysis of the IFRS options of the companies in our selection, between those IFRS for which one specific option is clearly preferred and those for which a variety of choices of option have been made depending on the companies particular circumstances..

IFRS options with a clear preference

- Few companies opted for Fair Value for tangible assets for either IAS 16: *Property, Plant and Equipment* (3%) or IAS 40: *Investment Property* (18%)
- 80% of Financial Institutions have however extensively taken advantage of the Fair Value Option of IAS 39 *Financial Instruments: Recognition and Measurement*.
- Among non-financial companies, only certain large groups (30%) used significantly the Fair Value Option of IAS 39 *Financial Instruments: Recognition and Measurement*, and less than 10% of small and medium sized companies.

⁶ Review of the implementation of IFRS in the EU, Committee of European Securities Regulators, Ref 07-352

- Only 25% of banks used the European Carve-Out option of the IAS 39 *Financial Instruments: Recognition and Measurement* for the valuation of macro hedge of portfolio of assets and/or liabilities:

11 banks among 43⁷ under review have been identified as using the European Carve-Out. None of these presented the impacts of applying the Carve-Out approach as compared to the results which would have been obtained if the Carve-Out approach had not been applied. No company in any other activity than banking has been found using the Carve-Out.

- 85% of companies engaged in exploration and extractive activities capitalise their exploration costs under the successful efforts accounting method [IFRS 6: Exploration for and Evaluation of Mineral resources]

IFRS options with a more varied distribution of options selected

- The presentation of the income statement shows an equal overall level of choice between function (40% of companies) and nature (34% of companies) classifications (IAS 1 *Presentation of Financial Statements*)
- Several options were selected for the recognition of actuarial gains and losses on post-employment benefits (IAS 19 *Employee Benefits*):
 - 53% of companies selected the corridor approach
 - 39% of companies opted for the “Equity model”
 - 8% selected the “Profit and Loss model”.
- 26% of companies disclose the capitalisation of borrowing costs (IAS 23 *Borrowing Costs*)

It is noteworthy that for the three companies out of four not disclosing capitalised borrowing costs, it is virtually impossible to conclude whether they expensed significant amounts of such costs or not. The revised IAS 23, not yet endorsed by the European Commission, makes mandatory the capitalisation of borrowing costs.

- 36% of companies elected for the proportionate consolidation method to report their interest in jointly controlled entities, while 21% elected for the equity method (IAS 27 *Consolidated and Separate Financial Statements*). 43% of companies did not disclose any interest in jointly controlled entities.
- 45 % of investment entities use the option provided by IAS 28 *Investment in Associates* to account for investments with significant influence but no control as under IAS39 *Financial Instruments : Recognition and Measurement* at fair value through Profit & Loss account (in lieu of equity accounting)
- 60 % of insurers applied “shadow accounting” option of IFRS 4 *Insurance Contracts*

⁷ Extended *ad hoc* sample comprising 28 banks under detailed review by Ineum, and 15 other banks surveyed either by ICAEW and/or Ernst & Young

2. Disclosures demonstrate Efforts made by Preparers and Auditors

2.1. Disclosures on accounting framework now identify almost unanimously IFRS-EU as the reference for the preparation of the Financial Statements

97% of the financial statements under review (and 99% for listed companies) were stated to have been prepared in accordance with IFRS-EU, showing a clear improvement over the results 2005 of the study, in which some ambiguity⁸ seemed to remain between the IFRS reporting framework as issued by IASB and the IFRS-EU as endorsed by the European Commission. 10% of these (11% for listed companies) were stated also to have been prepared in accordance with IFRS.

2.2. Improvements have been made in the presentation of the accounting principles to avoid ‘boilerplating’ copy and paste of financial reporting standards but further progress is needed

In 2005, comments had been made concerning a tendency for Group’s to apply standard texts, or “boilerplating”, for the notes on accounting policies, or presenting accounting policies for activities or operations for which there was no subsequent disclosure of transactions or balances in the Financial Statements.

Progress has been made in this area in 2006 although a number of cases still occur, and certain enforcers have referred to this in their communications to companies.

FRRP [United Kingdom] “*noted the inappropriate retention of UK GAAP descriptive material had diminished*”, but also “*noticed an amount of redundant information in summaries of accounting policies and encouraged the deletion of references to accounting policies which companies had either never applied or which had ceased to apply in past periods*”. FIN-FSA [Finland] noted⁹ that improvements, under way, must go further “*In the financial statements of 2006, both the summaries of significant accounting policies and other explanatory notes were more extensive than in 2005. However more focus should be paid on company specific accounting policies. In many financial statements it still remained unclear whether and how the disclosed accounting policy was relevant to the company’s business.*”

Continuing vigilance, and some form of information to companies, needs to be applied in this area to ensure that the accounting policies notes are the most informative and relevant to each company’s business model, operations and circumstances.

2.3. Incomplete disclosures on judgments and estimates remain a concern for a clear understanding of too many financial statements

FRRP [United Kingdom] stated that “*Few companies indicated the degree of sensitivity of carrying amounts to the methods, assumptions or estimates underlying their calculations*] and warned [Directors (...) to pay particular attention to disclosure of key assumptions and key sources of estimations during the forthcoming reporting season given recent developments and continuing difficulties within the financial markets].

⁸ IOSCO reiterated recommendations on that matter early 2008. International Organization of Securities Commission, Statement on Providing Investors with Appropriate and Complete Information on Accounting Frameworks Used to Prepare Financial Statements, 6 February 2008.

⁹ Survey on Finnish Companies Listed Companies’ 2006 IFRS Financial Statements, Rahoitustarkastus Finansinspektionen Financial Supervision, 11 Dec 2007

As FIN-FSA [Finland] put it “It is also important that companies consider carefully the situations where management uses judgement and give information on this, as it helps investors to understand what kind of effect management’s judgement has had on the items recognised in the financial statements”.

Our analysis of a sample of financial statements confirmed too frequent omissions in the disclosure of judgements, estimates, and assumptions used for calculations:

- ▶ 81 % of companies disclosed information on judgements and estimates, as required by IAS 1 *Presentation of Financial Statements*. Most estimates deal with impairment, pensions, tax position and provisions for risks. 19% of companies did not provide information relating to this topic.
- ▶ 76% of companies disclosing share-based payments provided detailed assumptions input into the valuation model. Different valuation models can be used by companies to value share-based payments. However, few companies provide justification or explanation of the use of a particular valuation model and in some cases do not even mention which model was used.
- ▶ 49% of the companies disclosing Defined Benefits Obligations provided information on life expectancy, and 17% disclosed both the life expectancy assumption and the source used to determine mortality rates.
- ▶ Only 22% of companies disclosing the capitalisation of borrowing costs provided both the amount capitalised and the interest rate compound for capitalisation.

2.4. The communication of alternative performance measures¹⁰ occurs only for a limited number of companies and they are in most cases reconciled to IFRS results

73% of companies comment their IFRS operating result in their management report, and 12% use an alternative operating result (9% providing reconciliation between IFRS and alternative operating result and 3% not providing this). 15% of companies do not mention operating result in their management report.

84% of companies comment their IFRS net result in their management report. Less than 1% uses an alternative net result. 15% of companies do not mention net result in their management report.

Regarding banks, 68 % of the banks under review provide performance indicators fully consistent with the aggregates presented on the face of the income statement and do not present additional indicators in their financial highlights. The remaining 32 % use non-IFRS measures, either in place of or in addition to IFRS figures and provide reconciliation with IFRS.

The main reasons provided for the presentation of non-IFRS figures is to eliminate the effect of non-recurring events, to present underlying or economic performance in line with pre-IFRS track record and/or to segregate heterogeneous activities.

2.5. Some preparers, operating in regulated financial activities, choose to present additional metrics beyond IFRS requirements

- ▶ 75% of banks disclosed their regulatory capital and/or their solvency ratios.
- ▶ 20% of insurance companies provided a full disclosure of their embedded value.

¹⁰ CESR had published in November 2005 a Recommendation on the use by listed firms of Alternative Performance Measures, Committee of European Securities Regulator, ref. CESR 05-178B

3. Issues related to Standard setting, Endorsement and Enforcement

3.1. Common application or enforcement issues should be addressed to improve consistency and comparability and the level of enforcement activities is still uneven between Member States

Although enforcement standards require national enforcers to report on their activities to the public¹¹, we encountered a wide variety of situations while trying to retrieve that information through the websites of some enforcers. Some of those we contacted directly advised us they were still in the process of implementing their communication and would post their reviews of financial statements in 2009 (dealing with 2007 financial statements).

This is in line with the status of enforcement processes within the European Union in 2006, as stated by CESR¹²: Out of 25 State Members, 10 had conducted enforcement activity in full compliance with CESR Standard # 1, 8 had partially abided by the standard, whereas 7 had not conducted enforcement activities.

3.2. Few companies are applying new standards ahead of the compulsory deadline, which seems to indicate that most preparers do not find the time lapse between the release of standards by the IASB and the full endorsement by the European Commission as detrimental to their financial reporting

Early adoption of standards and interpretations is generally permitted or encouraged by the IASB and by the European Commission after the endorsement process provided that such early adoption is disclosed.

Two standards and one amendment were subject to potential early adoption in 2006: IFRS 7: Financial Disclosures, IFRS 8: Operating Segments and the Capital Disclosures Amendment to IAS 1 Presentation of Financial Statements.

Less than 5% of companies in our sample disclosed in 2006 the early adoption of future IFRS standards or IFRIC interpretations. This is a notable drop from 2005 when as much as 30% of companies in the sample early adopted the amendment to IAS 19 *Actuarial Gains and Losses, Group Plan and Disclosures*, and 18% the Fair Value Option amendment to IAS 39 *Financial Instruments: Recognition and Measurement*.

IFRS 8 Operating Segments

Two companies in our sample under review early adopted IFRS 8 *Operating Segment*. Both were German SEC filers and first-time adopters of IFRS. It is likely that they chose to adopt IFRS 8 in order to avoid transitioning via IAS 14.

IFRS 7 Financial Instruments: Disclosures

Twelve companies in our sample under review early adopted IFRS 7 *Financial Instruments: Disclosures*. It included four banks out of twenty-eight in our sample. Enforcers linked the low level of early application with the demanding requirements of this new standard.

¹¹ Principle 21, Standard #1 in Financial Information, Committee of European Securities Regulators

¹² Review of the enforcement of IFRS in the EU, Committee of European Securities Regulators, Ref 07-352

3.3. A number of specific issues by standard would seem to need to be examined, either from a standard setting standpoint or a standard enforcement standpoint

The need for guidance on Fair Value accounting

Enforcers and auditors have expressed concerns that preparers may need more precise guidance on how to apply the principles of Fair Value accounting and impairment. Although these comments were made in the context of the 2008 economic downturn and liquidity crisis on certain markets¹³, it reflects the perception that IFRS provides principles rather than operating rules.

DRP/FREP [Germany] listed Goodwill and Impairment test as the most frequent subject on which guidance had had to be provided on to examined companies in 2006. It is to be remembered that enforcement standards prevent¹⁴ national enforcers issuing any general application guidance on IFRS, and limits their scope of intervention to the enforcing of standards and interpretations.

IAS 1 Presentation of Financial Statements

The lack of a common structure of the notes to financial statements

Disparities observed in the structure of accompanying notes make access to detailed information often challenging. A detailed table of contents is necessary to ensure easy use of the financial statements. In addition, several factors must be considered as constraints to genuine comparability of the financial statements of EU listed companies:

- ▶ differences in financial vocabulary used,
- ▶ lack of standardisation for financial aggregates,
- ▶ lack of harmonisation linked to the national legacy in terms of reporting requirements.

When these comments are put in the context of the overall size and volume of information provided by certain companies, particularly banks (verbatim quote - “*one set of financial statements per postman*”), additional study is needed on how to make the financial statements more accessible for ease of comparability.

The different forms of Profit and Loss Account presentation

The fact that companies can choose between a presentation of costs by function or cost by nature/cost type introduces an immediate difficulty in comparability of costs across companies, irrespective of country or industry sector. Full comparability can only be achieved by opting for one format of presentation or requesting both formats to be presented, which adds complexity.

In addition, the point was raised in discussions with certain regulators and professional bodies that further work is required in standardising the main profit and loss account indicators to be presented and improving the profit and loss account presentation to enable both a comparable presentation and also informative information based on each company’s underlying business model.

¹³ For example, in October 2008, IASB released *ad hoc* guidance on measuring and disclosing the fair value of financial instruments in non-active markets

¹⁴ Principle 20, Standard #1 in Financial Information, Committee of European Securities Regulators

IAS 7 Cash Flow Statements

The AFM¹⁵ [Netherlands] noted “IFRS has not yet resulted in greater comparability as a consequence of the alternative approaches provided by IAS 7 for the presentation of certain cash flows. Not only the starting point used in the cash flow statement may differ, but also the way cash flows regarding interest, dividend and, to a lesser extent income taxes are presented. It also concluded that “...users seeking good and useful cash flow information have to rely partly on companies providing more information in notes to the cash flow statement than strictly required under IAS 7”.

Cash flow was identified also by other regulators as an area of concern, including items such as:

- ▶ correct definition of profit,
- ▶ definition and handling of non cash items.

IAS 12 – Income Taxes

The DPR-FREP [Germany] identified Deferred Taxes as being one of the most frequent sources of problems.

The AFM [Netherlands] reported that “... *disclosure of accounting policies for income taxes was not extensive enough. ...disclosure of accounting policies for income taxes included in the financial statements can be improved by tailoring these policies to the circumstances of companies*”.

A number of disclosure issues were identified by regulators, notably relating to:

- ▶ disclosure of the separate components of income tax expense/(income) and the amount of deferred tax assets and liabilities,
- ▶ disclosure issues relating to tax loss situations and unrecognized deductible temporary differences,
- ▶ problems with netting of relatively significant dissimilar items and disclosure issues relating to effective tax rates.

IAS 14 *Segment reporting* – full disclosure has still not yet been achieved. Continuing vigilance is needed to ensure that when IFRS 8 Operating Segments is implemented, full disclosure is provided by all companies.

93 % of companies in our sample disclosed segment reporting. Most non-disclosing companies justified the absence of segment reporting by the fact that they operate a single business in a single geographical area.

However, disclosures for segment reporting are fully compliant for only 71% of the companies disclosing primary and/or secondary reporting. Other disclosing companies failed to disclose some of the indicators required by IAS 14.51-72.

Among the national enforcers, the FIN-FSA¹⁶ took the view that “*several Finnish companies still need to enhance their segment reporting to achieve higher transparency*”, noting that “*nearly one third of all [Finish] companies reported only one primary segment*”.

¹⁵ Supervision of the 2006 Financial Reports of Listed Companies, Autoriteit Financiële Markten [Netherlands]

¹⁶ Survey on Finnish Companies Listed Companies’ 2006 IFRS Financial Statements, Rahoitustarkastus Finansinspektionen Financial Supervision, 11 Dec 2007.

The information constituted by the wide range of minimum and maximum ranges of estimated useful lives is not in conflict with the standard [IAS 16 *Property, Plant & Equipment* and IAS 38 *Intangible Assets*], but may not be relevant for the users of the financial statements.

While many different situations will arise in companies, and the extension of the useful life of assets is a major performance improvement driver, the size of the current range spread would seem to create issues of comparability.

As an alternative or additional solution, disclosure on the distribution of assets within the useful life range may better represent the company portfolio of assets.

The application of the revision of IAS 19 *Employee Benefits*, effective in 2006 brought additional visibility on assets and liabilities linked to defined benefit obligations (DBO). However, several incomplete or disparate disclosure situations have been identified

The topic of post-employment benefits is one of the most complex subjects in IFRS, both for preparers and users of the financial statements. Additionally, it represents a heavy financial impact in the accounts of Groups.

We noted a wide variety of disclosures, assumptions, and differences in pension plan handling between countries. While this reflects to a great extent the differences between the legal and economic situations in countries, obtaining a view between companies on a comparable basis is very difficult. In addition, many companies provide little or no information on sensitivity analysis of changes in assumptions.

We believe that the standard should be reviewed to see how disclosures could be improved.

- ▶ Assumptions and sources regarding life expectancy are not fully disclosed and show discrepancies within similar environments. Comparability and clarity of understanding would be enhanced by encouraging preparers to use public data references (as published by local government or international agencies), or, when appropriate, to take into account the specific nature of the company workforce and disclose how much they depart from national average data.
- ▶ Sensitivity analysis on changes in actuarial assumptions is performed by only half of companies and generally focuses only on a portion of actuarial information.

This review should be made together with the actuarial profession and representatives of appropriate government agencies.

The application of IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* remain complex and sometimes incomplete

The underlying subject of Financial Instruments is in itself complex. The AMF [France] commented¹⁷ “This is a complex and sensitive area for issuers, in terms both of performance analysis and of reporting. Compound financial instruments often contain clauses that make it difficult to distinguish between these components and to measure the instruments upon initial recognition and at subsequent dates”.

¹⁷ AMF Recommendations regarding Financial Statements for 2007, Autorité des Marchés Financiers [France]

On the one hand, enforcers identified a number of issues relating to incomplete or unclear disclosures concerning items such as:

- ▶ details relating to impairment testing
- ▶ identification of the type and nature of instruments and the options used
- ▶ disclosure of the nature of risks being hedged and the analytical criteria and bases of measurement being applied
- ▶ difficulties of linkage between balance sheet items and the instruments described in the notes

Our analysis of companies has also identified areas in which disclosures were incomplete or unclear, for example:

- ▶ Disclosures on cash flow hedges
- ▶ Classification and treatment of non-consolidated financial investments carried on the balance sheet
- ▶ Disclosure of specific accounting policies on impairment of assets and recognition of a reduction in value for problem assets, particularly for small and medium sized companies.
- ▶ Information on effective interest rates on financial debt and risk disclosures

On the other hand, a number of opinions were given that the sheer weight of disclosures made, particularly for banks and financial institutions, made the size of financial statements unwieldy and difficult for people other than specialists to comprehend.

Accordingly, opinions were expressed that some way needs to be found to simplify these standards. The issue of complexity should be addressed at the same time as the current re-examination of using “Mark-to-Market” and “Fair Value” for financial instruments in Banks and Financial Institutions.

Some improvement in the application of IFRS 2 *Share Based Payments* would seem to be necessary if the financial statements are to provide clear, concise and easily understandable information.

A number of comments were made both on the difficulty for non specialists to understand the principles applied and also in being able to clearly identify the financial elements of the application of the Standard. Certain people expressed the opinion that the standard needs to be changed

The AMF [France] noted both variety and complexity in disclosures:

- ▶ “a detailed analysis of the disclosures made for the different assumptions reveals a wide variety of practices”.
- ▶ “... reference was also made to other pricing techniques such as Monte Carlo simulations. Since financial statement users are not necessarily familiar with these models ... we recommend that issuers provide a general explanation of the relevance of the models, having regard to the terms and conditions of their share plans”.

A number of major groups have multiple share option plans. Opinions were expressed that a tabular form of presentation rather than extended narrative would make assimilation of required information easier. It was also felt that the standard should encourage a greater degree of standard reporting as finding the income statement impact was sometimes difficult.

The AMF [France] reported:

“The vast majority of companies in our sample reported expenses arising on share-based payment transactions within personnel costs. However, in certain cases, the impact of share-based payment transactions on the income statement was not disclosed, and could not be determined from the personnel costs breakdown”.

Business Combinations (IFRS 3), Consolidations (IAS 27) and Special Purpose Entities (SIC-12)

The areas of Business Combinations, Consolidations and handling of special purpose entities have improved but continue to cause regulators to focus their attention on ensuring compliance and identifying potential accounting treatment and disclosure issues.

FIN-FSA [Finland] noted *“In the 2006 financial statements the disclosure on business combinations was somewhat more extensive compared to the previous year. Especially information given on impairment testing had improved.”*

Topics needing further improvements included notably:

- ▶ the application of the concept of control and providing adequate explanation and rationale as to why an entity was treated in a particular way or adequate explanations of changes in status,
- ▶ information about the purchase or disposal of material subsidiaries and other business units,
- ▶ providing explicit information on business combinations accounted for using provisional values.

The DPR-FREP [Germany] identified the most accounting issues in the area of Mergers and Acquisitions Accounting.

While IFRS 4 *Insurance Contracts* appears to be well applied by insurance companies, comparability should be further enhanced in the future by the harmonization of accounting practices not yet covered by IFRS

IFRS 4 does not provide any guidance in the treatment of several issues related to insurance contracts, in particular:

- ▶ Insurance contract acquisition costs. As a result different groups use different accounting and disclosure methods for these costs.
- ▶ Diversity also exists in the presentation of reinsurance costs in the Profit and Loss Account.
- ▶ The measurement of insurance liabilities is not yet addressed by IFRS.

On the other hand, the standard requires that groups perform impairment tests on reinsurance assets, but 8 out of 10 groups in our specific sample did not disclose their policy for this.

It is to be hoped that real harmonisation in this area across Europe, and full disclosure, will be achieved with the future standard on insurance contracts.

IFRIC 12 *Service Concession Arrangements*, not yet endorsed by the European Commission, may not cover as wide a scope as initially intended.

The review of fifteen companies reporting concession activities led us to identify cases under which concession assets are considered to be out-of-scope of the new proposed accounting rules. Consequently, IFRIC 12 may have a more limited relevance across Europe than that which was initially intended. 33% of the companies studied reported early application of IFRIC 12. Of the 67% that didn't (10 companies), 6 companies will have to change their methods, or accounting rules and procedures, in order to comply with IFRIC 12.

4. Appetite for wider application of IFRS

4.1. IFRS for internal management reporting: welcomed collateral benefits

A growing proportion of groups reporting under IFRS are also adopting IFRS for their internal management reporting. A fair share of them now consider IFRS based internal reporting to be beneficial for management purposes, although this is not a universally held viewpoint. The development of an internal “accounting common language” may therefore have emerged as one rewarding short-term benefit of the transition to IFRS. Some other groups however believe that this approach has made internal management reporting too complex.

4.2. IFRS for consolidated accounts of non-listed companies

The review of financial statements did not demonstrate any significant differences in the application of IFRS in the consolidated financial statements of non-listed companies compared to listed companies, except for some cases of shorter disclosures.

4.3. IFRS for individual accounts

The points mentioned earlier about the particular issues for small and medium-sized companies in relation to IFRS: less resources and skills, less transactions, less complexities to handle - does not, according to the view point of enforcers that we have met, justify two levels of standards for listed companies. However, in the case of individual accounts of non-listed companies, the situation is different and there is a case for having a more simplified version of IFRS to apply.

The wider application of IFRS for individual accounts would help particularly in the case of the individual accounts of European subsidiaries of listed groups (although the same standards as for the group will need to apply). In these cases, the choice of IFRS would enable the group to rely on a single set of accounting principles for all financial statements and basic accounting, rather than producing one set of financial statements for local filing purposes under local reporting standards and a separate set for group reporting purposes. Certain EU countries already allow this and we believe that this possibility should be extended across the EU as a whole, on a permissive rather than a mandatory basis.

However, for a wider application of IFRS to individual accounts to apply more generally, there is a need to close the gap with tax requirements through progressive alignment of tax rules on IFRS accounting.

In examining the way forward on this topic, an approach through convergence of national accounting frameworks, on the basis of IFRS standards, with a reduced span of options (e.g. restrictive use of Fair Value) should be considered as a potential solution. This would enable national accounting bodies and tax authorities to work together on consistent harmonisation within their country.

4.4. The shift from national GAAP to the IFRS paradigm encompasses important cultural aspects, and represents a case of deep change management

Over the past years, considerable efforts have been developed by auditors and professional bodies to educate the accounting profession and the business leaders to IFRS. A special mention is devoted to “Big 4” international networks, which have been, due to their global reach, at the forefront of the evolution.

Another important agent of change has been the academic world. A new generation of “IFRS-minded” accountants and managers is already stepping up the corporate ladder wherever IFRS courses have been initiated in universities as early as five or ten years ago.

However, based on the results of our interviews, the accounting profession as a whole across Europe¹⁸ and the overall business community have not yet fully become familiar with the new paradigm, and further significant efforts are needed, especially if wider application of IFRS is to be envisaged.

4.5. Translating IFRS into a common accounting language

English is the reference language in which the standards are drafted and distributed. IASC publishes and distributes reference standards and interpretations in several¹⁹ languages yearly. However, neither does this cover all official languages of the Member States of the European Union, nor is the IASC reference fully aligned with IFRS-EU as endorsed by the European Commission. All new endorsed IFRS-EU is made available in all EU official languages. Publication is of only the new IFRS-EU, and not a full collated version of all the IFRS-EU. A number of enforcers in non English speaking countries have identified this lack of availability of a full official up-to-date translation in each EU language as a problem.

At the same time, linguistic issues have also been identified during certain interviews, because certain of the IFRS concepts were not part of previous local standards and reporting frameworks and do not easily translate into some of the EU languages. Some linguistic issues have not yet been fully resolved and seem to prevent straightforward understanding in certain languages. Some key stakeholders including auditors and enforcers admitted that while being legally required to abide by national language wording, they often referred to English reference documentation to solve complex issues. While this may be a pragmatically accepted practice within large entities with international exposure and management, it may definitely be detrimental to the acceptance of IFRS by entrepreneurial companies, small local audit firms and public servants. Further work with certain national bodies should therefore be undertaken by the European Commission to resolve these linguistic issues.

The periodic release and cost-effective access to a full, up-to-date, collated and appropriately translated set of IFRS-EU standards, in each EU official language, together with related IASB official releases, bases of conclusions and other guidance, seems paramount to wider application of IFRS. The recent publication by the European Commission is a major step in this direction.

4.6. The ongoing role and focus of national stakeholders

The application of IFRS is felt as resulting to some extent in a loss of empowerment by national standard setters, because decision making has moved away from them to international bodies. The teams from the international Audit Firm's also have to rely more and more heavily upon "Expertise Centres" to resolve technical issues and relay solutions to their clients.

Enforcers have tended to have a lesser role in standard application guidance, mainly to avoid any unauthorised interpretation of standards.

However, we believe that thought needs to be given to a better way of harnessing, developing, and effectively using the talent and organisations in the individual Member States. Thought should be given particularly on how to:

- ▶ Maintain, encourage and foster additional regular feedback to standard setters at a European and international level on local issues encountered and suggestions for improvements.
- ▶ How to assist and reinforce the national bodies in a wider and strengthened role of application enforcement and some form of co-ordinated application guidance.

¹⁸ estimated to represent 2% of the active workforce for example in Portugal

¹⁹ including English, French, German, Spanish, Italian, and Dutch

5. Methodology

5.1. Technical analysis of 2006 Financial Statements

We selected a sample of 270 companies, for which market capitalisation²⁰ of the 250 listed companies represented 40% of the total European market capitalisation, and we performed a comprehensive desk study of their published 2006 IFRS financial statements

The sampling approach was designed to ensure a fair representation of the overall population of European companies on the basis of three criteria:

- ▶ Member State: 3 to 38 companies from each of the twenty-five Member States were selected, so that in each Member State the capitalization of sampled companies exceeds 20% of each market capitalization of domestic shares.
- ▶ Industry sector: 8 to 32 companies from each of the ICB eighteen “Super-sectors” were selected, so that in each ICB super-sector the capitalization of sampled companies exceeds 20% of the market capitalization of that sector at a European level.
- ▶ Company market capitalisation: 76 “large” companies (capitalisation in excess of EUR 15 billion), 87 “medium” companies (capitalisation between EUR 15 billion and EUR 500 million), 87²¹ small companies (capitalisation below EUR 500 million).

In addition for Unlisted companies : we selected 20 unlisted companies.

5.2. Opinion of enforcers and members of professional bodies

We collected input from seven national enforcers among the eighteen identified by CESR as performing enforcement activities in full or partial compliance with CESR Standard # 1 through:

- ▶ desk review of the published conclusions and summary of their reviews of 2006 Financial Statements and/or guidance for 2007 Financial Statements for Finland, France, Germany, Netherlands, Poland, Portugal, and United Kingdom,
- ▶ meetings with enforcers for Poland, Portugal and United Kingdom and certain professional bodies.

The reports available from a number of other enforcers were reviewed but were not found to have significant comments on the application of IFRS in the 2006 Financial Statements.

²⁰ About EUR 4.200 billion as of 29 December 2006

²¹ of which 9 companies are eligible for SME criteria

6. Conclusion

The application of IFRS in 2006 in the European Member States shows an improvement over the situation in 2005.

There is significant support for this overall IFRS initiative and its accompaniment from the sample of stakeholders that we have canvassed, for example:

- ▶ “Our national GAAP were well engineered, but nobody could understand them beyond our country”.
- ▶ “Our clients now make more easily cross border investments since they understand the figures”.
- ▶ “Cooperation and exchange of information through CESR is boosting the enhancement of enforcement of regulations”.

As our analysis of the 270 financial statements has shown, the quality of disclosure by preparers improved in 2006, although further efforts are needed to attain full compliance.

Additional efforts are also needed to further enhance the level of enforcement. As stated in paragraph 3.1 the level of enforcement varies widely between the 25 member states and the CESR identified in 2006 only 10 countries fully compliant with enforcement standards.

There are a number of issues to address with certain of the standards to simplify, adapt and/or make clearer the financial information reported as set out on paragraph 3.3.

Difficulties we encountered during our analysis of financial statements, and comments made by enforcers and other stakeholders, indicates that the issue of how far to go in standardising presentation formats for ease of reading and comparability needs to be addressed. This topic could potentially be examined in liaison with developments on potential computerisation and coding of financial statement disclosures.

During interviews with national stakeholders, it became clear that the implementation of IFRS in the European Union has changed and somewhat diminished their roles. These changes in roles and focus of national stakeholders need to be examined more fully in order to ensure that there is optimisation of all efforts of each of the national stakeholders in promoting, assisting in implementation and ensuring compliance with the IFRS as endorsed by the European Union.