23 nov 2005 | about fei | site map | members only | my account | logout | google

fei home
fe magazine
profile
current issue
editorial
past issues
advertising
online exclusives
order back issues

International Accounting: november 05

The Brave New World of IFRS

By Eva K. Jermakowicz and Sylwia Gornik-Tomaszewski

IFRS have been widely accepted, and are expected to enhance international financial reporting transparency, comparability and investment patterns. This progress will not come, however, without some unintended impacts on companies, countries and capital markets.

The year 2005 should be proclaimed "The Year of International Financial Reporting Standards (IFRS)." Thousands upon thousands of companies around the world are getting ready to prepare their 2005 financial statements, and at least one year of comparatives, according to a set of accounting standards they have never used before. IFRS were promulgated by the International Accounting Standards Board (IASB), headquartered in London.

A worldwide consensus has been building for many years on the need for high-quality global accounting standards that would better serve investors and facilitate more efficient allocation of capital. This is why the European Union (EU) introduced a regulation requiring all companies listed on a regulated market, including banks and insurance companies, to prepare their consolidated financial statements in accordance with IFRS from 2005 onwards. EU member states have the option to extend this requirement to unlisted companies and to unconsolidated financial statements.

Everywhere IFRS are being implemented, organizations are struggling to come to grips with the new system. The situation is particularly difficult in the EU, where companies are overwhelmed with a multitude of new regulatory demands coming into effect almost simultaneously - requirements under the impending Basel II Accord, a new Prospectus Directive and others resulting from the implementation of the Financial Services Action Plan. In addition, companies listed in the U.S. have to comply with the Sarbanes-Oxley Act.

Transition to IFRS - Much More Than an Accounting Issue

Implementing IFRS brings the need for change in the format of accounts, different accounting policies and more extensive disclosure requirements. In many EU countries, technical differences between local generally accepted accounting principles (GAAP) and IFRS are numerous, and the costly and resource-consuming conversion process could last up to 24 months.

Many organizations are experiencing a shortage of well-trained personnel, and there are necessary IT system changes and enhancements to be made. For many, it is not a matter of just replacing one accounting system with another, but rather the addition of a new accounting system on top of the existing one still to be used for statutory purposes.

this
Two G
How D
Are M
Horizo
Year-
Comp
Comp
Smart
Taking
The W
Quand
The B
IFRS
New T
U.S. F
Presid
Busine
Financ
Privat
Washi
Books
Cross
Table

Most companies adopt IFRS not only for the consolidated accounts, but also for internal management use in the parent and subsidiaries. Harmonization and streamlining of internal and external reporting by creating a single accounting language across the business is often listed among the most important benefits of conversion. The new accounting system may affect bonus and reward schemes, treasury options, business combinations, measurement and treatment of intangible assets, leases, financial instruments, tax liabilities and debt covenants.

Some European companies in EU member states are exempted until 2007 from adopting IFRS. This exemption is for companies that are listed in both the EU and in another non-EU jurisdiction (such as the U.S.) and that are following another internationally recognized set of accounting standards (such as U.S. GAAP).

One key challenge in adopting IFRS is their use of fair value as the primary basis of asset/liability measurement.

"The IASB advocates its fair value approach on the grounds of relevance; the board quite simply considers fair value to be the most relevant measurement basis," says Allister Wilson, senior technical partner with Ernst & Young. "We are concerned that the IASB has placed too much emphasis on 'relevant' information and has given insufficient consideration to the other attributes [of accounting information], in particular reliability and understandability," he adds.

Also, banks and insurance companies have been the biggest opponents of the controversial International Accounting Standard 39 (IAS 39) Financial Instruments: Recognition and Measurement, which requires the use of fair values for financial instruments such as derivatives.

This valuation approach may bring increased volatility in the reported values of assets as well as earnings. Under pressure from the banking sector, the European Commission (EC) deleted certain sections of IAS 39. Now, management will have to take actions to manage the volatility associated with conversion to IFRS.

An initial period of volatility in accounting numbers, lasting a few years, is expected and comparisons among companies will not be always an easy task. Common sense suggests that investors should look beyond net income forecasts to gauge how accounts will be affected by the switch to IFRS this year.

Growing Prominence of IFRS

All 25 EU member states and a number of other countries are implementing IFRS, indicating their growing prominence. IFRS already represent the standard, or the basis of standards, in many countries worldwide. Australia has decided to adopt national equivalents of IFRS (so-called A-IFRS) by the 2005-2006 fiscal year. Among other countries that have indicated they will or may move to IFRS are South Africa, China and Russia. It is estimated that about 15,000 listed companies will produce annual financial statements in compliance with IFRS this year.

Authorities in European countries are considering whether to extend the application of the EU regulation to unlisted companies and individual accounts. So far, most of the countries have permitted or even required IFRS for the consolidated statements of all, or at least some, unlisted companies.

More difficult decisions are to be made as to individual accounts. Some member states will permit at least some listed companies to prepare individual accounts under IFRS. But the extension of the regulation to individual accounts is not expected in the near future in countries such as Germany, France or Belgium, where individual accounts are traditionally used for statutory purposes, such as for determination of taxable income.

The impact of the changes taking place abroad on U.S. standard-setters and regulators is remarkable. In 2002, the U.S. Financial Accounting Standards Board (FASB) and the IASB signed the Norwalk Agreement committing them to converge their accounting standards.

In April 2005, the process of convergence received a new impetus as the U.S. Securities and Exchange Commission (SEC) and the EU reached an agreement on a roadmap that sets out steps the SEC will take to eliminate the need for non-U.S. companies using IFRS to reconcile to U.S. GAAP in order to access U.S. capital markets, possibly as soon as 2007, but no later than 2009. All major stock exchanges across the world accept IFRS, except those in the U.S. and Japan.

EU regulation on implementing IFRS will have significant implications for international corporations as well. U.S. subsidiaries of parent companies located in the EU, as well as U.S. companies with operations in the EU, will need to file IFRS-based reports. International joint ventures will also be affected by IFRS.

Areas for Future Exploration

Although IFRS will continue to evolve, in their current form, the standards are shorter and less detailed than U.S. GAAP. It is expected that the demand for more interpretations and detailed implementation guidance may increase significantly after 2005 as the number of companies applying IFRS increases. This means that initially, judgment will be used often, so application of the standards could be slightly inconsistent across the market.

A lot will depend on the auditing function. The EC proposed a new Directive on Statutory Audit of Annual Accounts and Consolidated Accounts. The proposal would adopt international standards on auditing and many other measures improving audit quality throughout Europe.

Enforcement is also extremely important. High-quality financial reporting depends on it, but at the present time, securities regulation in Europe is jurisdiction-specific and varies among countries. Moving toward IFRS may create the need for a single EU enforcement body.

National authorities in continental European countries will need to find solutions for organizing the tax computation in the future. A significant disharmony may arise between individual and consolidated accounts; companies will need to maintain complex and costly parallel running of the two or even three accounting systems, creating barriers to corporate development and competition between companies.

Questions also remain about what to do with small and medium-sized entities (SMEs). For example, in the EU, IFRS will be required for consolidated financial statements of approximately 7,000 listed companies in 2005, while about 5 million unlisted SMEs will most likely follow national standards. The IASB has an active project on IFRS for SMEs, with the likely result that these entities will eventually have the option of using a set of standards aimed specifically at smaller entities and aligned with IFRS.

IFRS has been accepted widely, since it is expected to enhance international financial reporting transparency, comparability and investment patterns, resulting in an efficient global financial market and increased economic growth. Some indicate that the EU regulation will have various unintended and unexplored impacts on corporate, economic and social life. IFRS impacts on corporate governance, human resource management, strategy or macroeconomic planning should be investigated.

Lessons from Voluntary Adopters

Companies currently transitioning to International Financial Reporting Standards (IFRS) may draw on the experience of companies that have adopted IFRS voluntarily, ahead of the 2005 deadline.

Belgacom, Belgium's largest telecom company, implemented IFRS in consolidated financial statements for the year 2003 with two comparative years. These statements were published for both the 2003 annual report and the prospectus for an initial public offering (IPO) in March 2004. Belgacom was convinced that using IFRS in the prospectus would support the success of the IPO by communicating financial information that is more transparent, relevant and internationally comparable.

The parent company and subsidiaries are still publishing their individual financial statements under Belgian accounting standards for statutory purposes. However, the financials used for internal reporting and performance measurement are established under IFRS, as the internal reporting focuses on the financial position and performance of the group and its business segments.

Eddy Van Den Berghe, director of Group Accounting and Financial Control of Belgacom, says, "The transition from Belgian accounting rules to IFRS has impacted most of the balance sheet and income statement captions in terms of recognition, measurement and/or presentation, in addition to much more extensive disclosure requirements under IFRS." He adds that in order to implement and computerize such changes, minor changes of systems were necessary, but "first of all, new processes have been set up to document transactions and to collect information."

Choosing to implement IFRS prior to the EU imposing the rules allowed Solvay, an international chemical and pharmaceutical group headquartered in Belgium, to meet the financial markets' expectations ahead of time. Thus, it was easier to turn to capital markets and facilitate contacts to rating agencies. However, the impact of this is not readily measurable.

Solvay's IFRS implementation was a well-prepared process, with two simulations, respectively, on the accounts of 1998 and 2000. Training sessions for the group's accountants were organized with the help of Solvay's external auditors. Additionally, all levels of management, including the board of directors (which made the final decision), and the financial media were kept fully informed before and during the implementation process. This allowed the company to start publishing quarterly under IFRS at the beginning of 2003.

Harold de Laveleye, Solvay's head of Corporate Controlling & Group Accounting, says: "The major impact of adopting IFRS on information systems resulted from the harmonization of useful lives and the ensuing changes to depreciation charges.

The biggest impact of IFRS on the company's financial statements, he notes, was around deferred taxes, pension liabilities and impairment of assets."

Food retailer Delhaize Group is implementing IFRS in 2005. Delhaize decided to publish IFRS-based financial statements for two comparative years, 2003 and 2004, to provide investors with a more complete view of its financial statements. In May 2005, Delhaize published a report, Transition to IFRS - Preliminary Financial Information, on the effect of IFRS on its financial statements.

Kimberly Bridgham, director of the group's International Accounting, says, "Delhaize Group views the change in accounting and reporting to IFRS, including the robust disclosure requirements, as a positive step towards improved financial transparency across Europe. Our financial results and financial position will be more easily compared and benchmarked with our European peers."

In addition, she says, Delhaize Group's financial statements will be more easily compared to U.S. peers because the concepts and measurements under IFRS are quite similar to those used in U.S. GAAP.

Eva K. Jermakowicz, Ph.D., CPA (Ejermako@usi.edu) is Professor of Accounting in the Department of Accounting and Business Law at the University of Southern Indiana. Sylwia Gornik-Tomaszewski (gornikts@stjohns.edu), DBA, CMA, CFM is assistant Professor in the Department of Accounting and Taxation in the Peter J. Tobin College of Business at St. John's University.