FINANCIAL
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EU IMPLEMENTATION OF IFRS AND THE FAIR VALUE DIRECTIVE

A report for the European Commission

The Institute of Chartered Accountants in England and Wales (ICAEW) has prepared this report *EU Implementation of IFRS and the Fair Value Directive* at the request of, and with funding from, the European Commission (EC). An Executive Summary is also available.

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AND THE FAIR VALUE DIRECTIVE

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1. Objectives, terms and approach

1.1 Key points

The study is designed to inform debate about the implementation of IFRS in the EU through the IAS Regulation and about the implementation of the Fair Value Directive. It involves the following principal workstreams:

- analysis of the legal implementation of the IAS Regulation and the Fair Value Directive based on questionnaires sent to interested parties in all member states and subsequent work to try to resolve conflicting responses;
- review of surveys and other literature on EU implementation of IFRS;
- roundtables, principally involving preparers and auditors of IFRS financial statements, held in Düsseldorf, London, Madrid, Paris, Rome and Warsaw and used to test and explore the preliminary findings from our other work;
- an on-line survey which generated usable responses from statistically valid samples of 51 investors, 162 preparers and 141 auditors across 23 member states covering understanding and use of IFRS financial statements, their preparation and audit, and the incremental costs to companies of applying IFRS;
- a review of regulators' statements on EU implementation of IFRS and selected published correspondence between the SEC and EU companies;
- an academic research paper on the relevance of IFRS information in explaining market prices and stock returns of French, Italian, Spanish and UK publicly traded companies;
- the application of the EU Common Methodology to assess the costs of the IAS Regulation;
- detailed technical analysis of the IFRS consolidated financial statements of a sample of 200 EU publicly traded companies referred to as Sample 1;
- high level technical analysis of IFRS consolidated financial statements of 18 EU non-publicly traded companies referred to as Sample 2; and
- high level technical analysis of IFRS legal entity financial statements referred to as Sample 3, comprising 32 Sample 1 companies and 18 other companies.

1.2 Objectives of the study

The objectives of the study of EU implementation of IFRS and the Fair Value Directive are to provide the European Commission with:

- a general analysis of the first year of application of IFRS in the EU so that DG Internal Market has the necessary information to carry out an evaluation of the functioning of the IAS Regulation and to feed into discussions in the Accounting Regulatory Committee on how the IAS Regulation has worked in practice; and
- information on the application of the modernised Accounting Directives, especially provisions related to fair value accounting in the Fourth Company Law Directive 78/660/EEC as amended by the Fair Value Directive so that DG Internal Market has the necessary information to carry out a review of these provisions.

1.3 Use of terms

Accounts and financial statements

The report uses the term financial statements rather than the term accounts. In the context of the report, there is no difference between these terms.

EU Common Methodology

This methodology for measuring the net costs imposed on enterprises by individual pieces of legislation is set out in the Annexes to Impact Assessment Guidelines (15 June 2005, with 15 March 2006 update of Annex 10, Assessing administrative costs imposed by legislation).

Fair Value Directive

The Fair Value Directive refers to European Union Directive 2001/65/EC of 27 September 2001 amending the Fourth Directive, the Seventh Directive and the Bank Accounts Directive on the valuation rules for annual and consolidated financial statements of certain types of companies as well as banks and other financial institutions. It requires member states to transpose its provisions into national law so as to permit or require the use of fair value accounting for financial instruments (including derivatives) in the legal entity and/or the consolidated financial statements of companies.

IAS Regulation

The IAS Regulation is Regulation (EC)1606/2002 of 19 July 2002 on the application of international accounting standards. It directly requires (without transposition into national law) the use of IFRS in the consolidated financial statements of publicly traded companies established in EU member states. It applies from the first financial year starting on or after 1 January 2005. Each member state may also extend the application of the IAS Regulation through national law to permit or require the use of IFRS in the legal entity financial statements of companies and the consolidated financial statements of non-publicly traded companies.

IFRS and IFRS-EU

The term IFRS refers to International Financial Reporting Standards issued by the International Accounting Standards Board (IASB). The term IFRS-EU refers to IFRS adopted by the European Union. As the differences between IFRS and IFRS-EU are few and do not affect many companies, the term IFRS is used in this report unless the use of the term IFRS-EU is necessary to explain or emphasise the difference between IFRS and IFRS-EU. IFRS include International Accounting Standards (IAS) issued by the former International Accounting Standards Committee (IASC). The abbreviation IAS is used in this report to refer to these IASC standards.

Legal entity financial statements

The term legal entity financial statements is used to refer to the financial statements of a single company. In the Fourth Directive, the IAS Regulation and the Fair Value Directive legal entity financial statements are referred to as annual accounts. While the term annual accounts has a legal meaning in the EU, many preparers, auditors and users use the term to refer to annual consolidated financial statements. The terms legal entity financial statements and consolidated financial statements are used throughout this report to avoid confusion. In IFRS, legal entity financial statements are referred to as separate financial statements. This term is not used frequently in practice. Legal entity financial statements include parent company financial statements and are also sometimes referred to as stand alone financial statements.

National GAAP

The term national GAAP refers to the national laws, regulations, standards and other requirements and guidance for the preparation of financial statements of business entities. In EU member states, national GAAP includes the transposition into national law of EU Accounting Directives.

Publicly traded companies

Publicly traded companies are companies whose securities are admitted to trading on a regulated market of any member state within the meaning of Article 1(13) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (the Investment Services Directive). Each member state is obliged to inform the European Commission of the regulated markets within its jurisdiction. These markets include all the major stock exchanges in EU member states but do not include some other markets.

1.4 Approach to the study

The principal workstreams involved in achieving the objectives of the study are set out below:

Analysis of the implementation of the Fair Value Directive

A questionnaire was sent to accountancy bodies, member firms of BDO International, other accounting firms and other contacts in each EU member state to confirm the extent to which each member state had implemented the Fair Value Directive and obtain for review examples of non-IFRS financial statements affected by the Fair Value Directive. We received replies from at least one source in each member state. Extensive work was required to try and resolve conflicting responses from different respondents and conflicts between responses and information already held by the European Commission. We reviewed two sets of non-IFRS financial statements which use fair value accounting for financial instruments on the basis of the implementation of the Fair Value Directive. The objective of this work was to understand the circumstances in which fair value accounting is being used for financial instruments and to assess the need to review and amend the Fair Value Directive.

The results of this work are reported in Chapter 2.

Analysis of the legal implementation of the IAS Regulation

A questionnaire was sent to accountancy bodies, member firms of BDO International, other accounting firms and other contacts in each EU member state to confirm the extent to which each member state had used the options in the IAS Regulation to allow or require the use of IFRS in the consolidated financial statements of non-publicly traded companies and in legal entity financial statements and obtain examples of IFRS financial statements for potential review. We received replies from at least one source in each member state. When necessary, we resolved conflicting responses from different respondents on the application of the IAS Regulation and conflicts between responses and information already held by the European Commission.

The results of this work are reported in Chapter 3.

Review of surveys and other literature on EU implementation of IFRS

We reviewed surveys, principally published by accounting firms, and other literature, including academic articles, on the transition to IFRS in the EU.

The results of this work are reflected throughout the report and, where appropriate, with references and quotations. The bibliography refers to all works reviewed whether or not they are referred to or quoted in the main body of the report.

Roundtables principally involving preparers and auditors of IFRS financial statements

We hosted roundtable discussions with the support of relevant national accounting bodies in Düsseldorf, London, Madrid, Paris, Rome and Warsaw. The roundtables were attended by between 10 and 20 people, principally preparers and auditors of IFRS financial statements, and there were also participants from the user and regulatory communities. They took place during July and August 2007 and were used to test and explore the preliminary findings from our other work.

The results of these roundtables are reflected throughout the report but particularly in Chapter 4 which sets out the views of preparers, users and auditors on EU implementation of IFRS.

On-line survey of investors, preparers and auditors involved with EU IFRS financial statements

We carried out an on-line survey of EU investors, preparers and auditors of IFRS financial statements. The survey was developed and managed in accordance with the UK Market Research Society's Code of Conduct by an independent research agency, Synovate, with supervision and accounting expertise provided by ICAEW staff. Usable responses were received from statistically valid samples of 51 investors, 162 preparers and 141 auditors across 23 member states. The objective of the on-line survey questionnaire was to provide information about the perceptions of investors, preparers and auditors to help us assess:

- whether users understand and use IFRS financial statements;
- the experiences of preparers and auditors on the implementation and application of IFRS and their use within companies; and
- the incremental costs to companies of applying IFRS in place of national GAAP.

The on-line survey results are reported principally in Chapter 4, which sets out the views of investors, preparers and auditors on EU implementation of IFRS, and in Chapter 7 which analyses the costs of implementing IFRS using the EU Common Methodology as referred to below. The on-line survey questionnaire is reproduced at Appendix 5.

Review of regulators' statements on EU implementation of IFRS

We reviewed public statements by EU securities regulators and other enforcement bodies regarding the IFRS financial statements of EU publicly traded companies and we reviewed selected published correspondence between the SEC and EU companies registered in the US. We supplemented this work through discussions with representatives of the Committee of European Securities Regulators (CESR) and the SEC and through engagement with national regulators who attended the roundtables described above.

The results of this work are reported in Chapter 5 on the role of regulators in EU implementation of IFRS.

Academic research paper on the relevance of IFRS information in explaining market prices and stock returns

We commissioned Joanne Horton from the London School of Economics and George Serafeim of Harvard Business School to write a paper that investigates whether

information about the transition from national GAAP to IFRS is value relevant. For French, Italian, Spanish and UK publicly traded companies, they investigated the ability of IFRS adjustments to national GAAP earnings and book values to explain market prices 3 months after the first year for which IFRS financial statements were prepared and stock returns for the preceding year. They did not include German companies in their study because many chose to apply IFRS prior to IFRS becoming mandatory under the IAS Regulation. The objective of the research was to indicate whether the mandatory EU implementation of IFRS has had a market impact.

The findings of the paper and a summary of the related academic literature are presented in Chapter 6 on the reaction of securities markets. The commissioned paper is reproduced in Appendix 4.

Application of the EU Common Methodology to the costs of the IAS Regulation

We interpreted the steps set out in the EU Common Methodology in the context of the IAS Regulation to provide a basis for comparison with the benefits of its implementation as revealed the roundtables, the on-line survey and the academic research paper. This interpretation was used to draft the cost-related questions in the on-line survey and to analyse the responses. We did not apply the EU Common Methodology insofar as we did not extrapolate the results from the on-line survey sample to estimate the total cost of the IAS Regulation. This was because of the relatively small sample size, concerns about its representativeness and the sensitivity of costs to industry, member state and size issues.

The results of this work are reported in Chapter 7.

The EU Common Methodology was not applied to the Fair Value Directive because, unlike the IAS Regulation, the Fair Value Directive does not impose clearly identifiable information obligations on enterprises.

Technical analysis of IFRS consolidated financial statements of EU publicly traded companies

We performed a technical analysis of the IFRS consolidated financial statements of a sample (referred to as Sample 1) of 200 publicly traded companies established across the 25 countries that were EU member states in 2005. The financial statements related to the first financial year starting on or after 1 January 2005. The objectives of our analysis were to:

- assess compliance with IFRS requirements;
- assess whether IFRS were applied consistently across industries, EU markets and member states;
- determine whether there are common application or enforcement issues that need to be addressed in order to achieve more consistent application of IFRS;
- determine whether there are significant issues which require changes to IFRS; and
- carry out technical analysis of selected issues.

Our reviews focused on the key principles on which we would expect to see full compliance as well as some of the more straightforward choices in IFRS. We also carried out specialist reviews of banks and insurance companies.

The Sample 1 companies are listed in Appendix 1. Chapter 8 explains how Sample 1 was selected and sets out the overall assessments of compliance with IFRS, the consistency of their application and other significant issues. The results of the technical analysis of selected technical issues are set out in Chapters 11 to 24 and form the greater part of the report.

Technical analysis of IFRS consolidated financial statements of EU non-publicly traded companies

We performed a high level technical analysis of the IFRS consolidated financial statements of a sample (referred to as Sample 2) of 18 companies established in the EU that are not publicly traded. The purpose of this analysis was to assess compliance with IFRS requirements and to see whether the financial statements gave rise to any issues of compliance or consistency or any other significant matters that were not apparent among the publicly traded companies in Sample 1. The restricted size of Sample 2 reflects the difficulty of identifying non-publicly traded companies that, as a result of the extended application of the IAS Regulation, prepared IFRS consolidated financial statements for the first financial year starting on or after 1 January 2005.

The Sample 2 companies are listed in Appendix 2 and the results of the related analysis are reported in Chapter 9.

Technical analysis of IFRS legal entity financial statements

We performed a high level technical analysis of the IFRS legal entity financial statements of a sample (referred to as Sample 3) of 50 companies established in the EU, comprising 32 publicly traded companies whose consolidated financial statements are included in Sample 1 and 18 non-publicly traded companies. The purpose of this analysis was to assess compliance with IFRS requirements and to see whether the financial statements gave rise to any issues of compliance or consistency or any other significant matters that were not apparent from the IFRS consolidated financial statements in Samples 1 and 2. The restricted size of Sample 3 reflects the difficulty of identifying companies that, as a result of the extended application of the IAS Regulation, prepared IFRS legal entity financial statements for the first financial year starting on or after 1 January 2005.

The Sample 3 companies are listed in Appendix 3 and the results of the related analysis are reported in Chapter 10.

2. Implementation of the Fair Value Directive

2.1 Key points

The Fair Value Directive and the IAS Regulation both emerged from a debate in the 1990s on the best way of achieving greater accounting harmonisation within the EU at the same time as allowing European companies that wished to access international capital markets to comply with emerging international best practice.

Since 2000, the EU's move towards IAS/IFRS has been implemented in two parallel and interlocking ways: an IAS Regulation approach; and an Accounting Directives approach. The Fair Value Directive belongs to the latter, but the two need to be considered together. A number of member states have implemented the Directive's requirements through their implementation of the Regulation.

The range of options allowed by the Fair Value Directive, together with the IAS Regulation, has created a complex picture across the EU as regards requirements and permissions to use fair value accounting, but as this reflects a deliberate decision to allow diversity, the differences among member states should perhaps be welcomed rather than criticised. However, we note that the use of Directives to track the requirements of IFRS is liable to create lags between international standards and EU practice.

Companies' use of fair value accounting under the Directive appears to have been limited. However, it is difficult to separate the effects of the Directive and the Regulation, and to a large extent compliance with both depends on member state options and companies' choices. Therefore we do not believe that compliance with the Directive merits further study.

2.2 The Fair Value Directive

From the 1970s onwards the EU attempted to harmonise member states' diverse national GAAPs through a series of Accounting Directives: in particular, the Fourth Company Law Directive on legal entity financial statements, the Seventh Company Law Directive on consolidated financial statements, the Bank Accounts Directive and the Insurance Accounts Directive. By the 1990s there was growing dissatisfaction with this approach, for two reasons in particular:

- although the Accounting Directives had imposed a degree of harmonisation, national GAAPs continued to diverge; and
- there was a growing demand internationally for an agreed approach to accounting issues from those involved in international capital markets.

This led to an extended debate, in which a number of possible approaches were discussed, as to the best way of achieving greater accounting harmonisation within the EU at the same time as allowing European companies that wished to access international capital markets to comply with developing international best practice for publicly traded companies. The Fair Value Directive and the IAS Regulation both emerged from this debate.

By 1995, the European Commission (EC) had identified International Accounting Standards as a potential solution to the problem at least for publicly traded multinationals, but there were open questions as to whether, and for which companies, compliance with IAS should be required or permitted. An EC task force looking into the compatibility of IAS with the Accounting Directives concluded (in the words of Karel van Hulle of the EC):

> 'that there were no major conflicts between IAS and the Accounting Directives. As a result, it was possible for a European company to prepare consolidated accounts in conformity with IAS without being in conflict with the Accounting Directives' (Karel van Hulle, 'From Accounting Directives to International Accounting Standards' in Christian Leuz, Dieter Pfaff and Anthony Hopwood (eds.), *The Economics and Politics of Accounting*, Oxford University Press, Oxford, 2004).

On this basis, therefore, where national law permitted, a significant number of publicly traded companies in some member states prepared consolidated financial statements in accordance with IAS. For example, as discussed further in Chapter 11, 49 of the 200 publicly traded companies in Sample 1 adopted IAS/IFRS voluntarily. The larger issue of the direction of accounting harmonisation in Europe remained to be resolved.

IAS 39 *Financial Instruments: Recognition and Measurement*, published in December 1998, presented an obstacle to the process of convergence as its fair value requirements were in clear conflict with the Accounting Directives. The Fair Value Directive was therefore needed both to allow European companies that already complied with IAS to continue to do so, and to promote the larger goal of convergence between European requirements and IAS.

While the Fair Value Directive was still being developed, in June 2000 the EU announced its plan to bring European accounting into line with international standards by requiring the consolidated financial statements of publicly traded companies to be prepared in accordance with IAS. This strategy was implemented in the IAS Regulation. Since 2000, the EU's move towards IAS/IFRS has therefore been implemented in two parallel and interlocking ways:

- **The IAS Regulation approach**. This requires publicly traded companies to prepare their consolidated financial statements in accordance with IFRS and leaves it to member states to decide how far to require or permit IFRS accounting to be extended to the legal entity financial statements of publicly traded companies and the consolidated and legal entity financial statements of other companies. This approach represents a radical new way of tackling the problems of accounting harmonisation, superseding – within the areas of its application – both national GAAP and the Accounting Directives.

- **The Accounting Directives approach**. Unless all companies are required by all member states to comply with IFRS in both their consolidated and legal entity financial statements, there remains a need for Accounting Directives to cover those companies that prepare financial statements other than in accordance with IFRS. However, as the intention is that EU accounting should be allowed to move in the same direction as IFRS, this approach implies a need to update the Directives from time to time to reflect changes in IFRS. The Fair Value Directive exemplifies this approach. An important aspect of it is that it allows national GAAP for legal entity financial statements to diverge to a greater or lesser extent from the more IFRS-directed approach envisaged for consolidated financial statements. This reflects the view of a number of member states that it is important that legal entity financial statements, which are used for determining tax liabilities and distributable profits (a critical element in creditor protection), should continue to be prepared in accordance with national GAAP rather than IFRS. This approach also allows, therefore, for the preservation and continuing evolution of national GAAPs.

2.3 Requirements

The Fair Value Directive applies to financial statements subject to the Fourth and Seventh Directives and the Bank Accounts Directive. Taken in isolation, it:

- requires member states to either permit or require the use of fair value accounting for some financial assets and financial liabilities in companies' consolidated financial statements; and
- gives member states an option additionally to either permit or require the use of fair value accounting for some financial assets and financial liabilities in companies' legal entity financial statements.

However, implementation of the Directive by member states is also regarded as being achieved by requiring or permitting non publicly-traded companies to comply with IFRS in their consolidated financial statements, in accordance with the IAS Regulation.

The text of the Fair Value Directive made extensive reference to the provisions of the 1998 version of IAS 39, which has subsequently been amended on a number of occasions, particularly in 2004 and 2005. The application of fair value accounting for financial instruments under the Fair Value Directive may therefore differ from that required under more recent versions of IAS 39. This highlights a problem that is liable to arise under the Accounting Directives approach, which is that the Directives have to be amended on a regular basis to keep pace with changes in accounting standards. Inevitably, there is a delay between changes in standards and changes in Directives, and the two may therefore become out of alignment.

In the context of fair value accounting, the problem of misalignment has been addressed through Directive 2006/46/EC, enacted in June 2006. The Directive allows account to be taken of changes to relevant accounting standards up to the date the Directive takes effect – 5 September 2006. Member states are required to transpose the requirements into national law by September 2008.

2.4 Implementation by member states

The Fair Value Directive, taken together with the IAS Regulation, allows member states a number of options as to its implementation in national law. The major options are:

- Member states can either permit or require the use of fair value accounting.
- The permission or requirement can cover both consolidated and legal entity financial statements or be restricted to consolidated financial statements.
- The permission or requirement can be achieved by permitting or requiring non-publicly traded companies to comply with IFRS under the IAS Regulation.

Implementation by member states was required to be in effect by 1 January 2004.

We sent questionnaires to the member firms of BDO International, professional accountancy bodies and other contacts requesting clarification of the legal position with respect to the Fair Value Directive in each member state. We received replies from all member states. We made follow-up enquiries when the replies conflicted with information supplied to us by the European Commission and when replies from respondents in the same member state differed from one another.

The legal position is complex and evolving. We understand that 20 member states have implemented the Fair Value Directive by transposing its requirements into national law.

Five member states have implemented it by requiring or permitting compliance with IFRS in accordance with the IAS Regulation:

- Malta has extended the mandatory use of IFRS to the consolidated and legal entity financial statements of all companies.
- France, Germany, Italy and Spain permit the consolidated financial statements of non-publicly traded companies to be prepared in accordance with IFRS. We have also been informed of disclosure requirements in France, Germany and Italy where fair value is not adopted in the financial statements.

We note that there is an alternative view of the Directive, which is that it requires member states to permit or require the use of fair value in accordance with the Directive in the consolidated financial statements of non-publicly traded companies except where compliance with IFRS for such financial statements is mandatory under national law. This interpretation is consistent with the view of the Accounting Directives approach as being intended to permit the evolution of national GAAPs that, while not identical with IFRS, evolve towards it. However, this interpretation of the Directive is not generally supported.

Some member states have implemented the Fair Value Directive in national law but also require the use of IFRS in the consolidated or legal entity financial statements of some or all companies. This is notably the case in Cyprus, for all companies, but is also the case selectively in other member states.

Some member states allow companies to use either IFRS or national GAAP in their financial statements. A company is required to use fair value accounting for financial instruments if it elects to use IFRS. Depending on the law and national GAAP in the member state, it may be required, permitted or not permitted to use fair value accounting for financial instruments if it elects to use national GAAP.

As a result of the member state options, the Fair Value Directive has been implemented across the EU in a number of ways. When, on top of this, the different options allowed by the IAS Regulation – which, depending on how a member state implements it, provides a partial or total alternative to the Fair Value Directive – are taken into account, the picture becomes very complex. While such complex outcomes might be regarded as a disadvantage of this approach, member state options on these matters are desirable in principle as they allow national GAAPs to evolve in the same direction as IFRS. The one respect in which it has been agreed that a uniform approach should be adopted across the EU is for the consolidated financial statements of publicly traded companies. EU legislation deliberately allows for diversity among member states in every other respect, so it should perhaps be welcomed rather than criticised.

Explanation of Table 2.1

Table 2.1 shows the different approaches to implementation adopted by member states. It will be noted that some member states differentiate between classes of company – in particular between financial institutions and other companies. However, insurance companies are excluded from the table as they are outside the scope of the Fair Value Directive.

The consolidated financial statements of publicly traded companies do not appear in the table as they are required to comply with IFRS under the IAS Regulation, and implementation of the Fair Value Directive is therefore not required to enable them to comply with the fair value requirements of IAS 39. This leaves the following as potentially within the Directive's scope:

- the legal entity financial statements of publicly traded companies;
- the consolidated financial statements of non-publicly traded companies; and
- the legal entity financial statements of non-publicly traded companies.

For the consolidated financial statements of non-publicly traded companies, it is possible to implement the Directive by permitting or requiring the use of IFRS under the IAS Regulation and/or by transposing the Directive's requirements into national law so as to permit or require the use of fair value in accordance with IAS 39. For legal entity financial statements (both of publicly traded and non-publicly traded companies) implementation of the Directive is optional. So:

- it can be implemented for these companies by permitting or requiring the use of IFRS under the IAS Regulation and/or by transposing the Directive's requirements into national law so as to permit or require the use of fair value in accordance with IAS 39; or
- implementation can exclude these companies, so that use of fair value in accordance with IAS 39 is not permitted except in accordance with the preparation of IFRS financial statements under the IAS Regulation.

The table therefore shows, for each of the three categories of financial statements, whether the use of fair value in accordance with IAS 39 is permitted, required or not permitted in national law under:

- implementation of the Fair Value Directive; and/or
- implementation of IFRS through the IAS Regulation.

Table 2.1: Implementation of the Fair Value Directive

		Publicly Traded Companies		Non-publicly Traded Companies			
		Legal Entity		Consolidated		Legal Entity	
Country	**Companies**	**Fair Value***	**IFRS**	**Fair Value***	**IFRS**	**Fair Value***	**IFRS**
Austria	All	Required	Not permitted	Required	Permitted	Required	Not permitted
Belgium	Credit Institutions	Permitted	Not permitted	Permitted	Required	Permitted	Not permitted
	Other	Permitted	Not permitted	Permitted	Permitted	Permitted	Not permitted
Cyprus	All	Required	Required	Required	Required	Required	Required
Czech Republic	All	Required	Required	Required	Permitted	Required	Not permitted
Denmark	All	Required	Permitted	Required	Permitted	Required	Permitted
Estonia	Financial institutions	Required	Required	Required	Required	Required	Required
	Other	Required	Required	Required	Permitted	Required	Permitted
Finland	Financial Institutions	Permitted	Not permitted	Required	Required	Permitted	Not permitted
	Other	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted
France	All	Not permitted	Not permitted	Not permitted	Permitted	Not permitted	Not permitted
Germany	All	Not permitted	Not permitted	Not permitted	Permitted	Not permitted	Not permitted
Greece	All	Permitted	Required	Permitted	Permitted	Permitted	Permitted
Hungary	All	Permitted	Not permitted	Permitted	Permitted	Permitted	Not permitted
Ireland	All	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted
Italy	Supervised financial companies and companies with financial instruments widely distributed among the public	IFRS	Required	IFRS	Required	IFRS	Required
	Other	Not permitted	Required	Not permitted	Permitted	Not permitted	Permitted
Latvia	Banks and other supervised financial institutions	IFRS	Required	IFRS	Required	IFRS	Required
	Other	Permitted	Permitted	Permitted	Permitted	Permitted	Not permitted
Lithuania	Banks and controlled financial institutions	IFRS	Required	IFRS	Required	IFRS	Required
	Other	Required	Required	Required	Not permitted	Required	Not permitted
Luxembourg	All	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted

Table 2.1: Implementation of the Fair Value Directive (continued)

		Publicly Traded Companies		Non-publicly Traded Companies			
		Legal Entity		Consolidated		Legal Entity	
Country	**Companies**	**Fair Value***	**IFRS**	**Fair Value***	**IFRS**	**Fair Value***	**IFRS**
Malta	All	IFRS	Required	IFRS	Required	IFRS	Required
Netherlands	All	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted
Poland	Banks	Required	Not permitted	Required	Required	Required	Not permitted
	Pending admission to regulated market	Not permitted	Permitted	Permitted	Permitted	Not permitted	Permitted
	Subsidiary in IFRS group	N/A	N/A	Permitted	Permitted	Not permitted	Permitted
	Other	Required	Permitted	Required	Not permitted	Required	Not permitted
Portugal	Banks and financial institutions	Not permitted	Not permitted	Permitted	Permitted	Not permitted	Not permitted
	Subsidiary in IFRS group	N/A	N/A	Permitted	Permitted	Not permitted	Permitted
	Other	Not permitted	Permitted	Permitted	Permitted	Not permitted	Not permitted
Slovakia	All	Required	Not permitted	Required	Required	Required	Not permitted
Slovenia	Banks	Required	Required	Required	Required	Required	Required
	Other	Required	Permitted	Required	Permitted	Required	Permitted
Spain	All	Not permitted	Not permitted	Not permitted	Permitted	Not permitted	Not permitted
Sweden	Credit institutions, securities companies,	Required	Not permitted	Required	Permitted	Required	Not permitted
	Other	Permitted	Not permitted	Permitted	Permitted	Permitted	Not permitted
United Kingdom	All	Permitted	Permitted	Permitted	Permitted	Permitted	Permitted

* This column shows whether fair value accounting in accordance with the Fair Value Directive is required or permitted by member states' law. It does not show all the relevant requirements of national GAAP. It also excludes provisions relating specifically to insurance companies under implementation of the IAS Regulation, as insurers are outside the scope of the Fair Value Directive.

2.5 Use of the Fair Value Directive by companies

Companies' use of fair value accounting under the Fair Value Directive appears to have been limited. As noted above, four EU member states with major economies – France, Germany, Italy and Spain – have implemented the Fair Value Directive by allowing the consolidated financial statements of non-publicly traded companies to be prepared in accordance with IFRS under the IAS Regulation. All other member states also permit or require IFRS financial statements at least to some extent beyond the Regulation's minimum requirements. It is therefore likely that, even excluding the consolidated financial statements of publicly traded companies, many – perhaps most – financial statements that comply with the fair value requirements of IAS 39 do so under the IAS Regulation, rather than under the Fair Value Directive.

Where companies comply with the fair value requirements of IAS 39 under the Fair Value Directive, it will be because they are doing so under national GAAP. It is possible, therefore, that there will be increased reliance on the Directive's provisions where national GAAP in member states moves closer to IFRS in those countries where fair value accounting under the Directive is permitted but not required. However, we have not reviewed the provisions of national GAAP in this respect to see how far this is likely.

As the number of companies across the EU complying with the fair value requirements of IAS 39 under the Fair Value Directive appears to be relatively small, it was difficult to find a sample of them. Accounting firms and others, including those attending the roundtables, advised that, in their experience, very few companies used fair value accounting for financial instruments in their national GAAP financial statements. Many

professional accountancy bodies in member states, accounting firms and other contacts were unable to help us to identify specific companies either because they were unaware of any that complied with IAS 39 under the Directive or because they were precluded by confidentiality requirements from passing on information about clients.

Two non-publicly traded UK companies using fair value accounting for financial instruments in compliance with national laws implementing the Fair Value Directive that were brought to our attention are **United Biscuits** and **Travelex Holdings**:

United Biscuits uses fair value accounting for derivatives. It enters into derivatives transactions (principally interest rate swaps, foreign currency contracts and commodity contracts) to manage the interest rate, currency, liquidity and commodity risks arising from its operations and its sources of finance. It reports these derivatives at fair value at the balance sheet date. It calculates fair value by discounting the expected future cash flows at prevailing interest and exchange rates. Gains and losses on financial instruments used for hedging interest rate exposure and foreign exchange risk and commodity risk are deferred until the exposure that is being hedged is itself recognised. The company discloses these deferred gains and losses.

Travelex Holdings uses fair value accounting for derivative financial instruments. The gain or loss on re-measurement to fair value is recognised immediately in profit or loss. When derivatives qualify for hedge accounting, recognition of any resulting gain or loss depends on the nature of the item being hedged. In the case of cash flow hedges, the effective part of any gain or loss on a derivative is recognised directly in equity and any ineffective portion is recognised immediately in profit or loss.

It seems to us that it is practically impossible to separate the effects of implementing the Fair Value Directive from those of implementing the IAS Regulation, particularly as the interaction of the Directive and the Regulation makes it difficult to decide in principle whether a company's accounting is in accordance with one rather than the other. For example, in some cases the fair value accounting permitted under the Directive is being undertaken in accordance with a permission or requirement under the Regulation. We therefore suggest that the question of compliance with the Directive is not one that can fruitfully be pursued as a distinct question in future studies.

2.6 Costs of implementation

Our approach to the quantification of incremental costs to companies is described in Chapter 7 which deals with the incremental costs of the IAS Regulation. This approach relied on obtaining information obtained from the on-line survey (see Chapters 4 and 7). We could not identify a sufficient sample with which to quantify the administrative costs with respect to the use of fair value accounting for financial instruments specifically in accordance with the Fair Value Directive. Nevertheless, the information provided in Chapter 7 on the costs of implementing IFRS requirements on accounting for financial instruments should provide an indication of the likely scale of costs involved.

More fundamentally, it is doubtful how far it is methodologically sound to attribute costs to implementation of the Directive given the range of:

- member state options under the Fair Value Directive;
- the interaction of the Directive and the IAS Regulation; and
- permissive provisions in national law.

Incremental costs seem to arise principally because of:

- member state choices;
- implementation of the Regulation; and

- companies’ choices.

The Fair Value Directive does not compel any companies to comply with the fair value requirements of IAS 39. Any compulsion under the Directive arises only where member states have chosen to require compliance rather than to allow it, and the costs of compliance are therefore arguably attributable to the member state’s decision rather than to the Directive. Where compliance is voluntary by the company, the costs are arguably imposed by the company on itself rather than by the Directive.

For these reasons, we do not believe that the cost of implementing the Directive as such is a question that can usefully be pursued in any future studies.

3. Implementation of the IAS Regulation

3.1 Key points

The IAS Regulation directly requires the use of IFRS as adopted by the EU (IFRS-EU) in the consolidated financial statements of publicly traded companies established in EU member states. Each member state may also extend the application of the IAS Regulation to permit or require the use of IFRS-EU in the legal entity financial statements of companies and the consolidated financial statements of non-publicly traded companies.

The IAS Regulation has been effective in achieving the core objective of all publicly traded entities preparing consolidated financial statements in accordance with IFRS-EU, subject to the deferral of implementation in some countries to 2007 for entities with only debt securities admitted to trading or those entities listed on a non-EU market and using internationally accepted standards.

Allowing member states discretion over the extent to which IFRS was to be used outside the consolidated financial statements of publicly traded entities has inevitably resulted in legal positions varying significantly. Some member states are prescriptive on the use of IFRS in the consolidated and legal entity financial statements, others allow some choice. A common theme is a more prescriptive regime for specific types of entity, particularly financial institutions. In many cases the legal position has changed from 2005.

In view of the complex nature of the application of the IAS Regulation in member states and its continuing evolution, we consider it important that the European Commission cooperates with member states, the European Parliament and other organisations to monitor developments to ensure that information on the public record is up to date and accurate.

3.2 The IAS Regulation

The IAS Regulation requires publicly traded companies to present consolidated financial statements in conformity with IFRS adopted by the European Union (IFRS-EU) for each financial year starting on or after 1 January 2005. Member states may permit such companies to defer the application of IFRS-EU when:

- only their debt securities are admitted to trading on a regulated market of any member state; or
- their securities are admitted to public trading in a non-member state and, for that purpose, they have been using internationally accepted standards since a financial year that started prior to 11 September 2002 (for this purpose, internationally accepted standards are generally understood to include only US GAAP).

The IAS Regulation allows member states to:

- require or permit non-publicly traded companies to present consolidated financial statements using IFRS-EU instead of national GAAP in conformity with the EU Fourth and Seventh Directives; and
- require or permit non-publicly traded companies to present legal entity financial statements using IFRS-EU instead of national GAAP in conformity with the EU Fourth and Seventh Directives.

In practice, the IAS Regulation allows jurisdictions to prohibit any specific type of company from using IFRS in their legal entity financial statements, and, in the case of non-publicly traded companies, their consolidated financial statements.

3.3 Approach

We sent questionnaires to the member firms of BDO International, professional accountancy bodies and other contacts in each member state requesting confirmation of the legal position with respect to the IAS Regulation in their member state. We made follow-up enquiries when the replies conflicted with information supplied to us by the European Commission and when the replies from respondents in the same member state differed from one another.

The legal positions vary significantly between member states and in some cases can be very complex, with different requirements for financial institutions or permissible treatments for individual companies within groups. Matters are complicated further by the fact that in some member states the legal position has changed from that which applied in relation to 2005 financial statements. The information in this chapter represents our current understanding of the legal framework in the individual member states for the period under review. Where possible we have noted significant subsequent changes.

3.4 EU publicly traded company consolidated financial statements

The IAS Regulation applies directly to publicly traded companies established in any member state which are required to present consolidated financial statements. Some member states have made consequential amendments to their laws to accommodate or clarify the requirements of the IAS Regulation to permit deferral of IFRS consolidated financial statements in the circumstances described below.

13 member states permit publicly traded companies to defer the application of IFRS-EU in their consolidated financial statements when only their debt securities are admitted to trading on a regulated market in any member state. Two member states restrict the use of the option to non-financial or non-banking companies (Table 3.1).

Table 3.1: Deferral to 2007 for publicly traded companies with only debt securities admitted to trading

Member state
Austria
Belgium
Denmark (non-financial companies only)
Finland
France
Germany
Hungary
Ireland
Luxembourg
Poland
Slovenia
Spain (non-banking companies only)
Sweden

Four member states permit publicly traded companies to defer the application of IFRS-EU in their consolidated financial statements until 2007 if their securities are admitted to public trading in a non-member state and, for that purpose, they have been using internationally accepted standards since a financial year that started prior to 11 September 2002 (Table 3.2). The low number of member states using this option reflects the fact that most member states previously required all companies to use national GAAP, rather than overseas GAAP.

Table 3.2: Deferral to 2007 if listed on non-EU market and use internationally accepted standards

Austria
Belgium
Germany
Luxembourg

As of 1 January 2008, all publicly traded companies in all member states should be producing consolidated financial statements in accordance with IFRS-EU.

Only Cyprus and Malta have extended the use of IFRS-EU to the consolidated and legal entity financial statements of all companies. In both cases, this reflects long-standing legal requirements and practices which existed at the time of the accession of Cyprus and Malta to the EU. The Institute of Certified Public Accountants of Cyprus has required the use of IFRS in any financial statements audited by its members since 1981 and since 1995, Cyprus stock exchange listed companies have been required by law to prepare IFRS financial statements. In Malta, the Companies Act (1995) requires the use of IFRS in the legal entity and consolidated financial statements of all limited liability companies.

The position in other member states is more complex.

3.5 EU non-publicly traded company consolidated financial statements

Slovakia, as well as Cyprus and Malta, requires the use of IFRS in the consolidated financial statements of all non-publicly traded companies.

Belgium, Estonia, Italy, Latvia, Lithuania, Poland and Slovenia require some financial institutions to prepare any consolidated financial statements in accordance with IFRS (Table 3.3). Finland requires all insurance companies, including those that are not publicly traded, to prepare consolidated financial statements in accordance with IFRS.

Table 3.3: IFRS required in consolidated financial statements of non-publicly traded financial institutions

Belgium (credit institutions)
Estonia (credit institutions, insurance companies, financial holding companies, mixed financial holding companies, investment companies)
Finland (insurance companies)
Italy (some supervised financial companies, insurance companies)
Latvia (banks, insurance companies, other supervised financial institutions)
Lithuania (banks and their controlled financial institutions)
Poland (banks)
Slovenia (banks, insurance companies)

Belgium, Estonia, Finland, Italy, Latvia and Slovenia permit, but do not require, other non-publicly traded companies to prepare IFRS consolidated financial statements.

Lithuania does not permit other non-publicly traded companies to prepare any consolidated financial statements in accordance with IFRS.

Poland permits publicly traded companies to prepare any consolidated financial statements in accordance with IFRS if they are issuers of securities pending admission to trading on a regulated market or where they are within the scope of consolidation of an entity that applies IFRS.

The remaining member states permit, but do not require, all non-publicly traded companies to prepare any consolidated financial statements in accordance with IFRS.

3.6 EU legal entity financial statements

The situation regarding the use of IFRS in legal entity financial statements is a patchwork of different requirements in each jurisdiction. These are hard to summarise, and even harder to monitor, as they remain subject to review and modification in many member states. In this area of financial reporting, practice across the EU is – and is likely to remain – highly diverse.

In eight member states the boundaries of IFRS penetration are tightly drawn. Austria, Belgium, France, Germany, Hungary, Slovakia, Spain and Sweden do not permit any companies to prepare their legal entity financial statements in accordance with IFRS. Companies may prepare supplementary legal entity financial statements in accordance with IFRS, but these financial statements do not meet national regulatory requirements.

In other countries, the regime is entirely permissive. Five member states (Denmark, Ireland, Luxembourg, Netherlands and the United Kingdom) permit all companies to prepare legal entity financial statements in accordance with IFRS.

Whilst Cyprus and Malta require all legal entity financial statements to be prepared under IFRS, some member states require all publicly traded companies to prepare their legal entity financial statements in accordance with IFRS (the Czech Republic, Estonia, Greece and Lithuania). Variations on this theme include the following:

- Italy requires all publicly traded companies except insurance companies (which are not permitted) to prepare IFRS legal entity financial statements; and
- Denmark currently permits all publicly traded companies to prepare IFRS legal entity financial statements, but will require all publicly traded companies except financial entities to prepare these financial statements in accordance with IFRS-EU from 2009. Non-publicly traded companies are permitted, but not required, to do so.

Often more stringent policies have been applied to financial institutions. Thus:

- Estonia requires all financial institutions, including those that are not publicly traded, to prepare IFRS legal entity financial statements whilst all other companies are permitted but not required to do so;
- Italy requires supervised financial companies and companies with financial instruments widely distributed among the public, to prepare their legal entity financial statements under IFRS whereas all other unlisted companies except insurance companies are permitted but not required to do so;
- Latvia requires banks, insurance companies and other supervised financial institutions to prepare IFRS legal entity financial statements. Otherwise, only entities quoted on the official list are permitted to do so;

- Lithuania requires all banks and controlled financial institutions to prepare IFRS legal entity financial statements but other unlisted companies are not permitted to do so; and
- Slovenia requires all banks and insurance companies to prepare IFRS legal entity financial statements whilst all other companies are permitted but not required to do so.

From 2006, Slovakia has required all financial institutions, companies exceeding specified size thresholds and other specified companies to use IFRS in their legal entity financial statements. Listed companies that do not meet the specified size criteria will be permitted to do so.

The Czech Republic requires all publicly traded companies to prepare legal entity financial statements in accordance with IFRS but non-publicly traded companies are not permitted to do so.

Finland permits all companies to prepare legal entity financial statements in accordance with IFRS with the exception of insurance companies, which are not permitted to do so.

Greece requires publicly traded companies to apply IFRS in their legal entity financial statements and permits non-publicly traded companies to do the same.

Poland permits all publicly traded companies to prepare legal entity financial statements in accordance with IFRS except banks, which are not permitted to do. Non-publicly traded companies are only permitted to prepare any legal entity financial statements in accordance with IFRS if they are issuers of securities pending admission to trading on a regulated market or are within the scope of IFRS consolidation.

Portugal permits but does not require the use of IFRS in the legal entity financial statements of all publicly traded companies, except banks and financial institutions, and all non-publicly traded companies within the scope of IFRS consolidation. From 2006 banks and financial institutions will be required to produce legal entity financial statements in accordance with IFRS. Financial statements prepared under local GAAP are required in addition to IFRS financial statements.

3.7 Summary

Table 3.4 summarises the application of the IAS Regulation in all the countries that were EU member states in 2005.

Table 3.4: Application of the IAS Regulation

	Companies	Publicly traded companies		Non-publicly traded companies	
		Consolidated	Legal entity	Consolidated	Legal entity
Austria	All	Required	Not permitted	Permitted	Not permitted
Belgium	Credit Institutions	Required	Not permitted	Required	Not permitted
	Other	Required	Not permitted	Permitted	Not permitted
Cyprus	All	Required	Required	Required	Required
Czech Republic	All	Required	Required	Permitted	Not permitted
Denmark	All	Required	Permitted	Permitted	Permitted
Estonia	Credit institutions, insurance companies, financial and mixed financial holding companies and investment companies	Required	Required	Required	Required
	Other	Required	Required	Permitted	Permitted
Finland	Insurance	Required	Not permitted	Required	Not permitted
	Other	Required	Permitted	Permitted	Permitted
France	All	Required	Not permitted	Permitted	Not permitted
Germany	All	Required	Not permitted	Permitted	Not permitted
Greece	All	Required	Required	Permitted	Permitted
Hungary	All	Required	Not permitted	Permitted	Not permitted
Ireland	All	Required	Permitted	Permitted	Permitted
Italy	Supervised financial companies, companies with financial instruments widely distributed among the public	Required	Required	Required	Required
	Insurance companies	Required	Not permitted	Required	Not permitted
	Other	Required	Required	Permitted	Permitted
Latvia	Banks, insurance companies and other financial institutions	Required	Required	Required	Required
	Other	Required	Permitted*	Permitted	Not permitted
Lithuania	Banks and controlled financial institutions	Required	Required	Required	Required
	Other	Required	Required	Not permitted	Not permitted
Luxembourg	All	Required	Permitted	Permitted	Permitted
Malta	All	Required	Required	Required	Required
Netherlands	All	Required	Permitted	Permitted	Permitted
Poland	Banks	Required	Not permitted	Required	Not permitted
	Pending admission to regulated market	N/A	N/A	Permitted	Permitted
	Subsidiary in IFRS group	N/A	N/A	Permitted	Permitted
	Other	Required	Permitted	Not permitted	Not permitted
Portugal	Banks and financial institutions	Required	Not permitted	Permitted	Not permitted
	Subsidiary in IFRS group	N/A	N/A	Permitted	Permitted
	Other	Required	Permitted	Permitted	Not permitted
Slovakia	All	Required	Not permitted	Required	Not permitted
Slovenia	Banks and insurance companies	Required	Required	Required	Required
	Other	Required	Permitted	Permitted	Permitted
Spain	All	Required	Not permitted	Permitted	Not permitted
Sweden	All	Required	Not permitted	Permitted	Not permitted
United Kingdom	All	Required	Permitted	Permitted	Permitted

* Latvia: companies listed on the official list of the Riga Stock Exchange are required to prepare IFRS-EU legal entity accounts for listing purposes only.

4. Views of preparers, users and auditors

4.1 Key points

The following were the key findings from the on-line survey:

- There was widespread agreement that IFRS has made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors.
- 63% of investors thought that IFRS had improved the quality of consolidated financial statements against 24% who thought that IFRS had made it worse. The corresponding figures for preparers were 60% and 14% respectively and for auditors 80% and 8%.
- 49% of investors thought that the switch to IFRS accounting had made financial statements more difficult to understand, although 32% disagreed. Investors found the majority of accounting areas easier to understand, but some specific accounting policies caused difficulty in understanding – particularly financial instruments.
- The move to consolidated IFRS financial statements had influenced the investment decisions of 41% of investors.
- A 51% majority of preparers were either very or fairly confident that fund managers and analysts fully understand the impact of IFRS but a 36% minority were not confident and 13% did not know.
- Preparers' views on board understanding of the financial impact of IFRS were broadly positive, although significant minorities were not confident of the board's understanding or did not express a view.
- 69% of preparers used IFRS accounting for internal reporting and 25% stated that IFRS financial statements had impacted the way the business was run.

The overall message of the roundtables was broadly consistent with the findings of the on-line survey. In particular, IFRS implementation had been challenging but successful; there was an absence of any general loss of confidence in financial reporting and IFRS implementation was generally seen as a positive development for EU financial reporting.

Key findings from the roundtables and supplementary telephone interviews were:

- Larger companies especially had prepared early, and had devoted considerable resources to educating and training their boards, staff and investors. The contribution of the IASB to this process, in making necessary improvements to IFRS in time for 2005 application, was referred to.
- There was broad agreement that the adoption of IFRS across the EU had improved the quality of financial reporting and had substantially increased comparability across countries, competitors and sectors.
- Success tended to be expressed more in terms of recognition and measurement, rather than disclosure, and the value of the significantly increased disclosure requirements was contested. There was general acceptance that 'boilerplate' accounting policies were used and that the disclosures required under

IAS 1 *Presentation of Financial Statements* in relation to judgements and estimates presented a challenge for preparers.

- A number of participants argued that it was too early to conclude with certainty that the migration to IFRS had, overall, been a success. In particular, the period under review had witnessed benign economic conditions, which could delay the identification of poor accounting and regulatory practices.

- The experience of smaller quoted companies was often very different from larger companies because, for example, of limited resources and a lack of prior experience of IFRS. Nonetheless, there was little evidence of problems being identified.

- Many participants pointed to the requirements of national legislation and national regulators and the enduring strength of national accounting traditions as factors contributing to the 'local accents' found in IFRS reporting in the EU.

- It was evident that in many jurisdictions the increased amount of judgement required by IFRS as a generally principles-based set of standards presented considerable challenges, and some concerns were expressed about consistency of application.

- Whilst there was a fair degree of satisfaction with the current suite of IFRS, certain standards were singled out for criticism, including IAS 39 *Financial Instruments: Recognition and Measurement*. A number of participants queried whether the valuations of intangibles required under IFRS 3 *Business Combinations* merited the associated costs.

- Participants at all of the roundtables expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values in IFRS and the possibility that convergence with US GAAP may lead to more rules-based standards. These concerns, coupled with awareness of the scale of the effort involved in IFRS implementation and concerns about some aspects of current IFRS, were reflected in a general lack of appetite at present for any wider application of full IFRS.

- The roundtables supported the view that, despite increasing levels of understanding, company boards were still in need of more advice and assistance on accounting matters than was the case prior to the transition.

- Participants at the roundtables supported the view that the audit firms had played a pivotal role in ensuring that the process of transition was generally a smooth one. Some participants and interviewees expressed dissatisfaction with the speed with which early questions of interpretation were addressed by their auditors, whilst recognising that this reflected a desire by audit firms to reach consistent answers.

- Finally, in a number of jurisdictions the issue of the quality of IFRS translations was highlighted as a major concern.

4.2 On-line survey overview

Our primary means of obtaining the views of preparers, users and auditors was an on-line survey. The survey questionnaire was developed and managed in accordance with the UK Market Research Society's Code of Conduct by an independent research agency, Synovate, with supervision and accounting expertise provided by ICAEW staff and

management. The survey questionnaire was available only in English and is reproduced at Appendix 5.

A link to the on-line survey was sent directly to in excess of 4,000 investors in four member states. It was also sent to professional bodies in 25 member states for onward distribution to their members and regulators across Europe and circulated to the European offices of the largest UK-based firms for onward transmission to partners and staff directly involved in the audit of IFRS financial statements.

We wrote to the chief financial officers of the 200 publicly traded companies in Sample 1 inviting them or an appropriate colleague to complete the on-line survey. We received 35 replies as a result of which we sent the link to the on-line survey directly to representatives of 35 companies in Sample 1.

We estimate that the link to the survey questionnaire was sent to in excess of 10,000 people in 25 member states. We received valid responses from statistically valid samples of 51 investors, 162 preparers of IFRS financial statements and 141 auditors of IFRS financial statements. These responses came from 23 member states.

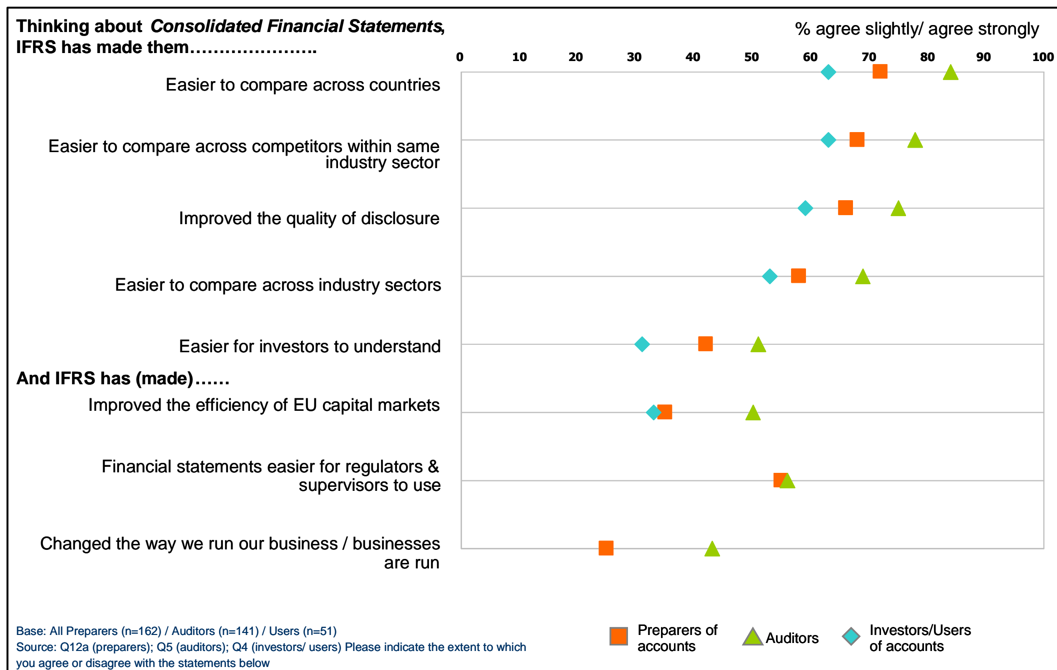
We ignored responses to the on-line questionnaire from:

- respondents who had not worked with IFRS;
- preparers who had not prepared IFRS financial statements;
- public accountants who had not audited IFRS financial statements; and
- investors and other users who were not at all familiar with or who had not used IFRS financial statements.

The groups responding to the on-line survey – investors, preparers and auditors – were generally positive about the introduction of IFRS and its effects on the quality and usefulness of published financial information in the EU. There was significant support for the premise that IFRS has made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors as well as improving the quality of disclosures in financial statements.

Preparers and auditors agreed that financial statements were easier for regulators and supervisors to use. There was less agreement over whether IFRS had changed the way businesses were run and a majority view among preparers and investors (but not auditors) that the switch to IFRS had made financial statements more difficult for users to understand (Figure 4.1).

Figure 4.1: Level of agreement with statements regarding IFRS among investors, preparers and auditors



We have undertaken supplementary analysis differentiating the results of respondents based in the major EU capital markets and those based in other EU jurisdictions. This analysis did not identify significant differences in attitudes.

4.3 Investor views

There were 51 investors with investments in 24 EU member states and all major sectors who responded to the on-line survey. They covered a range of countries (Figure 4.2) and industry sectors (Figure 4.3). 80% of the respondents stated they were very or quite familiar with IFRS (20% not very familiar) and 69% were either very or fairly confident in their understanding of the implications of IFRS as against 31% who were not very confident of their understanding of the implications (Figure 4.4).

Figure 4.2: Which of the following countries do you currently invest in or track?

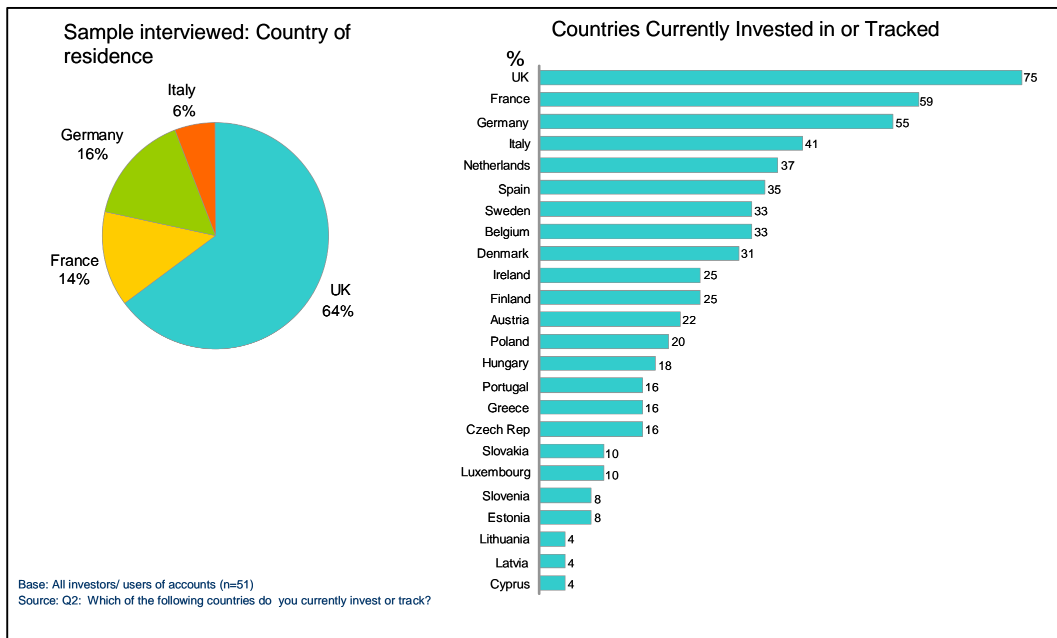


Figure 4.3: Which of the following industry sectors do you currently invest in or track?

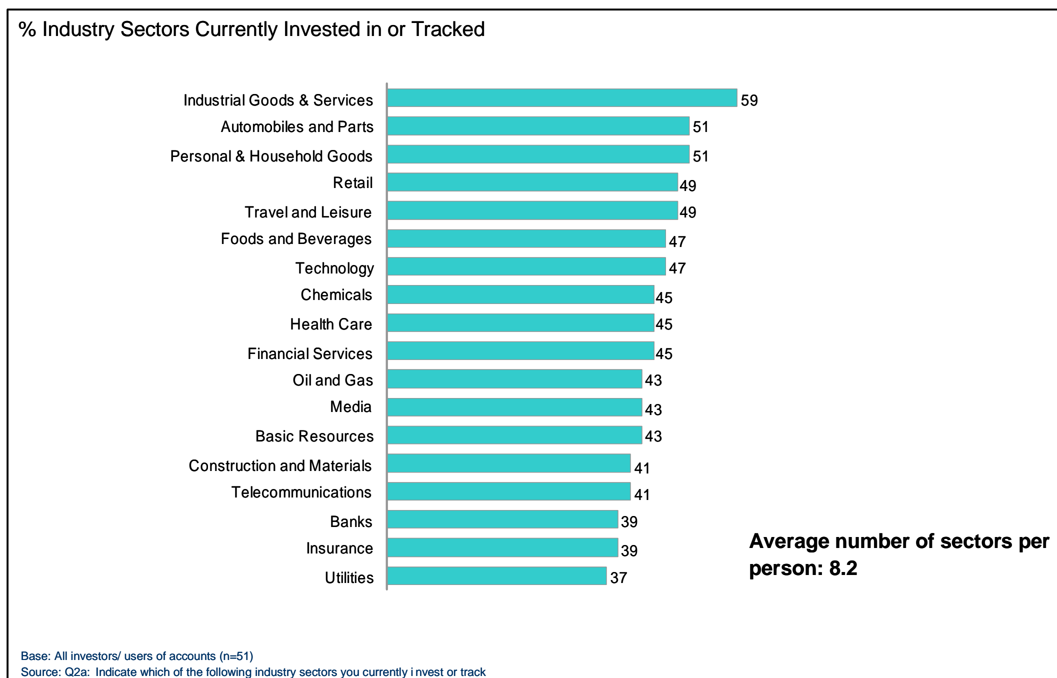
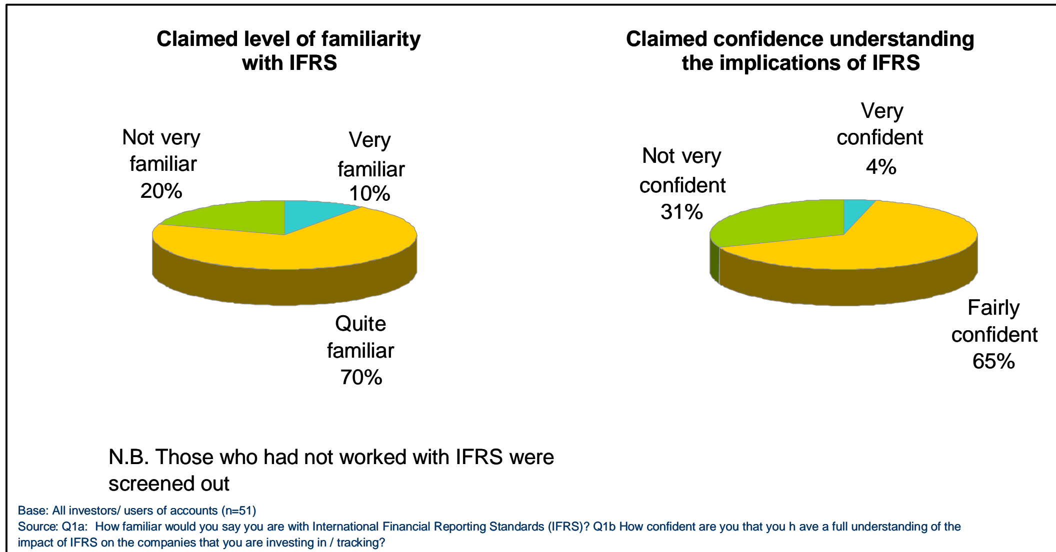
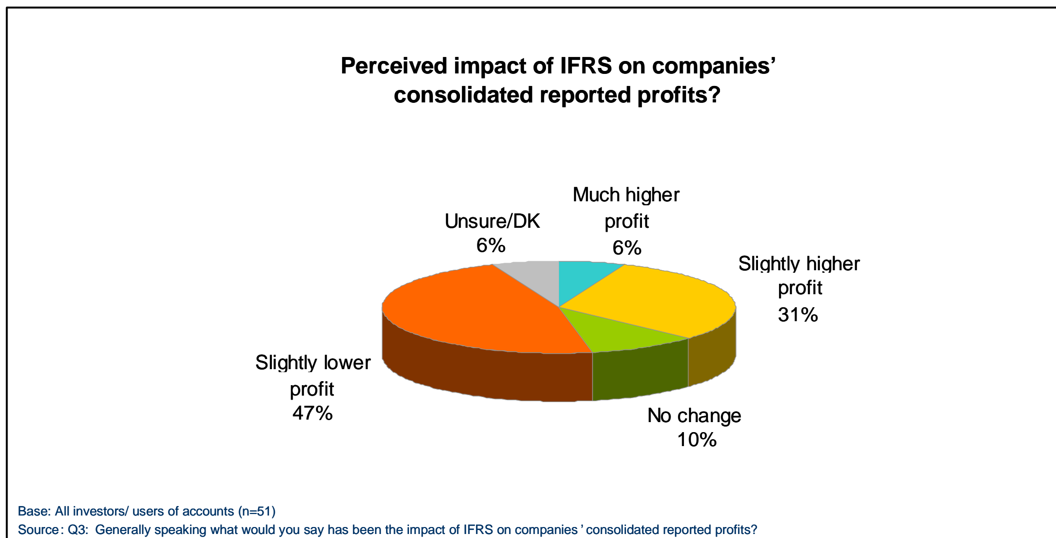


Figure 4.4: How familiar would you say you are with IFRS? How confident are you that you have a full understanding of the impact of IFRS on the companies that you are investing in/tracking?



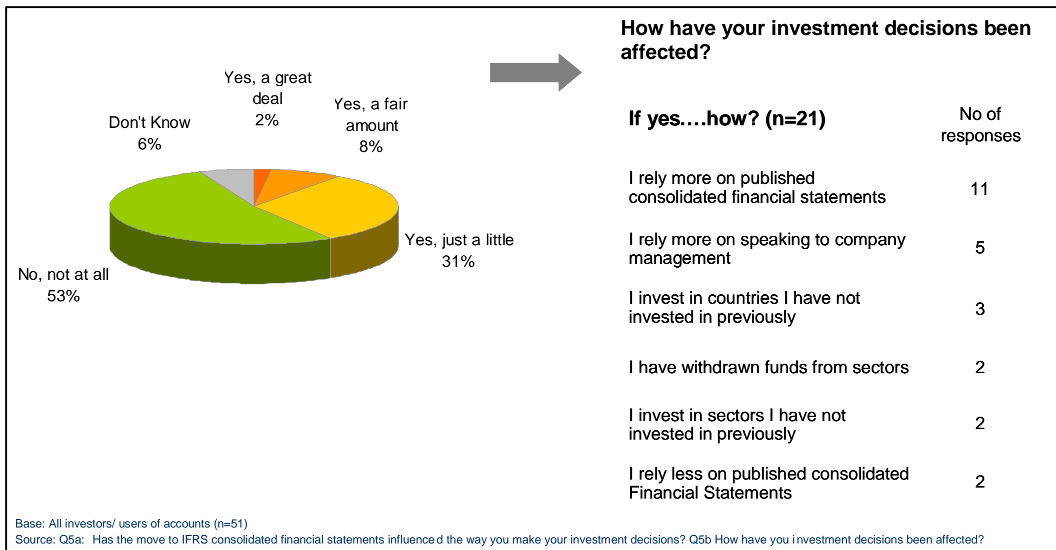
Views among investors of the impact of IFRS on companies consolidated reported profits were mixed. 6% thought that the impact had been 'much higher profit', 31% thought the impact had been 'slightly higher profit' but 47% believed the impact had been 'slightly lower profit'. 10% thought there had been no change to reported profits (Figure 4.5).

Figure 4.5: Generally speaking what would you say has been the impact of IFRS on companies' consolidated reported profits?



53% of investors stated that the move to IFRS had not influenced their investment decisions but 41% of investors stated that IFRS consolidated financial statements had influenced the way they made their investment decisions (2% a great deal, 8% a fair amount and 31% just a little) (Figure 4.6).

Figure 4.6: Has the move to IFRS consolidated financial statements influenced the way you make your investment decisions?

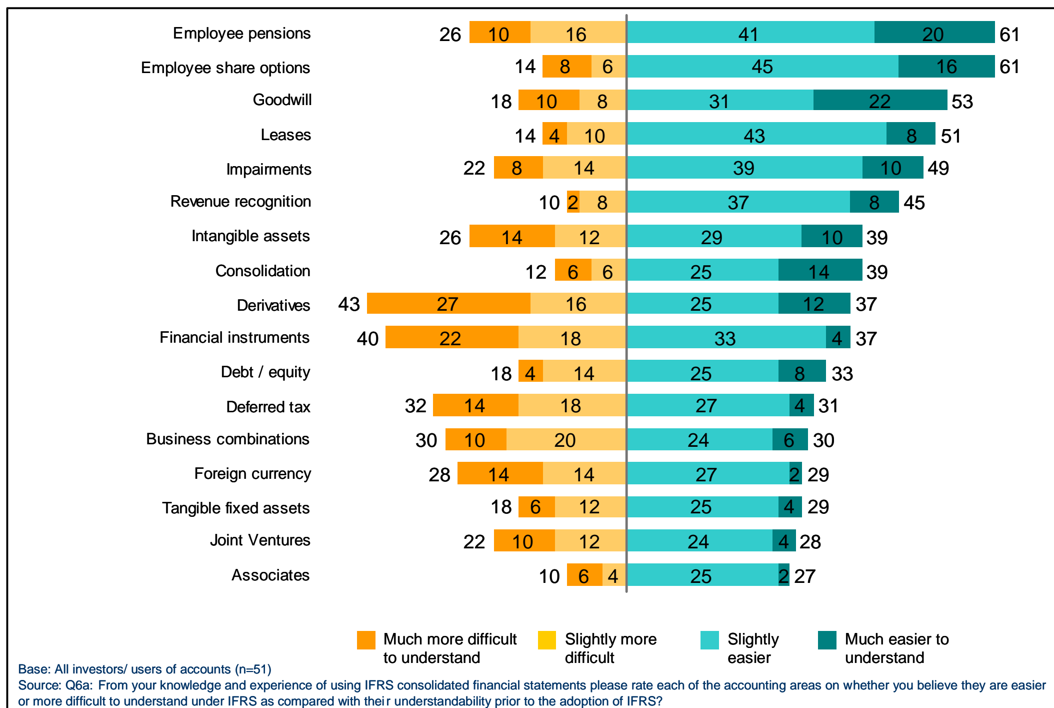


If yes….how? (n=21)	No of responses
I rely more on published consolidated financial statements	11
I rely more on speaking to company management	5
I invest in countries I have not invested in previously	3
I have withdrawn funds from sectors	2
I invest in sectors I have not invested in previously	2
I rely less on published consolidated Financial Statements	2

Base: All investors/ users of accounts (n=51)
Source: Q5a: Has the move to IFRS consolidated financial statements influenced the way you make your investment decisions? Q5b How have you investment decisions been affected?

The impact of IFRS on the understandability of the financial statements was assessed in relation to 17 key accounting policy areas. For a majority of those areas (12 of the 17), investors found IFRS accounting policies easier to understand. Only in relation to derivatives and financial instruments – where accounting requirements had previously been limited in many jurisdictions – was there an overall decrease in understandability. On deferred tax, foreign currency and business combinations, opinions were evenly divided on whether the accounting policies were easier or more difficult to understand (Figure 4.7).

Figure 4.7: Please rate each of the following accounting areas on whether you believe they are easier or more difficult to understand under IFRS

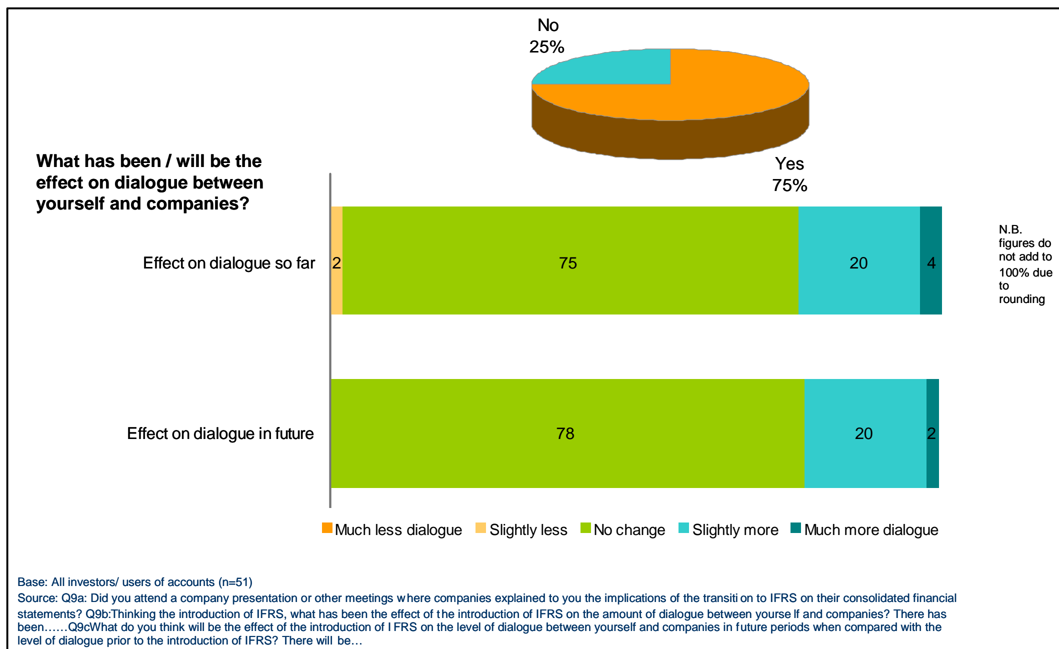


Accounting area	Total difficult	Much more difficult to understand	Slightly more difficult	Slightly easier	Much easier to understand	Total easier
Employee pensions	26	10	16	41	20	61
Employee share options	14	8	6	45	16	61
Goodwill	18	10	8	31	22	53
Leases	14	4	10	43	8	51
Impairments	22	8	14	39	10	49
Revenue recognition	10	2	8	37	8	45
Intangible assets	26	14	12	29	10	39
Consolidation	12	6	6	25	14	39
Derivatives	43	27	16	25	12	37
Financial instruments	40	22	18	33	4	37
Debt / equity	18	4	14	25	8	33
Deferred tax	32	14	18	27	4	31
Business combinations	30	10	20	24	6	30
Foreign currency	28	14	14	27	2	29
Tangible fixed assets	18	6	12	25	4	29
Joint Ventures	22	10	12	24	4	28
Associates	10	6	4	25	2	27

Base: All investors/ users of accounts (n=51)
Source: Q6a: From your knowledge and experience of using IFRS consolidated financial statements please rate each of the accounting areas on whether you believe they are easier or more difficult to understand under IFRS as compared with their understandability prior to the adoption of IFRS?

75% of respondents had attended company presentations where companies had explained the implications of the transition to IFRS on their consolidated financial statements (Figure 4.8). The introduction of IFRS had also seen a limited increase in dialogue between investors and companies so far with 24% reporting more dialogue (4% 'much more' and 20% 'slightly more'). These percentages did not significantly alter when investors were asked about the impact of the introduction of IFRS on future dialogue with companies.

Figure 4.8: Did you attend company presentations where companies explained to you the implications of the transition to IFRS on their consolidated financial statements?



Base: All investors/ users of accounts (n=51)
Source: Q9a: Did you attend a company presentation or other meetings where companies explained to you the implications of the transiti on to IFRS on their consolidated financial statements? Q9b:Thinking the introduction of IFRS, what has been the effect of the introduction of IFRS on the amount of dialogue between yourse lf and companies? There has been……Q9cWhat do you think will be the effect of the introduction of I FRS on the level of dialogue between yourself and companies in future periods when compared with the level of dialogue prior to the introduction of IFRS? There will be…

63% of investors agreed that the application of IFRS had improved the overall quality of published financial statements (6% significantly better and 57% slightly better). However, 24% thought that the move to IFRS had had an adverse effect on the quality of financial statements, (6% significantly worse and 18% slightly worse) (Figure 4.9). 45% of investors agreed that the standards more accurately reflect the economic reality of company performance and its position than national GAAPs but 30% disagreed with this proposition and 25% neither agreed nor disagreed (Figure 4.10).

Figure 4.9: What effect do you think the move to IFRS has had on the quality of companies' consolidated financial statements?

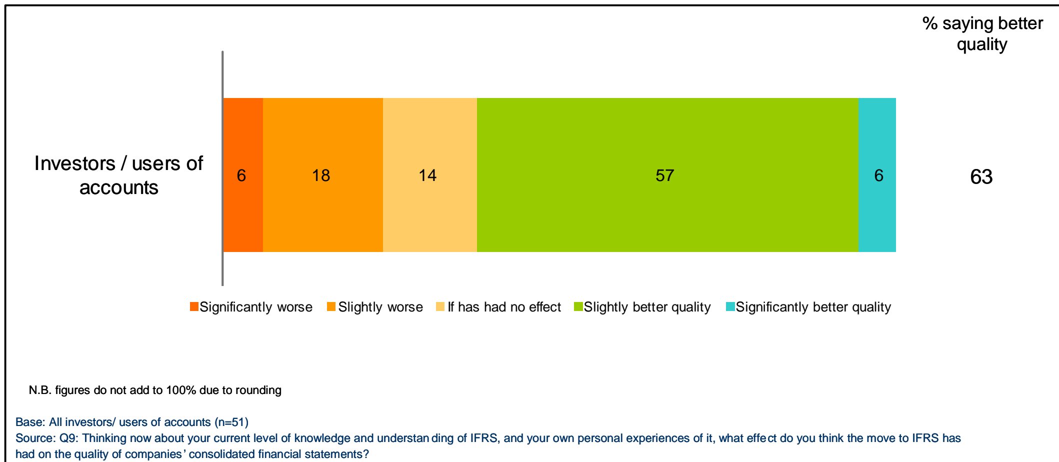
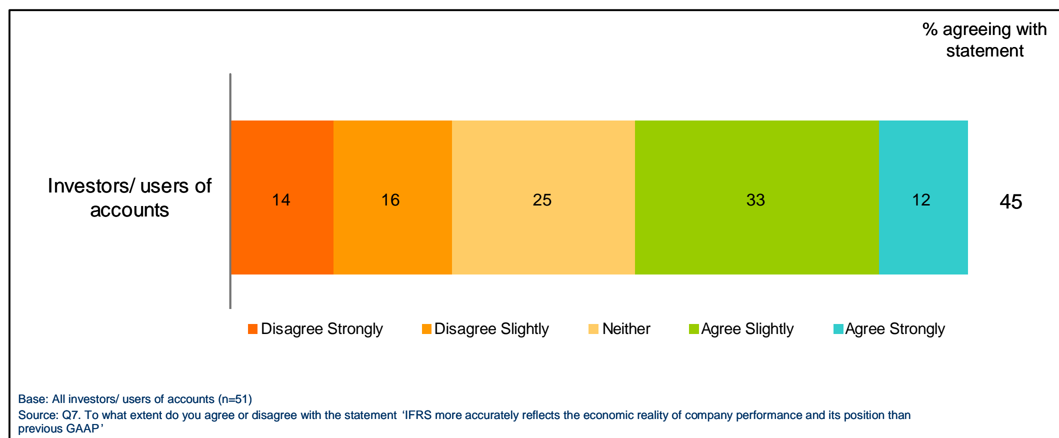


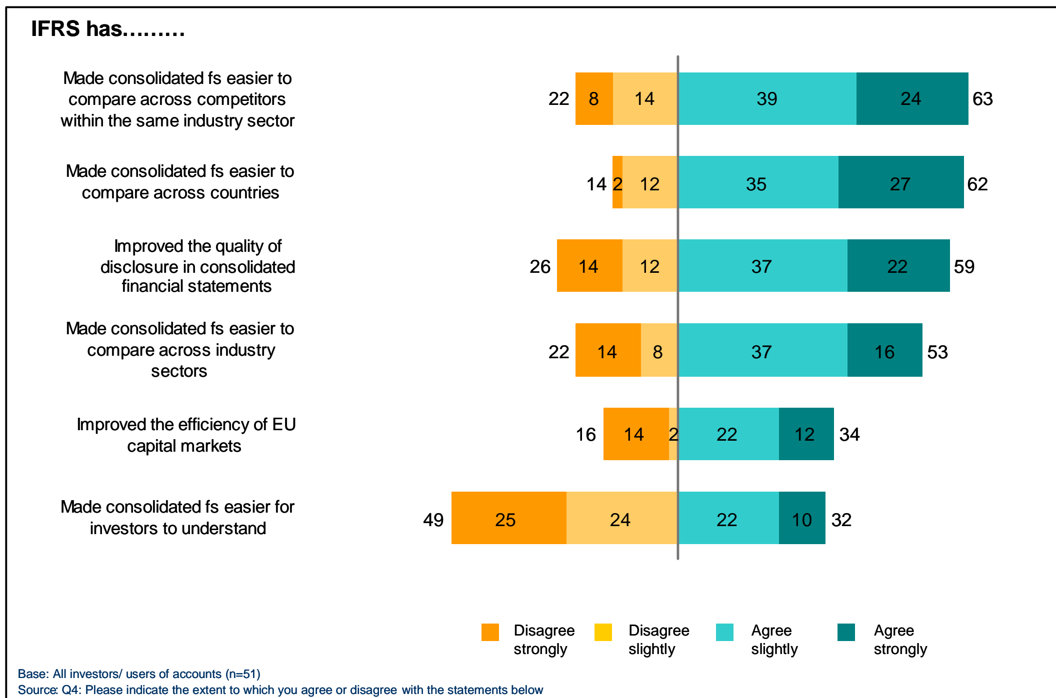
Figure 4.10: To what extent do you agree or disagree with the statement 'IFRS more accurately reflects the economic reality of company performance and its position than previous GAAP?'



There was some agreement among investors that IFRS made consolidated financial statements easier to compare with competitors in the same sector (63% either agreeing strongly or agreeing slightly and 22% disagreeing either strongly or slightly), easier to compare across countries (62% agreeing and 14% disagreeing) and easier to compare across industry sectors (53% agreeing and 22% disagreeing). There was also agreement that IFRS had improved the quality of disclosure with 59% agreeing that it had but 26% disagreeing with the proposition. However, 49% (25% strongly and 24% slightly) disagreed with the statement that IFRS had made consolidated financial statements easier for investors to understand with 32% agreeing with the proposition (10% strongly and 22% slightly) (Figure 4.11).

Whilst this last finding indicates that more needs to be done to explain IFRS to investors, on the whole, these findings might be regarded as an encouraging outcome for the first year of mandatory IFRS reporting.

Figure 4.11: Investors' level of agreement with statements regarding IFRS

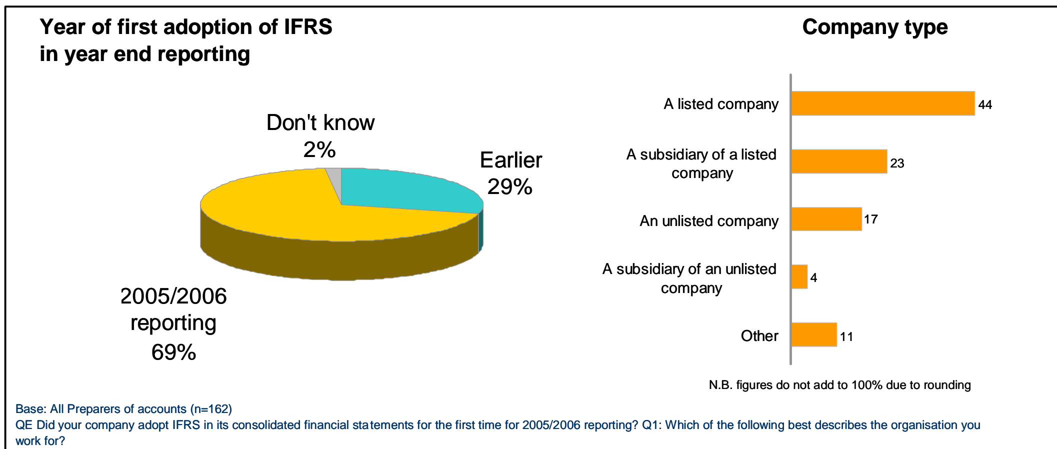


4.4 Preparer views

A total of 162 preparers of IFRS financial statements responded to the on-line survey. Not all respondents represented publicly traded companies, i.e. organisations directly affected by the IAS Regulation. The availability of views from a wide spectrum of European IFRS preparers facilitated a more in-depth assessment of the attitudes of those applying IFRS in their financial statements. But where appropriate, for example in relation to the assessment of the costs of IFRS adoption in Chapter 7, only data relating to publicly traded companies and their subsidiaries is reflected in the analysis.

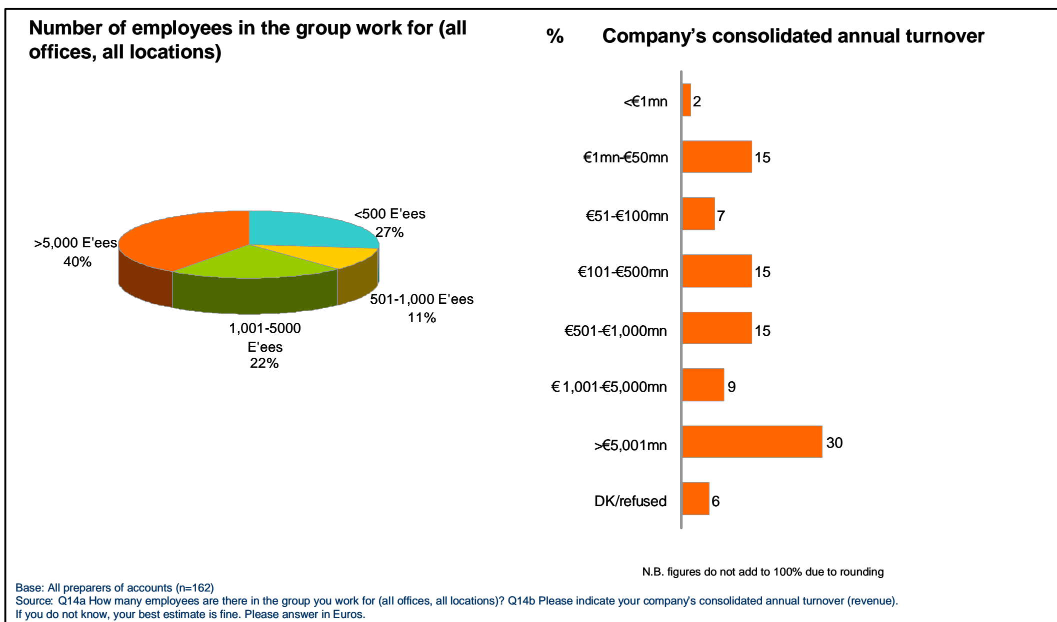
69% of preparers had adopted IFRS in 2005/6 and 29% at an earlier date (Figure 4.12). 39% of respondents had a consolidated annual turnover of up to €500m, 24% €501m to €5,000m, and 30% €5,001m and above. 6% were unwilling to disclose their turnover (Figure 4.13). The sample extended to preparers from a broad spread of countries of residence and industry sector (Figure 4.14).

Figure 4.12: Preparers' year of first adoption of IFRS and company type



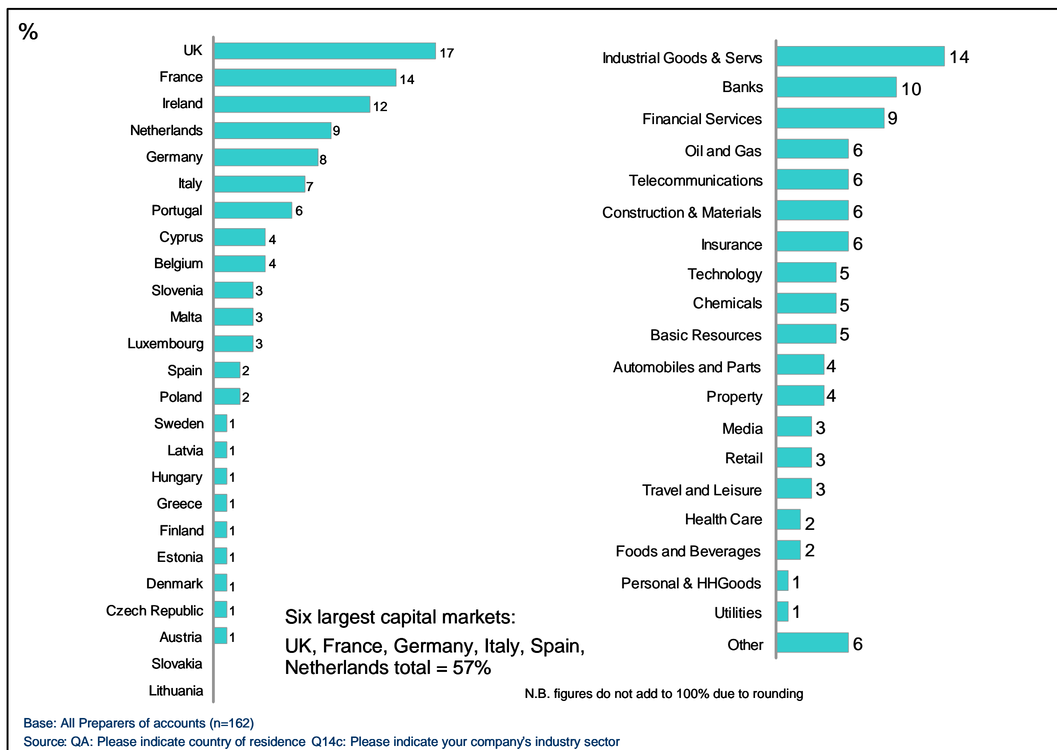
Base: All Preparers of accounts (n=162)
QE Did your company adopt IFRS in its consolidated financial statements for the first time for 2005/2006 reporting? Q1: Which of the following best describes the organisation you work for?

Figure 4.13: Preparers' size of company (number of employees and consolidated turnover)



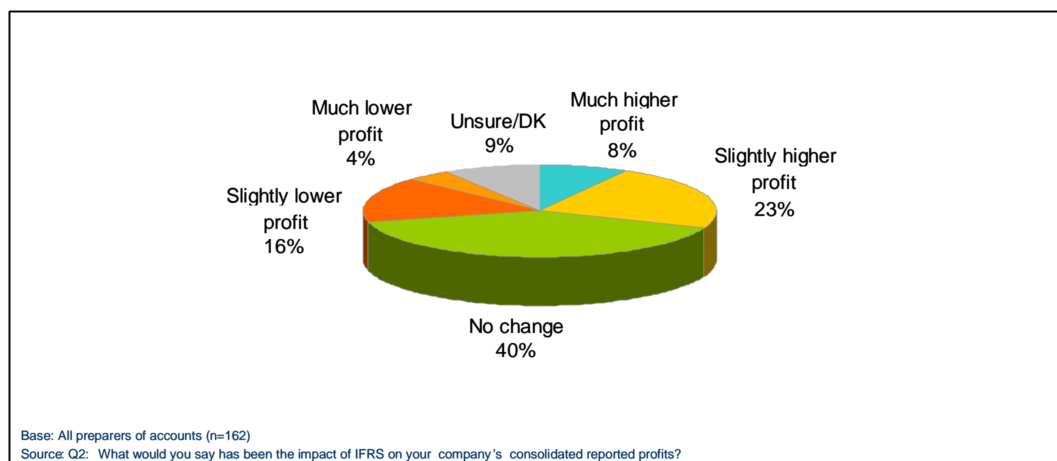
Base: All preparers of accounts (n=162)
Source: Q14a How many employees are there in the group you work for (all offices, all locations)? Q14b Please indicate your company's consolidated annual turnover (revenue). If you do not know, your best estimate is fine. Please answer in Euros.

Slide 4.14: Preparers' country of residence and industry sector



A majority of preparers (like investors) believed that the impact on reported profits was small with 23% stating the impact as a slightly higher profit, 40% no change and 16% a slightly lower profit. However, 8% of preparers thought IFRS had resulted in 'much higher' profit and 4% 'much lower' profit. 9% of preparers were unsure or did not know (Figure 4.15).

Figure 4.15: What would you say has been the impact of IFRS on your company's consolidated reported profits?



51% of preparers were confident (9% very confident and 43% fairly confident less 1% rounding adjustment) that fund managers and analysts fully understand the impact of IFRS on their companies' financial statements but 9% of preparers were not at all confident and 27% not very confident of fund managers' understanding (Figure 4.16). 59% of preparers also stated that their board of directors (or management board)

understood the effects of IFRS on reported profits with 17% believing their board's understanding of the effects on reported profits was poor (3% very poor and 14% quite poor) and 19% saying their understanding was neither good nor poor (Figure 4.17). Although these results may be viewed as encouraging, they indicate that there remains work to do to improve understanding of the impact of IFRS on financial statements.

Figure 4.16: How confident are you that fund managers and analysts fully understand the impact of IFRS on your company's consolidated financial statements?

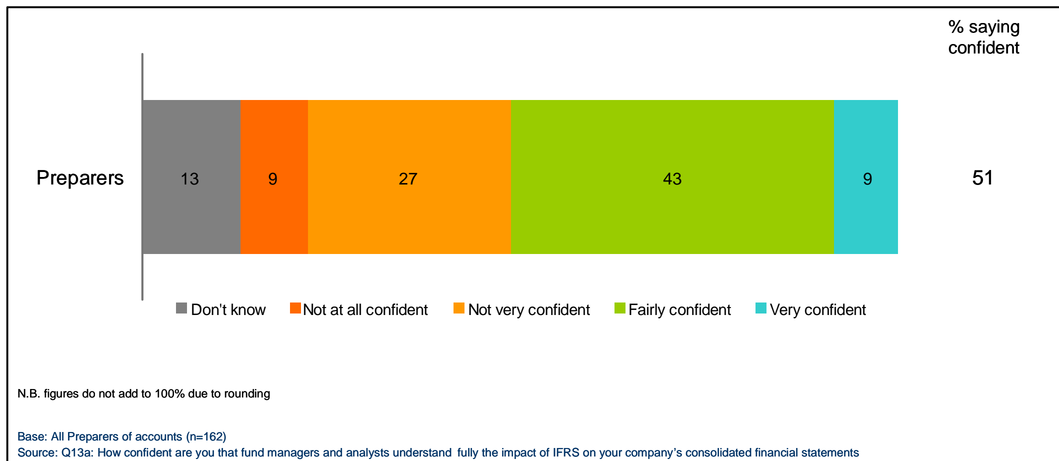
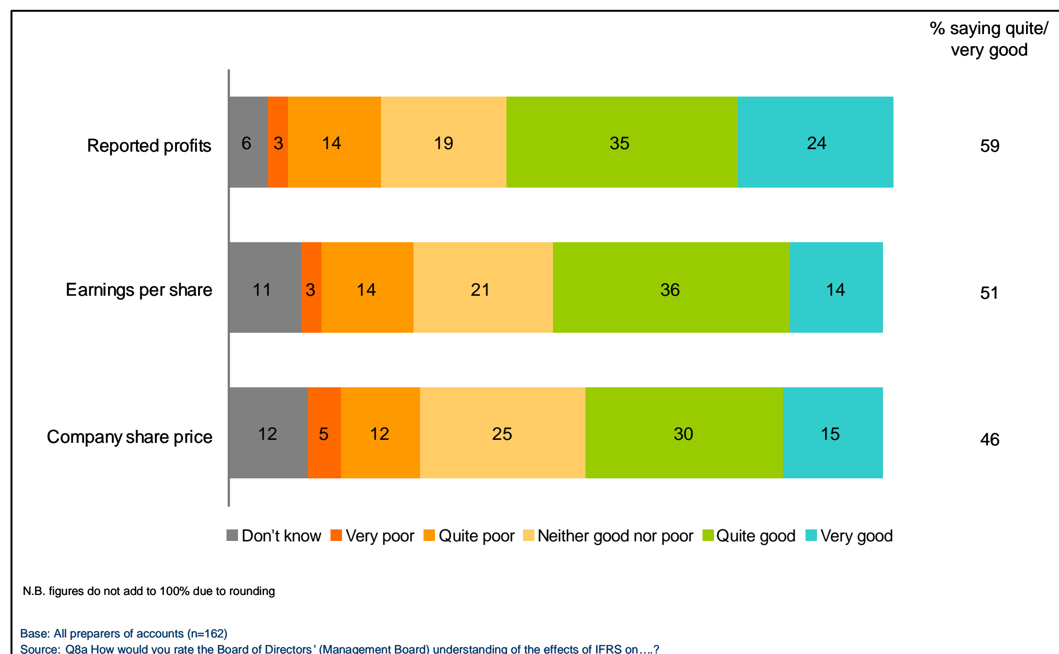
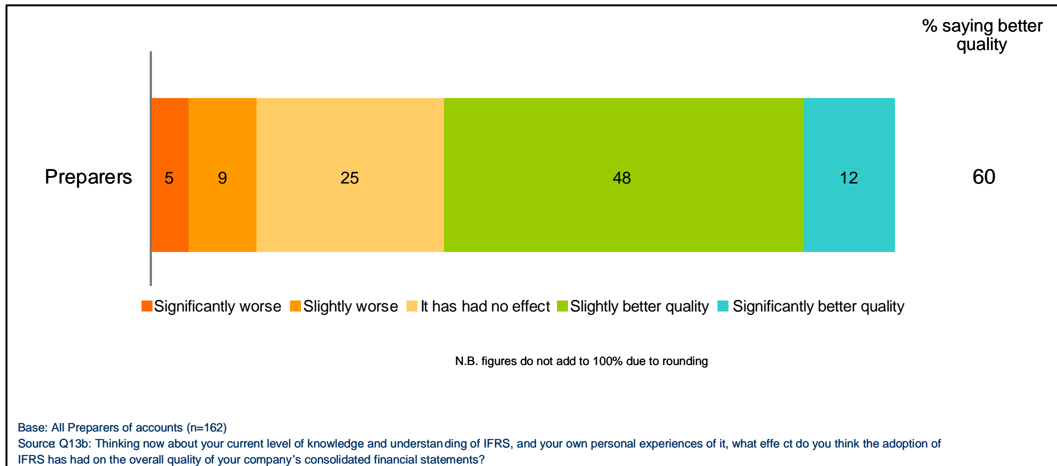


Figure 4.17: How would you rate the Board of Directors' understanding of the effects of IFRS on reported profits, earnings per share and company share price?



60% of preparers considered that the adoption of IFRS had improved the quality of their consolidated financial statements (12% significantly better quality and 48% slightly better quality) with 5% claiming IFRS had resulted in significantly worse quality, 9% slightly worse quality and 25% saying it had had no effect on quality (Figure 4.18).

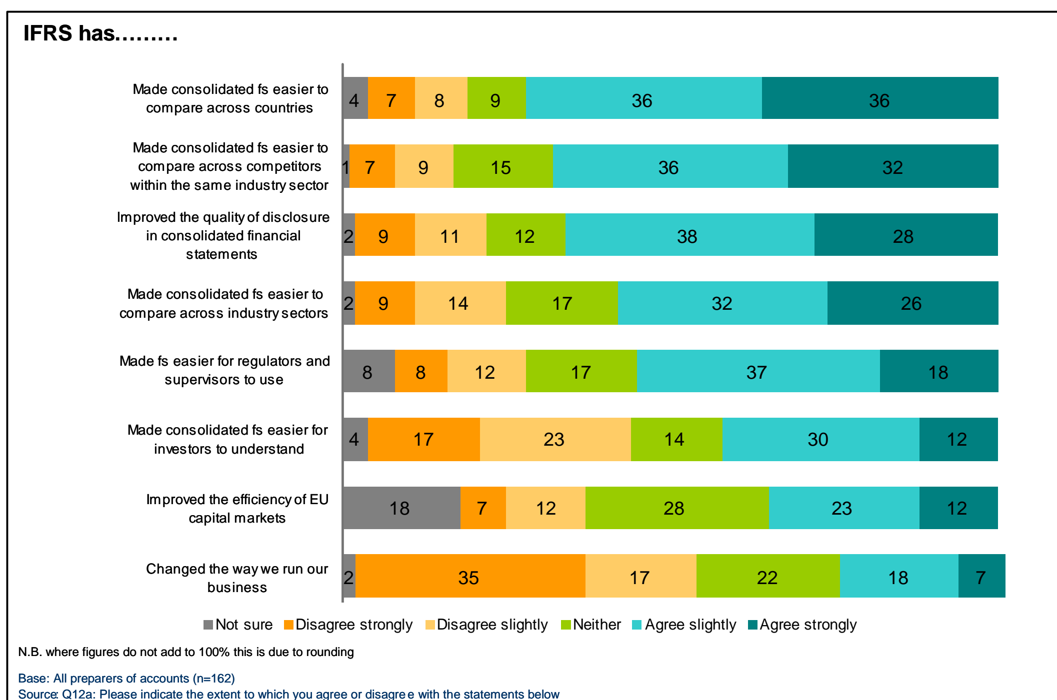
Figure 4.18: What effect do you think the adoption of IFRS has had on the overall quality of your company's consolidated financial statements?



There was also agreement among the preparers that IFRS had made consolidated financial statements easier to compare across countries (36% agreed strongly, 36% agreed slightly but 7% disagreed strongly and 8% disagreed slightly), easier to compare across competitors (32% agreed strongly and 36% agreed slightly but 7% disagreed strongly and 9% disagreed slightly) and easier to compare across industry sectors (26% agreed strongly and 32% agreed slightly but 9% disagreed strongly and 14% disagreed slightly).

Preparers also thought that IFRS had improved the quality of disclosures in consolidated financial statements (28% agreed strongly and 38% agreed slightly but 9% disagreed strongly and 11% disagreed slightly); and that IFRS had made it easier for regulators and supervisors to use the financial statements (18% agreed strongly and 37% agreed slightly but 8% disagreed strongly and 12% disagreed slightly) (Figure 4.19).

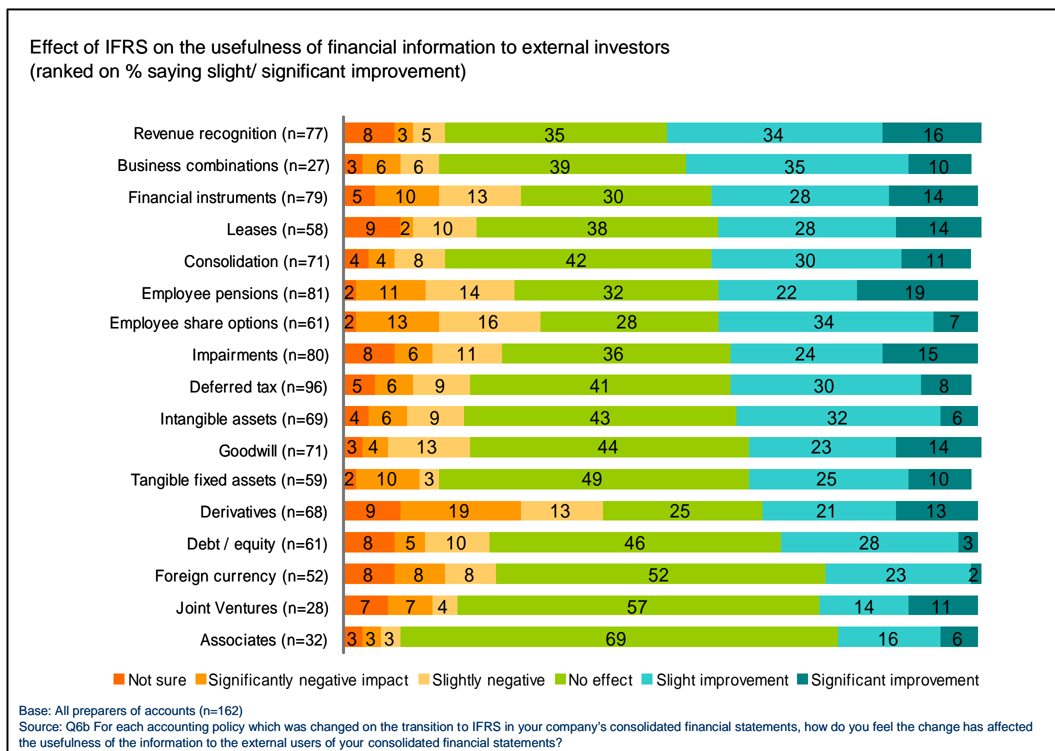
Figure 4.19: Preparers' level of agreement with statements regarding IFRS



Preparers also broadly believed that there had been an improvement in the usefulness of financial information to external investors as a result of IFRS, although agreement was greater in some of the accounting policy areas than in others. In the areas where IFRS had led to most changes in accounting policies:

- On deferred tax, 38% thought there had been either a significant improvement or a slight improvement but 6% believed IFRS had resulted in a significantly negative impact, 9% a slightly negative impact and 41% thought it had no effect.
- On employee pensions, 41% thought there had been either a significant improvement or a slight improvement but 11% believed IFRS had resulted in a significantly negative impact, 14% a slightly negative impact and 32% thought it had no effect.
- On impairments, 39% thought there had been either a significant improvement or a slight improvement but 6% believed IFRS had resulted in a significantly negative impact, 11% a slightly negative impact and 36% thought it had no effect (Figure 4.20).

Figure 4.20: For each accounting policy which was changed, how has this affected the usefulness of the information to external users?



75% of preparers believed that IFRS had not changed the way they run their business but 25% stated that IFRS had changed the way the business is run. Of those saying IFRS had affected the way the business is run, 22 (out of 40) said that the switch to the new standards has resulted in improvements (Figure 4.21). A higher proportion (69%) advised that they use IFRS accounting for internal reporting purposes (Figure 4.22). 62% of those who had adopted IFRS accounting at any early date (prior to 2005/6) thought this had been beneficial for management purposes but opinion was more divided among those who adopted IFRS in 2005/6 with 42% saying it had been beneficial for management purposes, compared with 37% who thought that IFRS had not been beneficial for management purposes and 21% who did not express an opinion (Figure 4.23).

Figure 4.21: Has the change to IFRS changed the way you run your business?

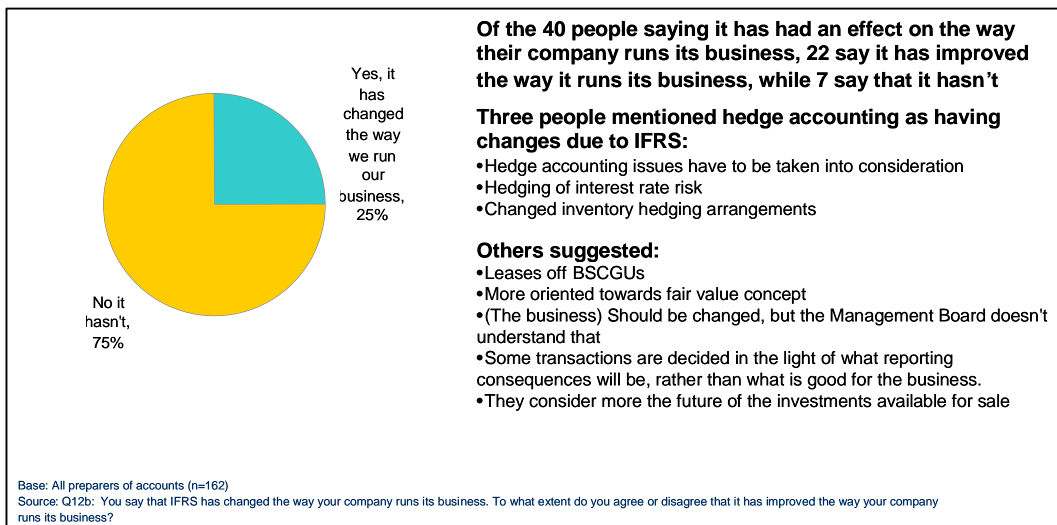


Figure 4.22: Do you use IFRS accounting for internal reporting and has it been beneficial for management purposes?

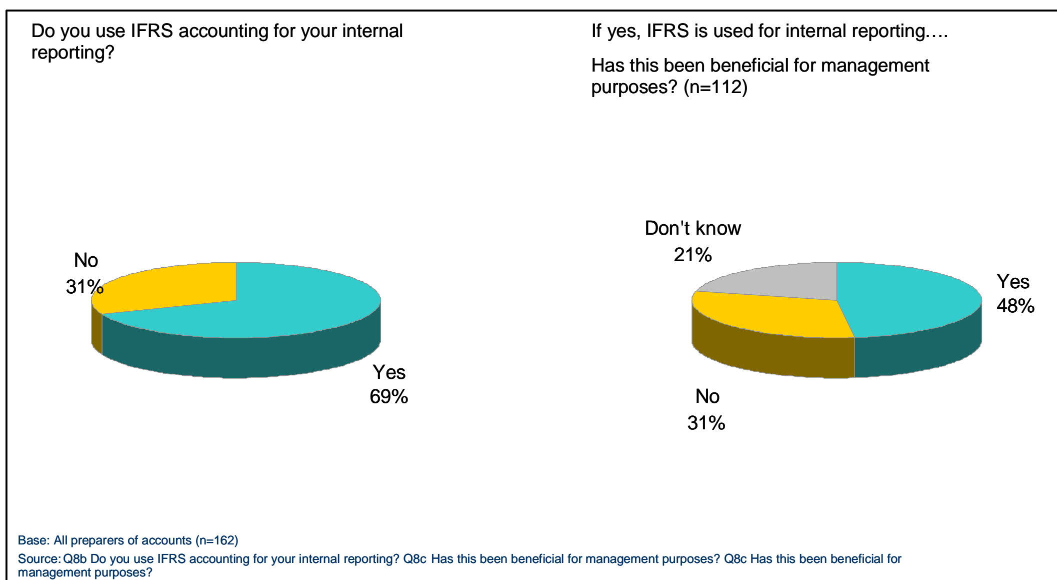
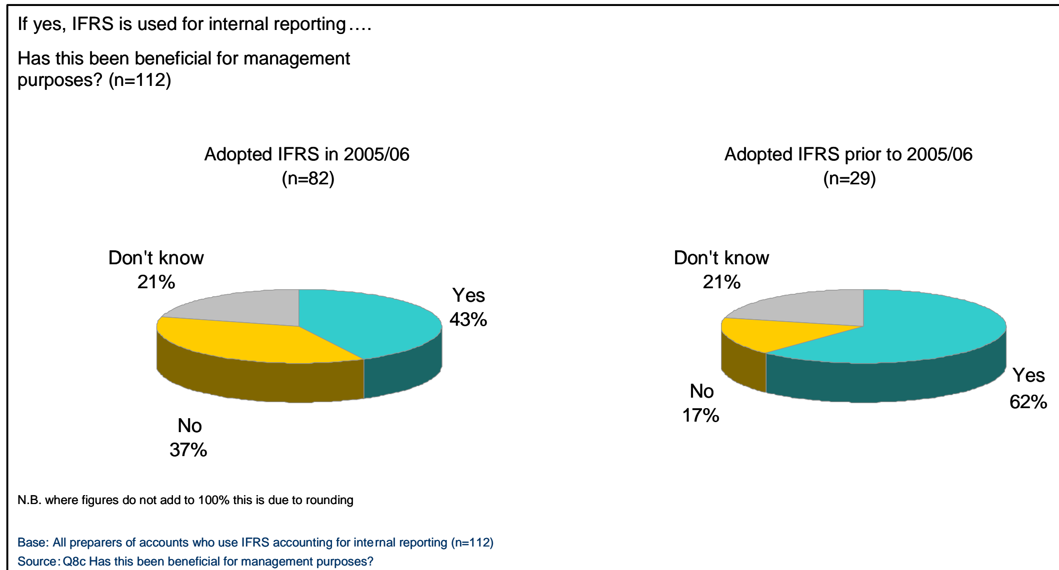
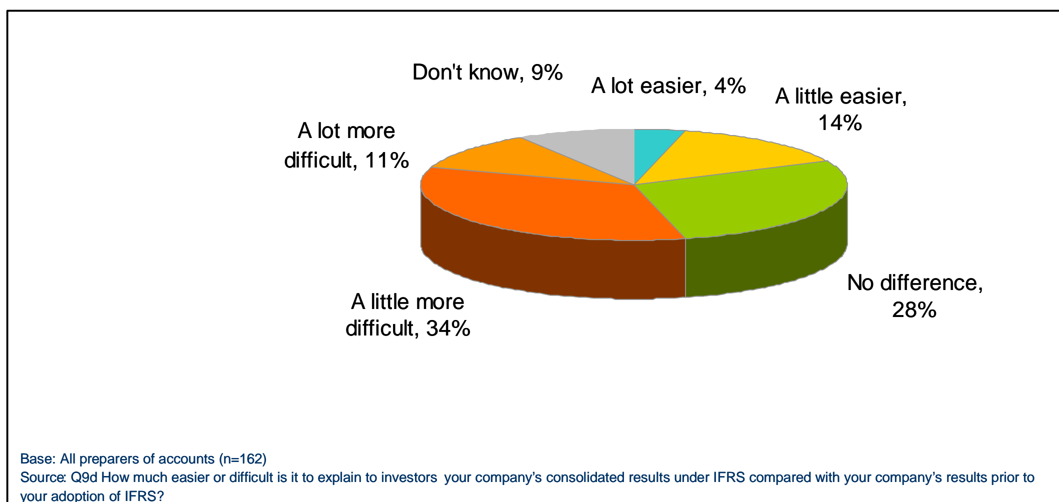


Figure 4.23: Analyses of those who say the use of IFRS accounting for management purposes has been beneficial showing those who first adopted IFRS for 2005/06 reporting and those who adopted it earlier



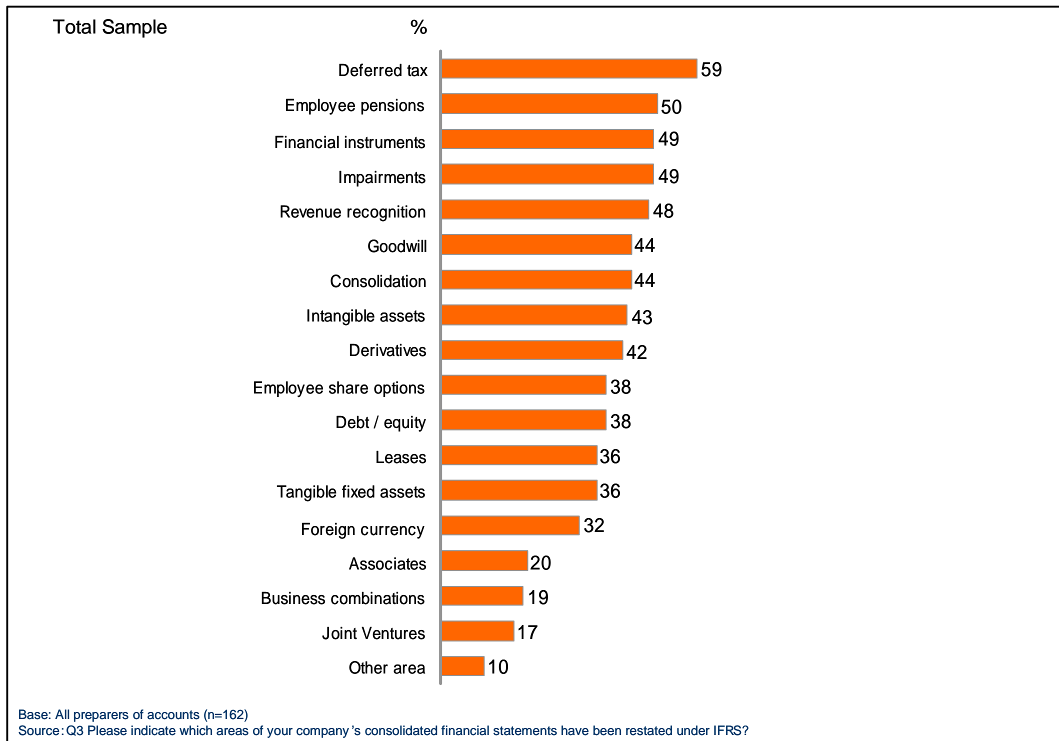
Mirroring opinion among investors, preparers were negative on whether IFRS had made it more difficult to explain their own company results compared with results prior to adoption of IFRS with 45% expressing difficulty (34% stating it was 'a little more difficult' and 11% 'a lot more difficult') but 18% finding explaining the results easier (4% stating explaining the results was 'a lot easier' and 14% 'a little easier'). 28% thought IFRS had made no difference and 9% expressed no opinion (Figure 4.24).

Figure 4.24: How much easier or more difficult is it to explain your company's results under IFRS compared with your company's results prior to adoption of IFRS?



The 162 respondents between them identified in total 1,092 accounting policy areas that had been restated in their financial statements on first adoption of IFRS. This averages seven accounting areas per company (Figure 4.25). Additional analysis not reported here confirmed that, as expected, the areas of accounting most often restated (deferred tax, employee pensions, financial instruments) also gave rise to the most significant impact on day-to-day accounting and year-end reporting procedures.

Figure 4.25: Which areas have been restated under IFRS?



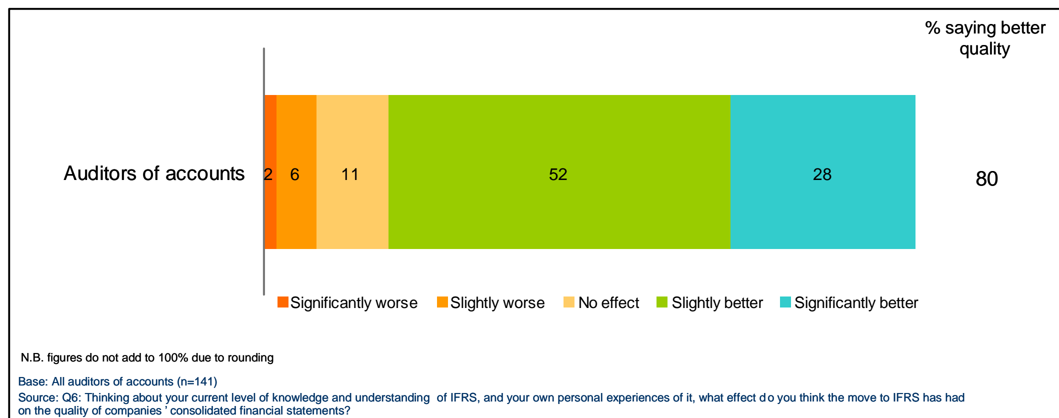
Base: All preparers of accounts (n=162)
Source: Q3 Please indicate which areas of your company's consolidated financial statements have been restated under IFRS?

4.5 Auditor views

A total of 141 auditors took part in the on-line survey. The auditors were asked to consider for one of their largest clients the effect of the change to IFRS. Those clients were drawn from a wide range of sectors, with the financial services, banks and insurance sector, industrial goods and services sector and resources sector all well represented.

Auditors were very positive about the effects of the introduction of IFRS on the quality of consolidated financial statements: 80% of respondents considered that the quality had improved (28% stated the quality was significantly better and 52% slightly better) but 2% thought IFRS had made the financial statements significantly worse and 6% thought they were slightly worse and 11% thought IFRS has had no effect on quality (Figure 4.26).

Figure 4.26: What effect do you think the move to IFRS has had on the quality of companies' consolidated financial statements?



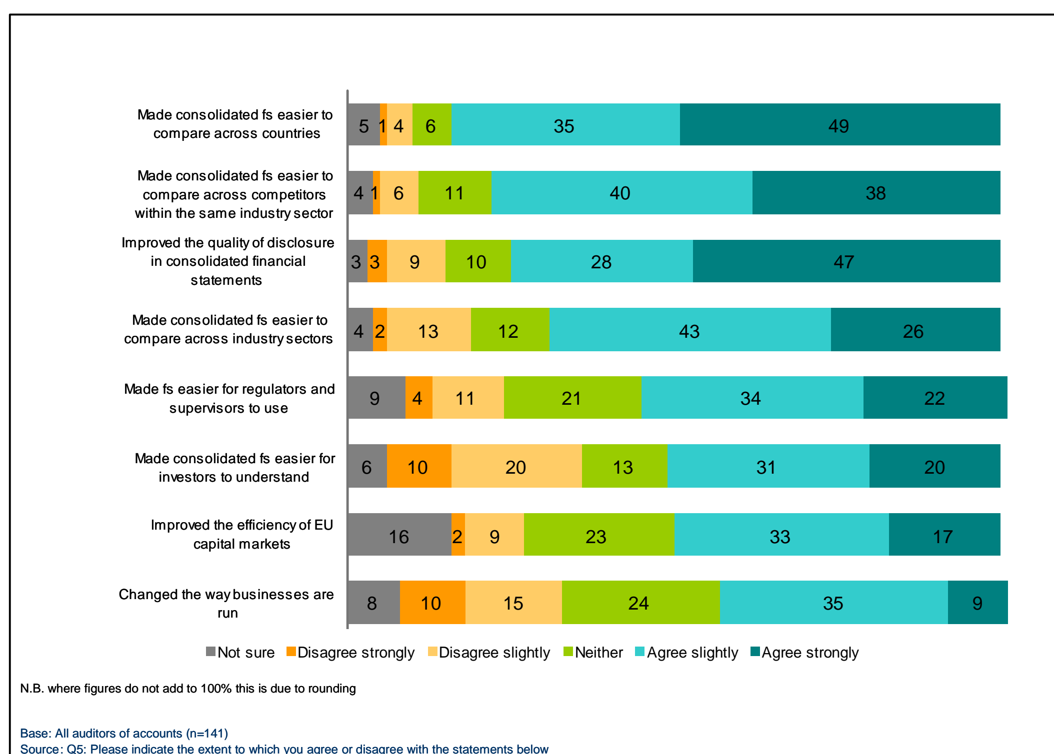
N.B. figures do not add to 100% due to rounding

Base: All auditors of accounts (n=141)
Source: Q6: Thinking about your current level of knowledge and understanding of IFRS, and your own personal experiences of it, what effect do you think the move to IFRS has had on the quality of companies' consolidated financial statements?

Auditors were generally more inclined to agree with assertions about the positive effects of IFRS with:

- 84% stating consolidated financial statements were easier to compare across countries (but 5% disagreeing), 78% easier to compare across competitors (but 7% disagreeing), 69% easier to compare across industry sectors (but 15% disagreeing);
- 75% agreeing that IFRS had improved the quality of disclosure in consolidated financial statements (but 12% disagreeing);
- 56% believing that IFRS application had made financial statements easier for regulators and supervisors to use (but 15% disagreeing and 21% neither agreeing or disagreeing and a further 9% not sure);
- 51% stating that IFRS had made consolidated financial statements easier for investors to understand (but 30% disagreeing); and
- 50% agreeing that the move to IFRS had improved the efficiency of EU capital markets (but 11% disagreeing, 23% neither agreeing nor disagreeing and 16% not sure (Figure 4.27).

Figure 4.27: Auditors' level of agreement with statements regarding IFRS



4.6 Roundtables and other discussions

In addition to the on-line survey, roundtable discussions with a cross-section of IFRS stakeholders were arranged with the assistance of professional bodies in six member states. The purpose of the meetings was to discuss views on the 2005 transition and in particular our preliminary findings.

The roundtables were held in July and August 2007 in the following locations:

- France – Paris

- Germany – Düsseldorf
- Italy – Rome
- Poland – Warsaw
- Spain – Madrid
- UK – London

There were between 10 and 20 people at each roundtable and participants included senior users, preparers, auditors and regulators. Investors were less well represented at the roundtables than other stakeholders, and we therefore carried out a number of supplementary telephone interviews. In addition we carried out a small number of telephone and face-to-face interviews with chief financial officers and others responsible for the preparation of the IFRS financial statements of publicly traded companies.

No single transition to IFRS

The roundtable discussions and interviews highlighted the fact that the journey from national GAAP to IFRS had varied enormously in different jurisdictions. At one extreme, in some countries IFRS had been used widely by large companies for many years, and for those companies at least, the transition was a fairly low key affair. In other countries, there was no experience of IFRS application and national GAAP bore no resemblance to international standards, resulting in tremendous challenges for all parties involved in the financial reporting process. The quality of financial reporting under national GAAP was acknowledged to have varied, and it was mentioned that SEC registrants were better equipped than others to make the transition. It was also apparent that the level of economic development and governance environments found in each jurisdiction had a major bearing on the process. In short the concept of a single transition to IFRS in the EU 2005 was shown to be of limited usefulness, even in the narrow context of publicly traded companies.

Overall success

Against this background, the message from the roundtables was broadly consistent, and substantially confirmed the findings of the on-line survey. In particular, IFRS implementation had been challenging, but successful, as evidenced by a lack of material problems uncovered with the 2005 numbers during the process of preparing financial information for 2006 and the absence of any general loss of confidence in financial reporting. It was reported that larger companies especially had prepared early, and had devoted considerable resources to educating and training their boards, staff and investors. The contribution of the IASB to this process, in making necessary improvements to IFRS in time for 2005 application, was referred to.

Even so, success tended to be expressed more in terms of recognition and measurement, rather than disclosure. Several participants doubted the value of the significantly increased disclosure requirements, and referred to the use of 'boilerplate' accounting policies and a reluctance to provide the often commercially-sensitive disclosures required under IAS 1 in relation to judgements and estimates. These shortcomings, including issues raised at the roundtables, are discussed in Chapter 12.

Areas for caution

A note of caution was sounded by a number of participants, who argued that it was too early to conclude with any certainty that the migration to IFRS had, overall, been a success, however that was defined. Reference was made to the fact that the period under review had witnessed benign economic conditions, which past experience suggested could delay the identification of poor accounting and regulatory practices. Nonetheless, there was broad agreement that the adoption of IFRS across the EU had improved the quality of financial reporting and had substantially increased comparability across countries and sectors. As understanding and experience of IFRS grew, these

benefits would improve; indeed, several participants noted a significant improvement in the quality of IFRS reporting in the second year of application.

It was also emphasised by several participants that the experience of smaller quoted companies was often very different from larger companies. Resources available to manage the transition and to deal with ongoing changes were far more limited, preparation tended to be undertaken at a later stage, and it was much less likely that the company or their auditors had prior experience of IFRS. Nonetheless, it was pointed out that there was little evidence of problems being identified with initial IFRS numbers in the second year of reporting under the IAS Regulation.

Many participants pointed to the requirements of national legislation and national regulators and the enduring strength of national accounting traditions as factors contributing to the 'local accents' found in IFRS reporting in the EU. It was thought that over time these national features of financial statements would become less evident as the body of IFRS practice evolved in the EU. True harmonisation would then follow, although one participant emphasised that this was less likely if companies were struggling to keep up with frequent changes to IFRS. It was notable, in this connection, that there were no indications that peer comparisons and competitive pressures were likely to cause a drift or a race to the bottom in terms of levels of disclosure and transparency. There was, instead, a sense that there would be steady improvement as companies sought to emulate best practice in their sector.

The enduring effect of pre-IFRS national practices is also found in a survey report in *The Application of IFRS: Choices in Practice* (KPMG, December 2006), which notes that 'In many cases a company's country of domicile, and its previous national accounting standards, appear to have the greatest influence on the [accounting] choices it makes.' It is possible that awareness of 'local accents' in IFRS reporting in the EU may account for some of the national differences in capital market responses to IFRS adoption detected in academic research (see Chapter 6).

Views on IFRS

The roundtable participants and interviewees reflected on the increased amount of judgement required by IFRS as a generally principles-based set of standards. It was evident that in many jurisdictions this presented considerable challenges, and concerns were expressed about the current level of consistency in the application of IFRS. Reference was made in this connection to the establishment in one member state of a forum for a particular key sector, at which relevant interpretations of IFRS were discussed. At several roundtables the absence of guidance on 'common control' issues was highlighted, although, in general, calls for greater application and interpretive guidance were few and far between.

Whilst there was a fair degree of satisfaction with the current suite of IFRS, certain standards were singled out for criticism by a number of participants and interviewees. IAS 39, for example, was referred to as a rules-based standard that did not always result in accounting that reflected the underlying economics. Weaknesses in the standards applicable to insurance companies and companies operating within the extractive industries were referred to, and, as discussed in Chapter 21, a number of participants and interviewees including users queried whether the valuations of intangibles required under IFRS 3 merited the associated costs.

Some concerns were of a more general nature. Participants at all of the roundtables expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values in IFRS (discussed further in Chapter 14) and the possibility that convergence with US GAAP may lead to more rules-based standards. Concern over the amount of information now disclosed in the notes to the financial statements, and whether it tended

on balance to make financial statements less useful, was raised by several participants. One corporate interviewee complained that the burden of disclosure in IFRS was far higher than under US GAAP.

Some issues were emphasised strongly in a single jurisdiction; for example, the need for the IASB to devote more attention to issues affecting separate financial statements, was emphasised strongly at one roundtable.

Other areas of concern

The roundtables supported the view that, despite increasing levels of understanding, company boards were still in need of more advice and assistance on accounting matters than was the case prior to the transition. However, there was no overall sense of a new level of disconnect between the information used by management to run the business and that reported externally. In one jurisdiction, there was a sense of enhanced board engagement with the financial reporting process, a realisation that judgements made in the application of some standards would have a major impact on reported performance. In another jurisdiction, levels of board engagement were considered to be generally problematic, although this was not a phenomenon exclusively related to the introduction of IFRS.

Some roundtable participants and interviewees referred to dissatisfaction with the speed with which early questions of interpretation were addressed by auditors, whilst recognising that this reflected a desire by audit firms to ensure that consistent answers were reached across jurisdictions to a wide range of new financial reporting issues. In some cases these delays had placed pressure on relationships. However, most commentators recognised that problems had been short-lived, and the roundtables supported the view that the audit firms had played a pivotal role in ensuring that the process of transition was generally a smooth one.

Finally, in a number of jurisdictions the issue of the quality of IFRS translations was highlighted as a major concern. Participants referred at one roundtable to the possibility that errors exist in the officially adopted versions of certain standards, and at another to the use of poor and out of date translations.

5. The role of regulators

5.1 Key points

European regulators, along with other stakeholder groups, play a key role in ensuring that IFRS are applied with a degree of consistency appropriate in the context of principles-based accounting standards. Our study includes an analysis of the process that securities regulators have applied in setting up enforcement activity relating to IFRS application in the EU and the outcome of those activities. It does not cover the co-ordination of those processes nor the wider responsibilities of regulators in relation to economic stability.

Our discussions with some securities regulators and our reviews of reports and correspondence confirm our view that the consolidated financial statements of Sample 1 companies generally comply with IFRS-EU, IFRS or both. They also confirm that there are issues which require further attention by companies, including disclosures regarding accounting policies and key judgements made by management, but that none of these issues are sufficiently major to undermine the level of compliance with IFRS-EU or IFRS.

Reports from the following national enforcement bodies are summarised and have also been used in our technical analysis:

- Finland: Financial Supervision Authority (FIN-FSA);
- France: Autorité des Marchés Financiers (AMF);
- Germany: Deutsche Prüfstelle für Rechnungslegung – Financial Reporting Enforcement Panel (DPR-FREP);
- Netherlands: Netherlands Authority for the Financial Markets (AFM);
- United Kingdom: Financial Reporting Review Panel (FRRP); and
- USA: Securities and Exchange Commission (SEC).

5.2 Regulation in the EU

In the strategy paper that led to the use of IFRS in the consolidated financial statements of publicly traded companies established in the EU, the European Commission argued that only IAS (now IFRS) that are properly and rigorously enforced will improve the functioning of the EU securities market. It explained that enforcement included, among other things, monitoring by supervisors and effective sanctions. The European Commission continued:

> ‘Securities supervisors also have a critical role in ensuring that listed companies comply with financial reporting requirements. There is clearly a major interest in ensuring accurate and consistent application of accounting standards in the securities markets they oversee. In the EU securities markets regulators must be actively involved in enforcement issues. In particular, the Commission looks to European securities markets supervisors (through FESCO – the Forum of European Securities Commissions) to develop and implement a common approach to enforcement. Such an approach would establish a level playing field and avoid the danger of regulatory arbitrage. Peer-reviews of securities markets supervisors’ practices could be considered as a useful instrument for ensuring a common approach.’

FESCO evolved into the Committee of European Securities Regulators (CESR) which plays a role in the development of enforcement standards across EU member states. This role was identified by the European Commission as reflected in Article 16 of the *IAS Regulation*:

> 'A proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. member states, by virtue of Article 10 of the Treaty, are required to take appropriate measures to ensure compliance with international accounting standards. The Commission intends to liaise with member states, notably through the Committee of European Securities Regulators (CESR), to develop a common approach to enforcement.'

In March 2003, CESR issued *Standard No. 1 on Financial Information: Enforcement of Standards on Financial Information in Europe* which was developed to assist harmonization and co-ordination of enforcement systems across EU member states. CESR members (the national securities regulators and, in some member states, the related enforcers) have now implemented Standard 1 which sets out 21 principles providing guidance around the:

- definition of enforcement;
- identification of competent enforcement authorities with reference to powers and responsibilities;
- identification of issuers and types of documents;
- methods of enforcement;
- actions available to enforcers (e.g. requests for reconciliation or corrective notes, restatements, etc);
- co-ordination between enforcement authorities; and
- reporting by enforcement authorities to the public.

CESR also issued guidance in December 2003 to publicly traded companies on the application of IFRS in its *Recommendation for additional guidance regarding the implementation of IFRS*. These recommendations aimed to provide useful information to issuers during the transition period from national GAAP to IFRS and referred to:

- 'What type of information could usefully be published before the year of transition in relation with the changeover to the IFRS framework;
- The accounting framework to be used by issuers when interim financial information is published during the financial year beginning on or after 1st January 2005; and
- How to achieve comparability of information published for the year 2005 with preceding periods.'

Following Standard 1, CESR published *Standard No. 2 on Financial Information: Co-ordination of Enforcement Activities* in April 2004. Standard No.1 aimed to establish a mechanism to facilitate discussion among CESR members and non-CESR enforcers regarding the enforcement of standards on financial information. Standard No.2 complemented this by focusing on major issues linked to the co-ordination of enforcement across member states. As such, CESR has developed a database of enforcement decisions provided by its members and made available to the public some of the content of the database.

We have also held discussions on an informal basis on implementation and enforcement with representatives of CESR and member state enforcement body staff and the SEC staff. It is noted that the SEC and CESR have a joint work plan focused on financial reporting and actively co-operate to promote:

- 'the development of high quality accounting standards;
- the high quality and consistent application of IFRS around the world;
- full consideration of international counterparts' positions regarding application and enforcement; and
- the avoidance of conflicting regulatory decisions on the application of IFRS and US GAAP.'

5.3 National securities regulation in EU member states

We obtained a number of the reports prepared by CESR members on the implementation of IFRS in the consolidated financial statements of publicly traded companies in their member states and have incorporated relevant information from these reports into our technical analysis. The reports selected relate to companies in five member states:

- Finland
- France
- Germany
- Netherlands
- UK

The general conclusions of the reports have been summarised below. We note that other recent regulators' reports tend to agree that the implementation process and level of compliance in 2005 were generally satisfactory.

Finland

The Financial Supervision Authority (FIN-FSA) reviewed the 2005 IFRS consolidated financial statements of 125 listed companies. It concluded that the quality of the IFRS financial statements varied, with some of good quality, but many were lower quality.

FIN-FSA explains that the adoption of IFRS had increased the significance of the notes compared with previous Finnish GAAPs. However, it noted that the notes to the financial statements were limited compared with the extensive and detailed requirements of IFRS.

Among the specific technical issues dealt with in the FIN-FSA report are:

- business combinations;
- impairment testing of goodwill;
- segment reporting;
- share-based payment arrangements; and
- fair values of investments.

More than half of the companies surveyed did not disclose information on the key assumptions concerning the future and the key sources of estimation uncertainty. Disclosures of accounting policies of several companies merely contained a short note stating that estimates and assumptions concerning the future are made when preparing the financial statements and the outcome may differ from the estimates and assumptions.

France

The Autorité des Marchés Financiers (AMF) reviewed the IFRS consolidated financial statements of French publicly traded companies. It found that a considerable effort had been made to meet the requirements at a high standard of quality. However, it noted diverse practices on several specific points including:

- the presentation of the income statement;
- the disclosure of significant accounting policies and estimates by management;
- business combinations;
- puts and forwards held by minority interests;
- impairment of assets;
- segment reporting;
- standards and interpretations whose application is not yet mandatory;

- development costs;
- employee benefits; and
- share-based payment.

As a result, the AMF issued recommendations on improvements for 2006 financial statements. Among other things, it recommended that companies should improve their disclosures of the assumptions and sources of uncertainty relating to estimates made by management as of the balance sheet date whenever there is a significant risk that the estimated amounts will be materially adjusted during the following period.

Germany

The Deutsche Prüfstelle für Rechnungslegung – Financial Reporting Enforcement Panel (DPR-FREP) examined a sample of financial statements of companies listed on capital markets. The sample includes both referred cases and random selections.

When carrying out its examinations, FREP identified a number of areas in which there were repeated deficiencies or in which there was otherwise room for improvement. It offered general advice for preparers in the following areas that are relevant to IFRS:

- presentation of the income statement;
- share-based payments;
- business combinations;
- deferred taxes on loss carryforwards; and
- cash flow statements.

Netherlands

The Netherlands Authority for the Financial Markets (AFM) reviewed a sample of 2005 financial reports of Dutch listed companies. It reports a 'top-five' of financial reporting areas for which it raised questions concerning the application of financial reporting standards. The AFM emphasises that raising questions does not necessarily imply non-compliance with reporting standards. The five issues were:

- financial instruments: disclosure, presentation, recognition and valuation;
- income taxes;
- conversion to IFRS;
- presentation of the financial statements; and
- leases.

United Kingdom

The Financial Reporting Review Panel (FRRP) reviewed a sample of IFRS consolidated financial statements of publicly traded companies drawn from the FTSE 350 and smaller listed companies. It identified a good level of compliance with IFRS.

It complained about the tendency for companies to include 'boilerplate' descriptions of accounting policies. In some cases, it appeared that the wording of accounting policies had been copied from the relevant standards with no indication of company specific application. There was also evidence of 'boilerplating' in the accounting policies selected for disclosure.

Disclosures of the judgements that management has to make in applying the accounting policies and the key assumptions concerning the future that have a significant risk of

causing a material adjustment to the carrying amount of assets or liabilities in the following year showed significant variation. Some companies set out clearly both items with details relevant to their particular circumstances. Other companies did not appear to have made any specific disclosure.

Specific technical issues mentioned by the FRRP included:

- business combinations and goodwill;
- impairment testing of goodwill; and
- presentation of the income statement.

5.4 Regulation of foreign issuers in the US

The SEC regulates US markets in securities and in that role determines and enforces the accounting requirements that apply to domestic and foreign companies that wish to raise capital or list their securities on public markets in the USA. The SEC relies on the private sector to develop accounting standards (since 1973 the Financial Accounting Standards Board (FASB)) but the SEC oversees the standard setting process, issues its own staff guidance on accounting and disclosure requirements and reviews compliance with all the accounting and disclosure requirements by any company that falls within its jurisdiction. In addition, the SEC staff, through a process of review and comment on financial statements, in our view shapes how accounting standards are interpreted and applied.

The SEC requires domestic issuers to publish US GAAP financial statements. It allows foreign issuers to publish financial statements prepared under another comprehensive body of standards (including IFRS) provided that there is also, inter alia, a reconciliation of reported net income and reported shareholders' equity to US GAAP. In July 2007, it issued proposals to remove that reconciliation requirement for companies that use IFRS as issued by the IASB.

We have met with representatives of the SEC staff to discuss with them their work on reviewing IFRS consolidated financial statements, including financial statements of companies established in the EU. The SEC staff also published a brief summary on its review – *Staff Observations in the Review of IFRS Financial Statements*.

The summary notes some general observations about the application of IFRS but does not formulate comprehensive conclusions about companies' overall compliance with, or consistency in application of, IFRS. Among key findings were the following:

- The vast majority of companies asserted compliance with a jurisdictional version of IFRS and most also asserted compliance with IFRS as published by the IASB.
- There were a number of variations in the language companies and their auditors used to describe IFRS as applied in the financial statements.
- Companies based in the same jurisdiction and companies in the same industries sometimes used different income statement formats.
- Some companies used a starting point other than that permitted by IAS 7 *Cash Flow Statements*, or inappropriately characterized items.
- There was a range of accounting treatments for common control mergers, recapitalizations, reorganizations, acquisitions of minority interests, and similar transactions.
- It was unclear why some companies did or did not consolidate a subsidiary or use the equity method of accounting.
- In the absence of an extensive standard in IFRS, there was substantial variation in: accounting for insurance contracts; and reporting of extractive industry exploration and evaluation activities.

- There were instances of companies scattering disclosure that IFRS requires on a topic among a number of locations in the filing, including locations outside the audited financial statements.

The SEC staff also asked a number of companies to provide additional information or disclosure about:

- revenue recognition, especially where a company provided generic policy disclosure and did not provide disclosure specific to its circumstances;
- intangible assets and goodwill, including the factors that led a company to recognize them in a business combination;
- their policies for identifying and evaluating impairment, the circumstances resulting in recognized impairment, or the circumstances surrounding impairment reversals of long-lived assets including goodwill;
- leases, including their terms and the future minimum payments under operating and financial leases;
- contingent liabilities, including their nature and estimated financial effects; and
- the significant terms of financial instruments, including derivatives, their effect on future cash flow and the recognition and measurement criteria the company applied.

The SEC staff also questioned whether various banks complied with IAS 39 *Financial Instruments: Recognition and Measurement* in determining loan impairment. Discussions on this topic are ongoing.

5.5 Reviews of SEC correspondence with companies

As part of its reviews of the financial statements of all issuers, the SEC staff often exchanges comments and responses with companies. The relevant correspondence is publicly available on the SEC's EDGAR database. Correspondence is publicly available only after the exchange of correspondence has been completed, in other words when the company has responded to the SEC's staff's questions and the SEC staff have indicated that they have no further questions. There is usually a short delay after the final letter before the correspondence appears on the EDGAR database.

We have reviewed any correspondence between any company in our Sample 1 companies and the SEC that was available as at 1 August 2007 (Table 5.1). We did not review the correspondence for the **National Bank of Greece** (Greece), **Philips** (Netherlands) and **Tomkins** (UK) as all these companies filed US GAAP financial statements with the SEC.

No correspondence was available as at 1 August 2007 from the other companies which are registered with the SEC. This may indicate either that there is no correspondence or that the correspondence had not yet been completed.

Table 5.1: Companies with correspondence with the SEC

Belgium	**Ireland**	**Spain**
Delhaize	CRH	Repsol
		Telefónica
Denmark	**Italy**	
Novo Nordisk	Ducati Motor	**UK**
	Enel	BG
Finland	Eni	Cadbury Schweppes
Nokia	Fiat	Diageo
	Telecom Italia	GlaxoSmithKline
France		Royal & SunAlliance
AXA	**Netherlands**	Royal Bank of Scotland
Technip	Royal Dutch Shell	
Germany	**Portugal**	
BASF	EDP	

Many of the points raised by the SEC lead to requests for further information in circumstances in which the SEC staff clearly believe that the financial statements disclosures are inadequate. In many cases, the SEC requests enhanced disclosures or explanations in subsequent filings.

Recurring points in SEC comment letters include:

- whether the financial statements comply with IFRS issued by the IASB;
- the identification of discontinued operations;
- the determination of cash generating units for impairment testing;
- the classification of cash flows in the cash flow statement;
- the determination of cash flows from operating activities in the cash flow statement;
- the consolidation of less than majority owned investments;
- the disclosure of 'non-GAAP' measures in the income statement;
- the determination of earnings per share;
- accounting policies for revenue recognition (in particular, industry-specific issues);
- identification of segments; and
- country-specific employee benefits.

6. The reaction of securities markets

6.1 Key points

The voluntary adoption of IFRS in Europe from the late 1990s and the EU's decision to mandate IFRS from 2005 have led to a large number of research studies on IFRS. These find that larger companies that rely more on equity financing and have more foreign exposure perceive the benefits of IFRS as greater than other companies. They also find that there are economic consequences of both voluntary and mandatory IFRS adoption but that they are unevenly distributed. Research on mandatory IFRS is at an early stage and currently there is only limited and somewhat inconsistent evidence on the consequences.

The preliminary results of research undertaken for this report, however, suggest that IFRS do in some cases provide information that is value relevant to stock market participants:

- For companies previously reporting under UK, French or Italian GAAP, the IFRS earnings reconciliation adjustment helps to explain share prices as measured three months after the first year of mandatory application of IFRS. This is particularly significant for UK and French companies.
- For French and UK companies, the IFRS earnings reconciliation adjustment is also significant in explaining stock returns, that is year-on-year changes in share prices as measured three months after the end of the first year of mandatory IFRS reporting.

6.2 Approach

To gauge the reactions of EU securities markets we:

- reviewed the research literature on the effects of adopting IFRS. Such research is broadly divided between the determinants and consequences of voluntary adoption before 2005, and the consequences of mandatory adoption subsequently; and
- commissioned academics from the London School of Economics and Harvard Business School to investigate whether the information about the transition from national GAAP to IFRS is value relevant – that is, whether it provides information that is relevant to investors in making investment decisions and so may affect the company's market value.

6.3 Literature review

In the late 1990s, companies in several EU member states were allowed to voluntarily apply IFRS rather than local GAAP. For instance, Germany allowed such voluntary adoption from 1998 and a large proportion of German listed companies decided to apply this option.

The increased use of IFRS prompted a stream of academic research into the determinants and consequences of voluntary IFRS adoption. With the IAS Regulation requiring the use of IFRS throughout the EU from 2005, the focus of academic research changed to consider the effects of mandatory adoption on investors and companies. Our review of the academic research literature makes a distinction between academic research on voluntary and mandatory IFRS adoption because there are key differences in both the research questions investigated and the conclusions that can be drawn.

Voluntary adoption of IFRS

Research on voluntary IFRS adoption concentrates on two questions:

- What determines whether a company adopts IFRS voluntarily?
- What are the consequences of voluntary IFRS adoption?

Several studies examine the characteristics of voluntary IFRS adopters. The voluntary adopters studied are mainly based in Europe and adopted IFRS prior to 2005. These studies generally find that voluntary adopters rely more on equity financing and have a greater need for external financing. Furthermore, a voluntary adopter is on average larger and has more foreign exposure either through a cross-listing abroad or a large proportion of foreign sales (Harris et al. 1999; Leuz et al. 2000; Ashbaugh 2001; Tarca 2004; Cuijpers et al. 2005).

The studies interpret the greater reliance on equity financing and the need for external financing as consistent with IFRS's objective of providing information that is useful to people outside the company, for example equity investors. The intuition is that a company is more likely to benefit from adopting IFRS if it relies on outsiders in the financing of its activities. The studies often explain the observation that larger companies are more likely to adopt IFRS voluntarily by reference to compliance costs. If these costs have a fixed component, the costs per 'unit of size' decrease as companies increase in size. Companies with more foreign exposure are also likely to derive greater benefits from IFRS adoption because more of their financial statement users are likely to be based outside their home country.

The extent to which voluntary IFRS adoption affects the cost of capital is one of the most debated topics in the academic literature on IFRS. Answering the question is complicated by the fact that there is not an undisputed way to measure the cost of capital (see Botosan 2006). Studies have either indirectly examined the issue by relating adoption to something that is theoretically connected to the cost of capital, or by directly estimating the implied cost of equity.

The studies that take the indirect approach generally find that voluntary compliance is associated with increased analyst following, reduced bid-ask spreads and positive market reactions when announcing future compliance (Leuz et al. 2000; Cuijpers et al. 2005; Karamanou et al. 2005). These results are consistent with a reduced cost of capital after voluntary IFRS adoption.

The studies that take a more direct approach find no change or even an increase in the cost of capital (Cuijpers et al. 2005; Dargenidou et al. 2006; Daske 2006). These studies all stress that the results could be driven by the short period that is available after voluntary IFRS adoption and by the difficulty of estimating the cost of capital. Daske et al. (2007) extend these studies by focusing on whether the impact varies with the degree of compliance. Survey evidence documents that compliance varies considerably among voluntary adopters (Cairns 1999; Cairns 2000). Daske et al. (2007) show that the cost of capital is only reduced when adoption is serious – that is, it leads to improved accounting quality.

In summary, academic research on voluntary adoption of IFRS finds that larger companies with more foreign exposure and reliance on equity financing, on average, adopt IFRS before other companies. Academic research on the economic consequences of voluntary IFRS adoption finds some evidence of positive effects that could be associated with reduced cost of capital. However, when applying more direct proxies of the cost of capital, the results are mixed and hence it is difficult to draw a definitive conclusion.

Companies that adopt IFRS voluntarily early do so because in their view the benefits exceed the costs. Their choices might indicate who is likely to benefit most from mandatory implementation of IFRS. However, because benefits are likely to exceed costs for voluntary adopters, we cannot use them to assess the economic consequences of mandatory adoption.

Mandatory adoption of IFRS

In recent years a stream of academic research has developed that investigates the mandatory use of IFRS. The research follows mainly from the IAS Regulation which mandated IFRS for the consolidated financial statements of EU publicly traded companies from 2005. It falls into two separate groups. The first group examines whether IFRS information is used by investors in a different way from national GAAP information. The second group attempts to measure the economic consequences of mandatory IFRS.

If investors' use of mandatory IFRS information is to affect positively the operation of financial markets, IFRS need to provide some information that was not available under the previous accounting regime. We therefore need to know:

- whether IFRS disclosures include information that was not available under national GAAP; and
- whether investors use this information.

Mutual fund managers' responses to questionnaire surveys indicate that they find the information useful and some even claim that they have altered investment decisions based on IFRS information disclosed by companies (PwC 2005; PwC 2006).

Market-based evidence shows that IFRS income explains market prices over and above national GAAP income (Gordon et al. 2007; Horton et al. 2007) and that reconciliations between IFRS and local GAAP convey new information at least for some companies (Christensen et al. 2007b; Horton et al. 2007).

The finding that IFRS provide information that was not available under the prior regimes is supported by evidence suggesting that analysts were unable to predict all changes from local GAAP to IFRS (Aubert et al. 2007).

The economic consequences of mandatory IFRS are potentially many. De Jong et al. (2006) find that Dutch companies bought back preference shares prior to IFRS adoption, presumably to avoid re-classifying them from equity to debt. This is an example of how the mandatory adoption of IFRS can change the real behaviour of companies.

Most academic research, however, focuses on whether the cost of capital is reduced as a consequence of mandatory IFRS. Armstrong et al. (2007) show that the decision to impose mandatory IFRS in the EU has on average a positive effect on the value of companies, suggesting an overall reduction in the cost of capital. Hail and Leuz (2007) find that first-time mandatory adopters of IFRS experience a statistically significant reduction in cost of capital in 2005 (relative to non-IFRS firms), but suggest that previous voluntary IFRS adopters experience a corresponding increase in cost of capital at this time. Other studies find that the cost of capital implications vary from company to company.

The evidence suggests that the net benefits depend either on the expected increase in information when IFRS is implemented (Comprix et al. 2003) or indicators of companies' willingness to adopt IFRS voluntarily (Christensen et al. 2007a). The intuition is that the variable outcomes observed in a mandatory setting arise because the law forces some companies to comply against their will.

These studies are all based on information from the transition period and it is unclear whether the results will hold in the longer run. Furthermore, the studies apply the same proxies for the cost of capital as the studies on voluntary adoption and, as noted above, researchers do not agree on their validity.

In summary, academic research on the mandatory use of IFRS is still at an early stage. It is limited to the short time that IFRS has been mandatory in the EU, which reduces the ability to draw conclusions. The early findings suggest that IFRS financial statements include information that was not available under national GAAP and that investors use this information. IFRS has affected the value of companies, but the effect is not equally distributed.

Conclusions from literature review

The widespread voluntary adoption of IFRS in Europe from the late 1990s and the mandatory adoption of IFRS in the EU in 2005 have led to a large number of academic research studies on IFRS. These find that larger companies that rely more on equity financing and have more foreign exposure perceive the benefits of IFRS as greater than other companies. They also find that there are economic consequences of both voluntary and mandatory IFRS adoption but they are unevenly distributed. Research on mandatory IFRS is at an early stage and currently there is only limited and somewhat inconsistent evidence on the consequences.

6.4 Commissioned academic paper on value relevance of transition disclosures

For the purposes of this report, Joanne Horton from the London School of Economics and George Serafeim from Harvard Business School were commissioned to investigate whether the information provided when making the mandatory transition from national GAAP to IFRS is value relevant. The resulting academic research paper is reproduced in Appendix 4.

In this context, information is value relevant to investors if it can be used by them in making investment decisions and so may affect a company's market value. The question of IFRS's value relevance is of great importance given the part accounting information plays in equity valuation and the facilitation of investment decisions.

The research paper focuses on the explanatory power of accounting information for measures of market value. Specifically, it investigates the ability of IFRS adjustments to earnings and book values to explain:

- share prices three months after the end of the first year of mandatory application of IFRS; and
- stock returns – that is, changes in share prices over the year ended three months after the end of the first year of mandatory application of IFRS.

The researchers do this by using the aggregate reconciliations of earnings and shareholders' equity provided by companies on transition from national GAAP to IFRS to address two important issues:

- whether, on a country by country basis, adjustments to profit and shareholders' equity on moving from the national GAAP to IFRS are associated with a company's market value. If so, it would suggest that IFRS financial statements provide more information to investors in valuing a company than domestic GAAP; and
- whether the impact of IFRS compliance, in relation to investors' pricing of companies, is larger for some countries than others.

Research design

IFRS reconciliations capture the impact of the pure accounting change in terms of the 2004 earnings and 2005 opening equity of moving from one accounting regime (national GAAP) to another (IFRS). The research design enables the relative power of the two regimes to be examined by holding constant the companies, the financial period and the institutional setting, in order to isolate the change in accounting regimes. Regression analysis is used to indicate whether the change in accounting information provided under the two regimes can be associated statistically firstly with differences in share prices and secondly with stock returns. While such associations may be statistically valid, they do not necessarily demonstrate causality.

The research also identifies the value relevance of IFRS numbers within countries and then holds constant the accounting regime (that is, IFRS) in order to make comparisons between countries.

A key factor in the research was to examine regimes in which IFRS compliance was not permitted prior to the mandatory move to IFRS. For this reason, Germany, for example, where a substantial cohort of companies previously followed IFRS, was not a suitable case for study, because any sample would not be representative of companies generally due to 'self-selection bias'. The sample used in the research consisted of 605 French, Italian, Spanish and UK companies included in the DataStream EU Index, a number of companies having been excluded due to lack of comparable data that could be used by the researchers.

There are a number of limitations and caveats attached to the research. For example, the assumption that the market will understand the implications and effects of IFRS compliance and act accordingly is undermined if investors are unable to process the information. Moreover, the level of actual or perceived compliance with IFRS was not investigated but could well have had some effect on the weight the market places on the information and hence its value. Furthermore, even where the reconciliation adjustments are found to be highly associated with market value, this may simply be because they reflect previously known information. For example, a sophisticated investor may well have been able to estimate the value relevant data in respect of some IFRS adjustments from the previous domestic GAAP financial statements where relevant information was disclosed in the notes.

It is therefore not possible to be conclusive when making inferences about the usefulness of IFRS requirements from the results of the research.

Preliminary results

The preliminary results are summarised in Table 6.1.

Table 6.1: Value relevance of transition disclosures

	1. IFRS earnings adjustment explains share price		2. IFRS earnings adjustment explains stock return		3. IFRS equity adjustment explains share price		4. IFRS equity adjustment explains stock return	
	Yes/No	High/ Medium/ Low	Yes/No	High/ Medium/ Low	Yes/No	High/ Medium/ Low	Yes/No	High/ Medium/ Low
France	Yes	H	Yes	H	No	-	Yes	L
Italy	Yes	L	No	-	No	-	No	-
Spain	No	-	No	-	Yes*	M	No	
UK	Yes	H	Yes	M	No	-	Yes	M
Total	Yes	H	Yes	L	No	-	No	-

* Negative

High - indicates confidence at 99.9% level that an association exists
Medium - indicates confidence at 98.0% level that an association exists
Low - indicates confidence at 95.0% level that an association exists

Column 1 indicates that the difference between companies' earnings reported under national GAAP and earnings reported under IFRS is highly associated with companies' market value. This suggests that for those companies previously reporting under French, Italian and UK GAAP, the earnings reconciliation adjustment required to achieve compliance with IFRS does provide value relevant information over and above the national GAAP numbers. Regardless of whether this is new information to the market or information that market participants are already obtaining or inferring from other means, it would appear that the IASB has had at least some success in achieving its objective of providing information that is useful because it is relevant to the decision making needs of users.

To address the issue of whether IFRS provide new information to the market or purely reflect information that market participants have already obtained or inferred from other sources, the research also looked at companies' stock returns (that is, the change in the share price over time). If the information about 2004 IFRS earnings and equity were already known to the market, then there would be little association between IFRS adjustments and stock returns. Column 2 shows that, overall, the adjustment from national GAAP to IFRS earnings has a positive, but low, association with stock returns. For the French and UK samples, the association is high and medium respectively. This suggests that presenting IFRS earnings provides some new information to the market, particularly for French and UK companies.

In contrast, column 3 indicates that the adjustment made to shareholders' equity in order to comply with IFRS does not provide any price useful information since there appears to be no association with the share price.

Similarly, column 4 suggests that there is no association overall between the equity adjustment and stock returns, although France and the UK show a low and medium association respectively.

The research was also able to indicate that overall the results are not affected by industry specific factors.

Overall conclusions

The preliminary results of the research confirm that IFRS do provide information that is value relevant to stock market participants.

For companies previously reporting under UK, French or Italian GAAP, the earnings reconciliation adjustment helps to explain share prices as measured three months after the first year of mandatory application of IFRS. This is particularly significant for UK and French companies.

Consistent with these results, the research indicates that for French and UK companies, the earnings reconciliation adjustments is also significant in explaining stock returns, that is year-on-year changes in share prices as measured three months after the end of the first year of mandatory IFRS reporting. However, for Italian companies there is no significant level of association between the earnings reconciliation and stock returns despite the association between the earnings reconciliation and share prices. In the case of Spanish companies, the earnings reconciliation adjustment does not appear to be associated with either share prices or stock returns.

The shareholders' equity adjustment appears not to be associated overall with either share prices or stock returns.

6.5 Future research

A major indication of whether adopting IFRS is beneficial for companies is whether it serves to decrease their cost of capital. As noted above in the literature review, the existing research into the effects of adopting IFRS in this area is inconclusive.

The academic research paper commissioned for this report looks only at short-term impacts on market prices, which are not necessarily a good proxy for measures of cost of capital. Moreover, the paper provides only a transitional snapshot. The value relevance of IFRS might, for example, increase over time as confidence in the quality of implementation increases. However, such effects will be difficult to isolate and measure now that the one-off mandatory transition has taken place.

Further longer-term study will be required in order to reach more reliable conclusions on cost of capital issues. The INTACCT research network may well provide a vehicle for this research. INTACCT is a major collaboration between leading university accounting and finance research groups across the EU, funded by the EC, which will examine IFRS compliance and enforcement over a five-year period and seek to determine the real economic costs and benefits of adopting IFRS.

7. Costs of implementing IFRS

7.1 Key points

Based on the results of our on-line survey and application of the EU Common Methodology, insofar as this was practicable, a broad estimate of the typical cost of preparing the first IFRS consolidated financial statements of publicly traded companies is:

Companies with turnover below €500m	0.31% of turnover
Companies with turnover from €500m to €5,000m	0.05% of turnover
Companies with turnover above €5,000m	0.05% of turnover

Our survey also found that the broad estimate of the typical recurring costs of preparing IFRS consolidated financial statements in following financial years is:

Companies with turnover below €500m	0.06% of turnover
Companies with turnover from €500m to €5,000m	0.01% of turnover
Companies with turnover above €5,000m	0.008% of turnover

However, detailed examination of the figures suggests that at both extremes of the turnover size bands (below €100m and above €10,000m) the relationship between IFRS transition costs and turnover might be more variable than the percentages quoted above. We also think that even though we asked respondents for estimated incremental costs, some of the above costs might not be truly incremental.

These figures indicate that the smallest companies bore the proportionately greatest costs. There appear to be economies of scale, even among larger companies with more complex transactions requiring more sophisticated accounting policies. Small companies appear to have been unable or unwilling to utilise internal resources and relied upon external advice and support to a greater extent. The analysis also suggests that the largest companies were more prepared to embed accounting changes to reduce future costs.

The costs of auditing IFRS implementation were significant, ranking as the second highest cost for companies with turnover below €500m and the third highest for larger companies. Auditor responses to the on-line survey and the roundtables provided extra insight into the costs of IFRS implementation by bringing the importance of the relationship between companies and their auditors into focus.

7.2 Use of on-line survey

As noted at 4.2 above, we carried out an on-line survey of EU investors, preparers and auditors of IFRS financial statements. One of the objectives of the on-line survey questionnaire was to help us assess the incremental costs to companies of applying IFRS in place of national GAAP. The questionnaire is reproduced at Appendix 5. The questions in the on-line survey relating to costs were developed in the light of the EU Common Methodology.

7.3 Application of EU Common Methodology

The EU Common Methodology has been developed by the European Commission to measure the net costs imposed on enterprises by individual pieces of legislation. It is set out in the Annexes to Impact Assessment Guidelines (15 June 2005, with 15 March 2006 update of Annex 10, Assessing administrative costs imposed by legislation).

The aim of the EU Common Methodology is to assess the net costs of administrative obligations imposed on enterprises by individual pieces of legislation. Net costs are 'costs introduced by legislation minus the costs eliminated by legislation at EU and/or national level.'

The EU Common Methodology defines 'administrative costs imposed by legislation' as: 'the costs incurred by enterprises … in meeting legal obligations to provide information on their action or production, either to public authorities or to private parties.'

Thus net costs are the incremental costs to companies of complying with a piece of EU legislation over the costs of complying with superseded member state or EU requirements. Net costs do not include opportunity costs. They do not include an allocation of costs that would have been incurred irrespective of the legislation. This is important as much of the transition and implementation work in many companies was undertaken by people working longer hours or working on IFRS rather than other projects. Net costs exclude such costs.

Application of the EU Common Methodology involves 10 steps as set out in Table 7.1. Table 7.1 sets out how we have interpreted these steps in the context of the IAS Regulation insofar as this is practicable.

Table 7.1: Summary of ICAEW's application of EU Common Methodology to the IAS Regulation

Phase 1: Preparatory analysis

Step 1	*Identification and classification of information obligations* The relevant information obligations are those arising under the IAS Regulation that apply to publicly traded companies
Step 2	*Identification of required actions* On-line survey questions identify costs for required actions such as taking external advice, training staff, etc
Step 3	*Classification by regulatory origin* On-line survey identifies costs by regulatory origin such as requirements for financial instruments, deferred tax, etc
Step 4	*Identification of target groups* On-line survey segments preparers by reference to industry sector, member state, employee numbers and turnover
Step 5	*Identification of frequency of required actions* Preparation of annual consolidated financial statements
Step 6	*Identification of relevant cost parameters* On-line survey identifies costs as either recurring costs or one-off implementation costs
Step 7	*Choice of data sources* Preparers and auditors responding to the on-line survey are the relevant data sources and specific questions within the survey are used to capture data

Phase 2: Data capture and standardisation

Step 8	*Assessment of number of entities* Not applicable
Step 9	*Assessment of performance of "normally efficient entity"* On-line survey asks preparers to identify if they could have implemented IFRS at a significantly lower cost in order to identify what the methodology refers to as "normally efficient entities" and so permit standardisation of the results
Step 10	*Extrapolation to estimate total administration costs* Not performed – see below

The work summarised in Table 7.1 permits us to identify, analyse and average costs incurred by 98 preparers and by clients of 141 auditors responding to the on-line survey. However, this report does not contain extrapolation of this information to estimate the total administration costs of the IAS Regulation at the EU level (step 10). This is because of:

- the relatively small size of the samples in relation to the population of publicly traded companies in the EU;
- the significant differences in administrative costs borne by companies depending on their industry sector, member state and size;
- the fact that while all Sample 1 companies were invited to respond to the on-line survey, we cannot assume that survey respondents as a whole are representative of companies subject to the IAS Regulation; and
- inherent uncertainties associated with the cost estimates.

7.4 Uncertainties associated with cost estimates

It is important to note that the use of an on-line survey involves inherent limitations as to the accuracy of responses. For example, our questionnaire asked respondents for additional costs, but it is likely that some of the costs identified – while incurred in the context of IFRS implementation – might not be totally incremental. For example, IFRS project teams might include staff not fully engaged on IFRS or software changes for IFRS might include costs of other upgrades of financial software made concurrently. Thus the figures derived below need to be treated with some caution. In addition, the high level of "don't knows" in the responses on costs indicates that many companies did not track this information. A number of companies, particularly large ones, appear to have not thought it worthwhile to record separately the costs of IFRS implementation.

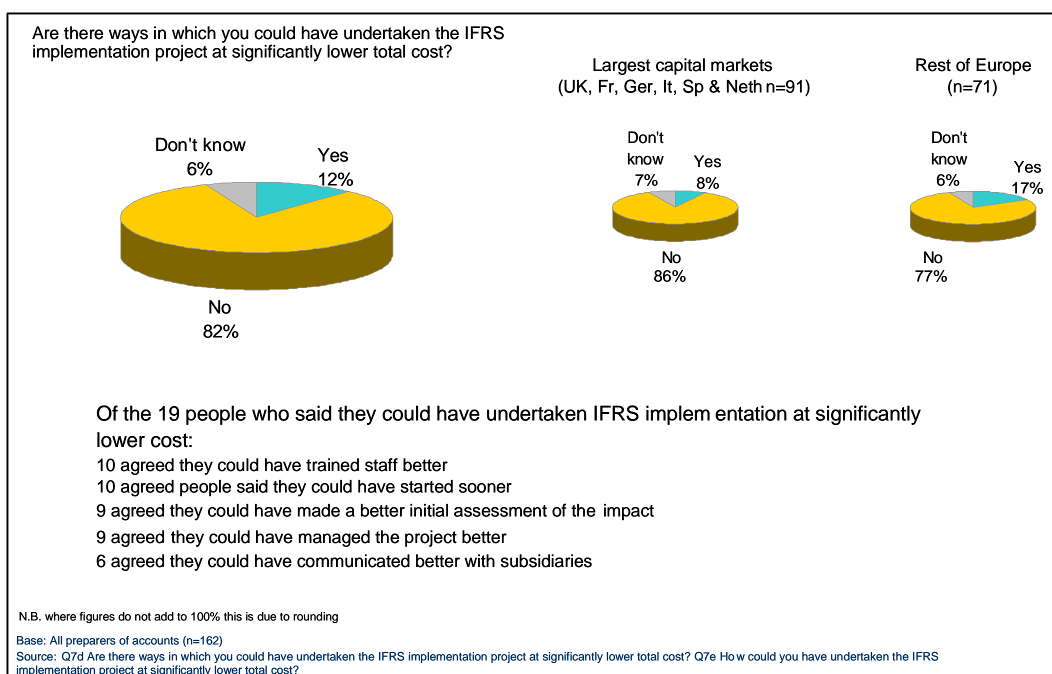
As far as we can ascertain, there have been no previous EU-wide surveys that attempt to assess the incremental costs of implementation of IFRS. Most previous surveys cover one or a small number of member states, include non-incremental costs and do not build up the total cost from individual cost categories. Moreover, we were able to compare the total IFRS conversion cost quoted at one of the roundtables by the representative of a large listed company to the estimated cost of conversion derived from the on-line survey. This exercise lent credence to the on-line survey results.

The roundtable discussions also suggest the some of that costs identified by on-line survey respondents might not be truly incremental. For example, it was suggested that some costs would have come through national GAAP changes in any event and that some companies used IFRS to justify overdue systems changes.

7.5 Estimation of costs based on preparer responses

Some of the preparer respondents to the on-line survey were not working for publicly traded companies or their subsidiaries and have been excluded from the results of the survey on costs. Respondents were asked whether they could have implemented IFRS at significantly lower cost (Figure 7.1). The respondents who answered positively to this question have been removed from the cost calculations to ensure that the focus is on "normally efficient entities" as required by the EU Common Methodology, leaving a base of 98 respondents for the cost questions.

Figure 7.1: Are there ways in which you could have undertaken the IFRS implementation project at significantly lower total cost?

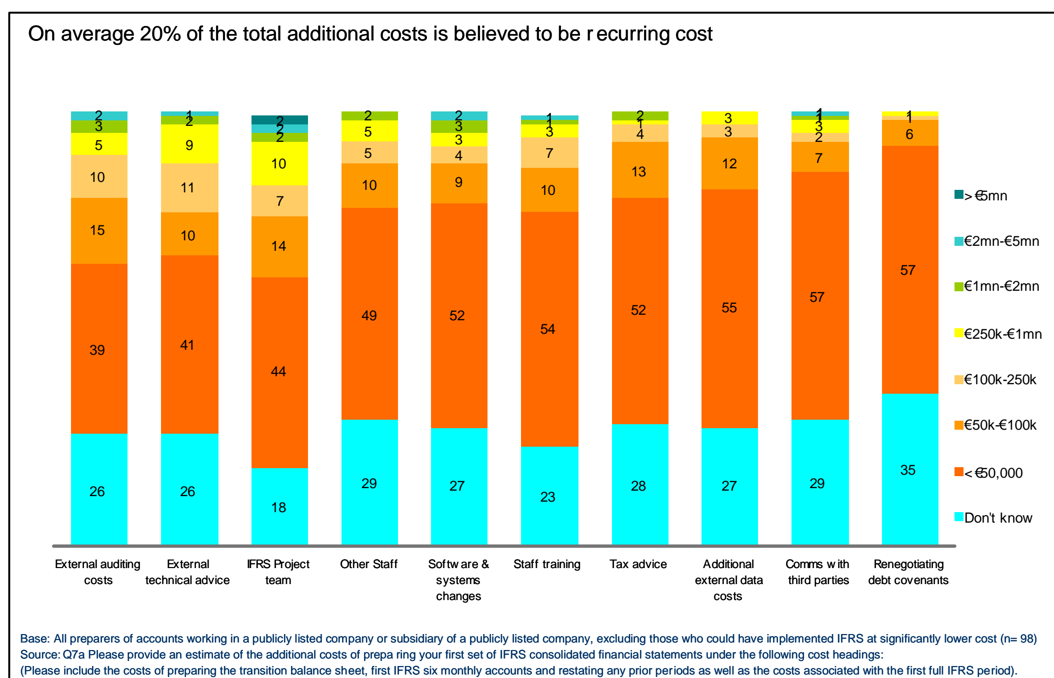


Respondents were asked to provide an estimate of the additional costs of preparing their first IFRS consolidated financial statements under ten cost headings which were:

- IFRS project team
- Other staff (such as IT staff, internal audit and management)
- Training of staff
- External technical advice
- Tax advice
- Software and systems changes
- Communications with third parties
- Additional external audit costs
- Costs arising from changes such as renegotiating debt covenants
- Other external data requirements

The results are shown in Figure 7.2.

Figure 7.2: Estimates of additional costs incurred in preparing first set of IFRS consolidated financial statements (excluding those who could have implemented IFRS at significantly lower cost)



Base: All preparers of accounts working in a publicly listed company or subsidiary of a publicly listed company, excluding those who could have implemented IFRS at significantly lower cost (n= 98)
Source: Q7a Please provide an estimate of the additional costs of preparing your first set of IFRS consolidated financial statements under the following cost headings:
(Please include the costs of preparing the transition balance sheet, first IFRS six monthly accounts and restating any prior periods as well as the costs associated with the first full IFRS period).

Preparers were asked to select a cost band applicable to each of the ten cost headings. To calculate an aggregate cost, mid-point estimates were applied for each cost band. The cost bands and mid-point aggregates were:

€0 to €50,000	€25,000
€50,000 to €100,000	€75,000
€100,000 to €250,000	€175,000
€250,000 to €1m	€625,000
€1m to €2m	€1,500,000
€2m to €5m	€3,500,000
Over €5m	€5,100,000

The mid-point estimate for the 'Over €5m' cost category was set at €5.1m as only 2 of the 98 respondents indicated additional costs of this level. Given that the majority of respondents indicated lower additional costs, the probability is that those in the highest cost category only marginally exceeded €5m.

Further analysis of responses is undertaken by size of company. Turnover is regarded as the most appropriate indicator of size in considering implementation costs of the IAS Regulation and the analysis of the findings in this chapter is calculated on this basis. Average turnover has been calculated by applying a value weighting to each turnover band. These were:

Under €1m	€0.5m
€1m to €50m	€25m
€51m to €100m	€75m
€101m to €500m	€300m
€501m to €1,000m	€750m
€10001m to €5,000m	€3,000m
Over €5,000m	€7,500m

As a large proportion (40) of the 98 respondents fell into the top 'Over €5,000m' turnover category, the mid-point between €5,000m and €10,000m (€7,500m) has been taken for purposes of weighting.

The responses have been aggregated into three broad categories to summarise the cost effects on companies of different sizes. The size bands chosen were based on turnover. Average turnover for each of the three turnover bands has been calculated by applying a value weighting to each band. Turnover categories (number of respondents in each category is in brackets) and value weightings were as follows:

Turnover below €500m (27)	€177m
Turnover from €500m to €5,000m (27)	€1,583m
Turnover above €5,000m (40)	€7,500m

Based on these calculations and as set out in Figure 7.4 the broad estimate of the typical cost of implementing the first IFRS consolidated financial statements for publicly traded companies was:

Companies with turnover below €500m	0.31%
Companies with turnover from €500m to €5,000m	0.05%
Companies with turnover above €5,000m	0.05%

Detailed examination of the figures suggests that at both extremes of the turnover size/bands (below €100m and above €10,000m) the relationship between IFRS transition costs and turnover might be more variable than the above figures suggest.

Figure 7.3: Calculation of additional costs incurred in preparing first set of IFRS consolidated financial statements as a percentage of turnover and recurring additional costs as a percentage of turnover

	Calculating *additional* costs incurred in preparing first set of IFRS consolidated financial statements as a percentage of turnover			*Recurring* additional costs as a percentage of turnover		
Company size based on turnover	Average turnover (€ mns)	Average claimed additional cost of implementation (€'mns)	Additional cost as percentage of turnover	% Recurring cost	Total recurring cost (€mns) (D*B)	Total recurring cost as percentage of turnover % (E/A)
	A	B	C	D	E	F
Turnover <€500mn (n=27)	177	0.554	0.31%	19%	0.105	0.06%
Turnover €500mn-€5,000mn (n=27)	1,583	0.867	0.05%	24%	0.208	0.01%
Turnover €5,000+ (n=40)	7,500	3.430	0.05%	17%	0.583	0.008%

Base: All preparers of accounts working in publicly listed companies or subsidiaries of publicly listed companies (excluding those who could have implemented IFRS at significantly lower cost) and giving company turnover (n=94)
Source: Q7a Please provide an estimate of the additional costs of preparing your first set of IFRS consolidated financial statements under the following cost headings:
(Please include the costs of preparing the transition balance sheet, first IFRS six monthly accounts and restating any prior periods as well as the costs associated with the first full IFRS period).

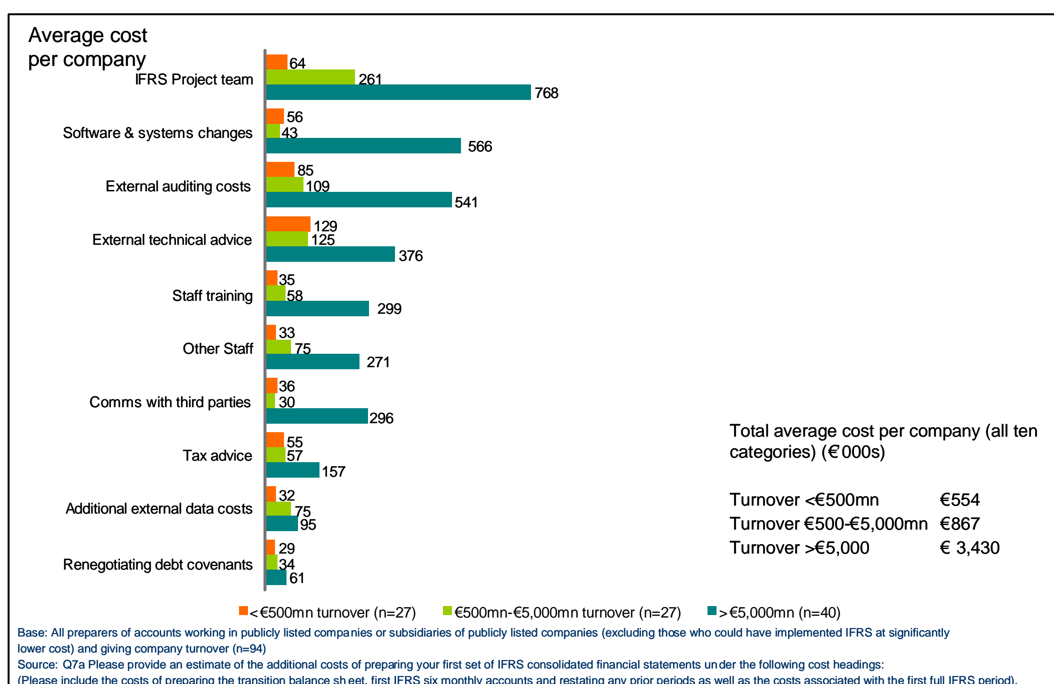
The detailed analysis of responses related to the additional costs incurred in preparing the first set of IFRS consolidated financial statements by turnover category is included in Figure 7.3. A comparison of the responses for the companies below €500m and those in the turnover category €500m to €5,000m reveals that the costs of the lower turnover companies are in many of the cost categories of the same order as the companies in the turnover group above them, although the average turnovers are €177m and €1,583m

respectively, which suggests some economies of scale. Further analysis of the companies in the below €500m turnover reveals a significant division in the costs for those with turnovers below €100m and those with turnovers between €100m and €500m. Although the sample sizes of both sub-groups are small, it appears that in the smallest companies (below €100m) where the chief financial officer has wide ranging responsibilities and has been unable to deploy in-house resources, cost as a percentage of turnover is lower than in companies in the turnover range €100m to €500m, particularly if the company has less complex transactions to consider for IFRS. This suggestion has been given some weight in some of the roundtable discussions.

Respondents were also asked to estimate the costs of preparing financial statements to the current IFRS standards in following financial years. The responses were expressed as a total recurring cost as a percentage of turnover according to the turnover size bands outlined above. The following were the resulting figures:

Companies with turnover below €500m	0.06% of turnover
Companies with turnover from €500m to €5,000m	0.01% of turnover
Companies with turnover above €5,000m	0.008% of turnover

Figure 7.4: Estimate of additional costs incurred in preparing first set of IFRS consolidated financial statements (excluding those indicating they could have implemented IFRS at significantly lower cost) based on company size according to consolidated turnover



Base: All preparers of accounts working in publicly listed companies or subsidiaries of publicly listed companies (excluding those who could have implemented IFRS at significantly lower cost) and giving company turnover (n=94)
Source: Q7a Please provide an estimate of the additional costs of preparing your first set of IFRS consolidated financial statements under the following cost headings:
(Please include the costs of preparing the transition balance sheet, first IFRS six monthly accounts and restating any prior periods as well as the costs associated with the first full IFRS period).

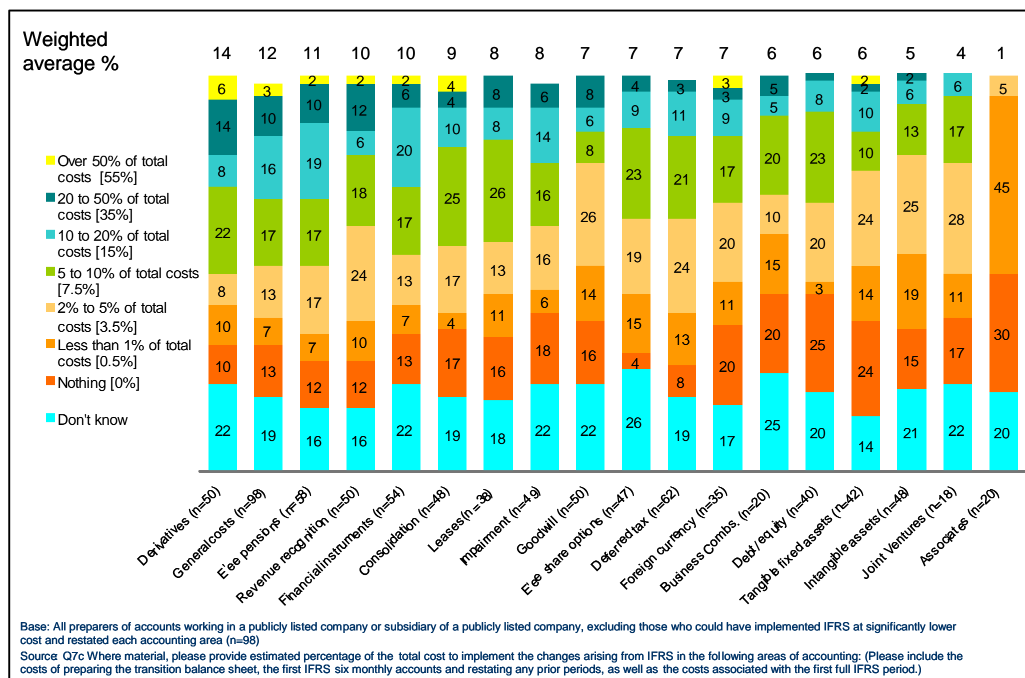
Consideration of the detailed responses reveals that companies with ‘below €500m turnover’ appear to have spent proportionately more on external advice, with ‘external technical advice’ and ‘external auditing costs’ ranking first and second respectively. Companies with a turnover between €500m and €5,000m spent most on their IFRS project team and ‘technical advice’ whilst the largest companies devoted a higher proportionate spend to their project team and software and systems changes (Figure 7.4 and Table 7.2).

Table 7.2: Ranking of implementation costs by size of company

	Turnover below €500m	Turnover €500m to €5000m	Turnover above €5000m
IFRS project team	3	1	1
Software and systems changes	4	8	2
External auditing costs	2	3	3
External technical advice	1	2	4
Staff training	7	6	5
Other staff	8	4 =	7
Communications with third parties	6	10	6
Tax advice	5	7	8
Additional external data costs	9	4 =	9
Renegotiating debt covenants	10	9	10

Respondents were asked to provide estimates in percentages of the total cost of implementing IFRS across 17 specified areas of accounting plus the general costs of preparing financial reports such as financial statement redrafting. The results are set out in Figure 7.5.

Figure 7.5: Estimate of cost increase in each accounting area to implement changes arising from IFRS (excluding those indicating they could have implemented IFRS at significantly lower cost)



The weighted average of the percentages for each accounting policy area was applied to the estimate of total additional costs. The following table (Table 7.3) summarises the responses of the normally efficient entities, ie excluding those who said that they could have introduced IFRS at significantly lower cost. The figures in Table 7.3 are derived from the weighted average percentages applied to the total implementation costs for companies in each turnover category (Figure 7.5).

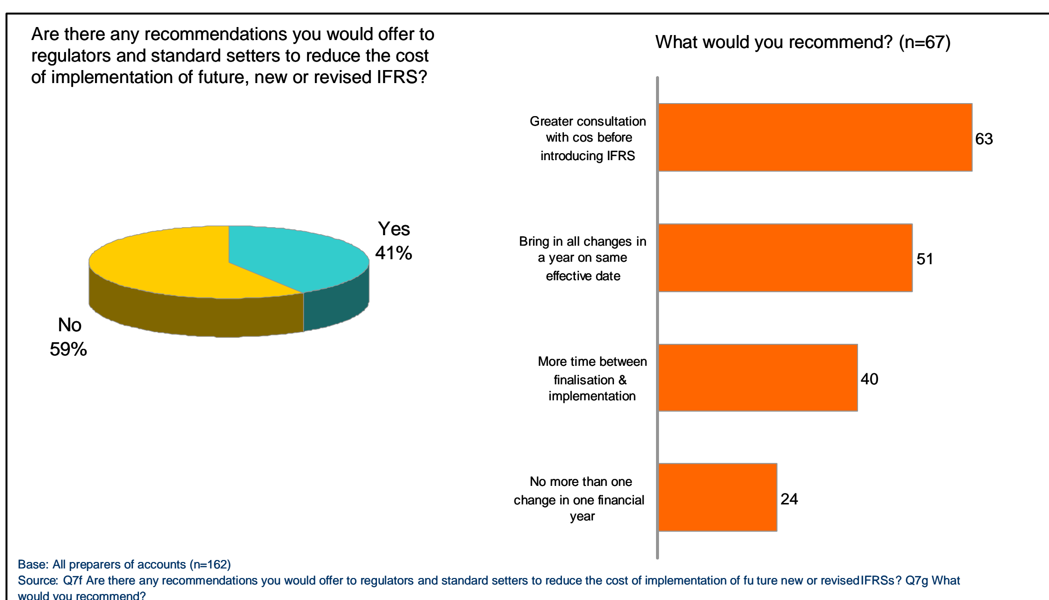
Table 7.3: Average implementation cost by area of accounting and size of company

	Turnover below €500m €000's	Turnover €500m to €5,000m €000's	Turnover above €5,000m €000's
Derivatives	56	88	348
General costs	48	75	298
Employee pensions	44	69	273
Revenue recognition	40	63	249
Financial instruments	40	63	249
Consolidation	36	57	224
Leases	32	50	199
Impairment	32	50	199
Goodwill	28	44	174
Employee share options	28	44	174
Deferred tax	28	44	174
Foreign currency	28	44	174
Business combinations	24	38	149
Debt/Equity	24	38	149
Tangible fixed assets	24	38	149
Intangible assets	20	31	124
Joint ventures	16	25	99
Associates	4	6	25
Total implementation costs	**554**	**867**	**3430**

7.6 Preparer views on containing costs of IFRS implementation

Preparers were asked if there were any recommendations they would offer to regulators and standard setters to reduce the cost of implementation of future IFRS standards. 59% of respondents had no recommendations to make. Amongst those with recommendations, 'greater consultation with companies before introducing IFRS' was the strongest suggestion with 'bringing all changes in a year on the same effective date' the second preferred recommendation (Figure 7.6).

Figure 7.6: Preparers' recommendations to regulators to reduce the cost of future implementation of future, new or revised IFRS



Base: All preparers of accounts (n=162)
Source: Q7f Are there any recommendations you would offer to regulators and standard setters to reduce the cost of implementation of fu ture new or revised IFRSs? Q7g What would you recommend?

In terms of lessons learnt by respondents, Figure 7.1 offers some insights. Those who stated they could have significantly reduced their IFRS implementation costs would have done so by:

- training staff better;
- starting the transition project sooner;
- making a good initial assessment of the impact;
- managing the project better; and
- communicating better with subsidiaries.

Some of these themes were emphasised at the roundtables. For example, one large UK oil company trained 700 people around the world. In another case the use of parallel national GAAP and IFRS accounting systems for six months helped the board to better understand the changes. It was also apparent from the roundtables that those companies, usually large, which treated the IFRS introduction as a business project and involved staff across the company, were more likely to have a smoother transition, and that the cost of IFRS transition was not generally a source of concern.

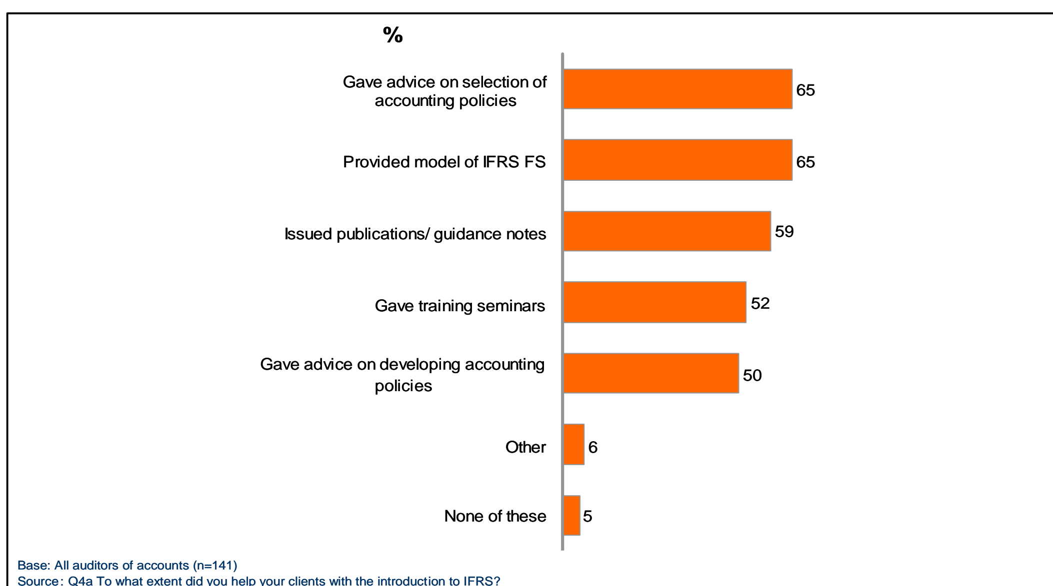
7.7 Auditor impact on costs

As shown by Table 7.2, external auditing is a significant cost heading, ranking second in the cost headings of companies below €500m turnover, and third for companies with a turnover between €500m and €5,000m and those with a turnover above €5,000m. The answers provided by auditors to questions in the on-line survey relating to audit costs are broadly consistent with preparers' responses and provide valuable additional insights.

The support offered by auditors with the introduction of IFRS included:

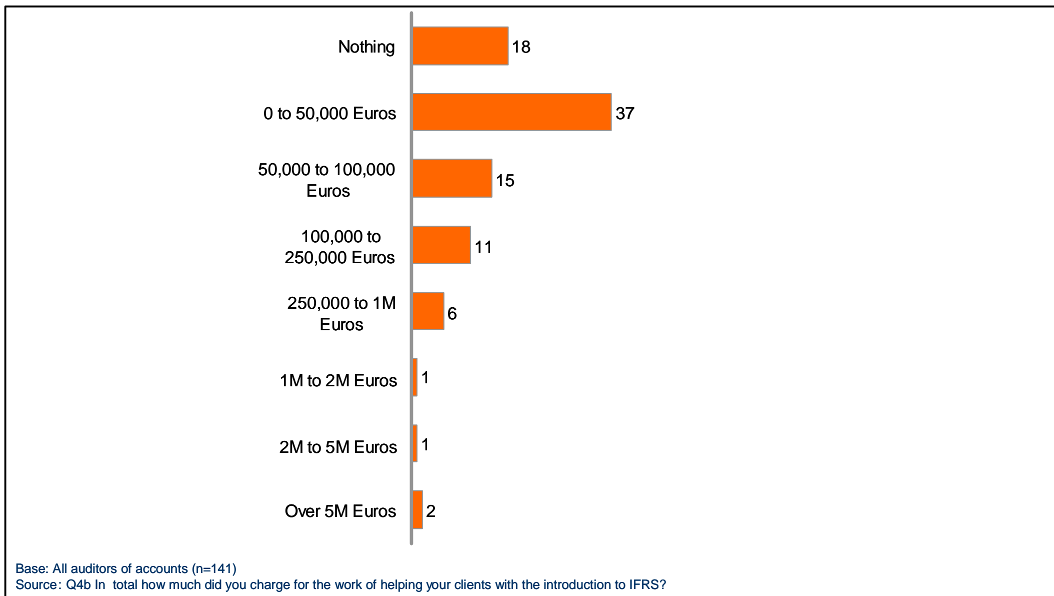
- giving advice on selection of accounting policies;
- providing model IFRS financial statements;
- issuing publications/guidance notes;
- giving training seminars; and
- giving advice on developing accounting policies (Figure 7.7).

Figure 7.7: To what extent did you help your clients with the introduction of IFRS?



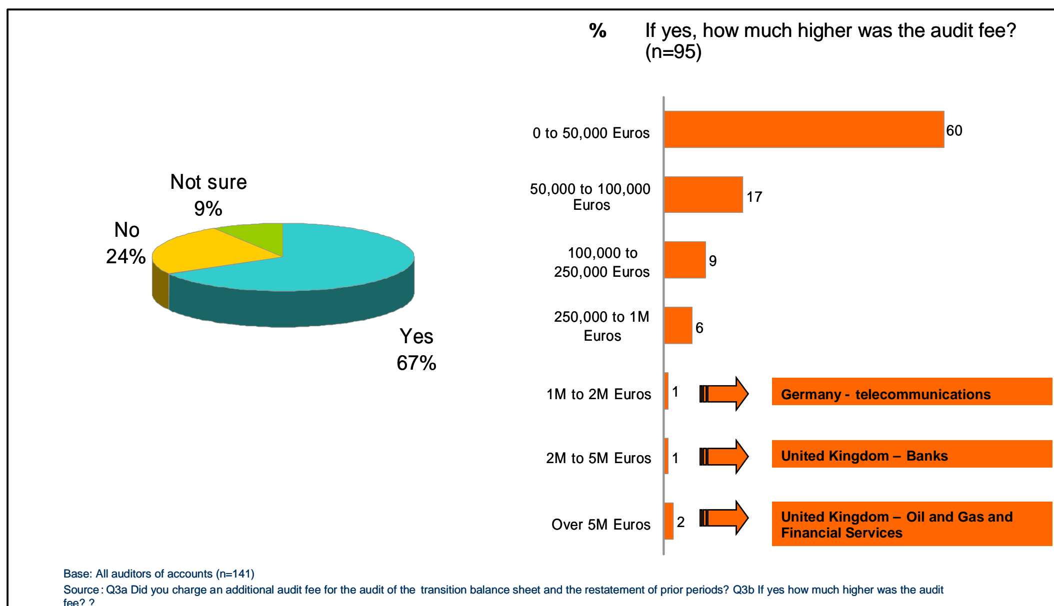
Charges for this support varied widely, with 55% of respondents charging €50,000 or less but 10% charging over €250,000 (Figure 7.8).

Figure 7.8: In total how much did you charge for the work of helping your clients with the introduction of IFRS?



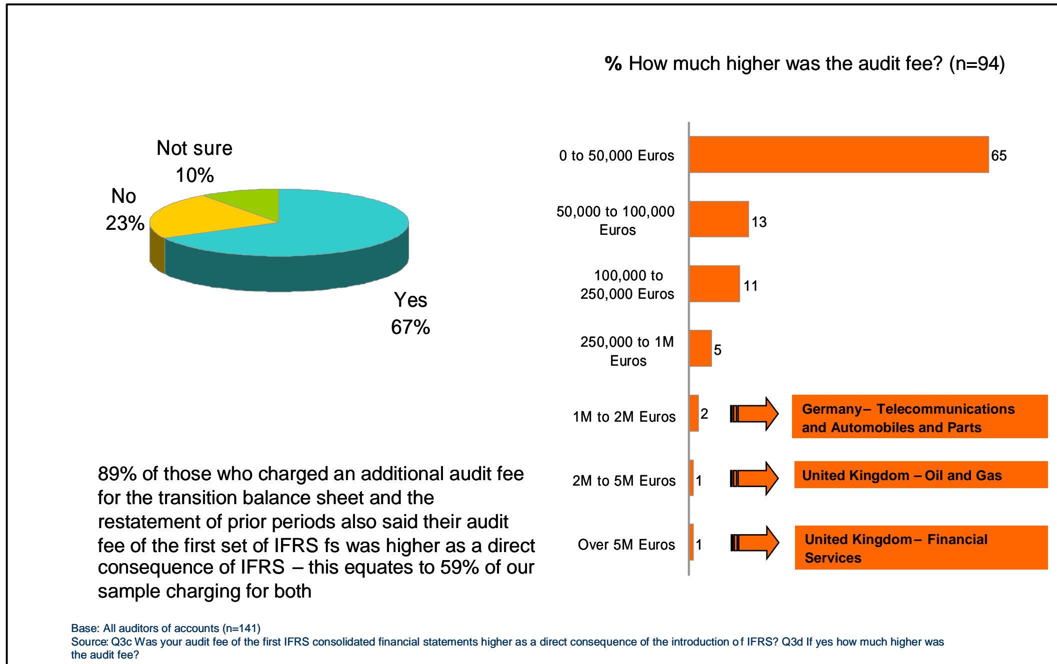
A similar spread is evident for work by auditors in auditing the transition balance sheet and the restatement of prior periods, with 60% charging less than €50,000 but 10% charging over €250,000 (Figure 7.9).

Figure 7.9: Did you charge an additional audit fee for the audit of the transition balance sheet and the restatement of prior periods?



When auditors were asked how much higher audit fees were as a direct consequence of the introduction of IFRS, 65% stated that the additional fee was €50,000 or less and 9% stated that the additional audit fee was over €250,000 (Figure 7.10).

Figure 7.10: Was your audit fee of the first IFRS consolidated financial statements higher as a direct consequence of the introduction of IFRS?



The roundtables provided extra insight into the reasons behind some of the costs of IFRS implementation by bringing the importance of the relationship between companies and their auditors into focus. It was generally felt the transition to IFRS had been challenging but went reasonably well due, in part, to very substantial hands-on involvement of the audit firms. Nevertheless, there was general acceptance of the view that the first year implementation had put pressure on audit partner relationships with clients because of the need to consult firm experts in order to ensure consistency across countries and within industries. This had meant that it had initially been hard to obtain answers from auditors and the number of issues where IFRS were not clear led to some difficult discussions. Relationships had however improved as understanding increased. It was also felt that auditing the enhanced disclosures in IFRS financial statements was a challenge for auditors.

8. IFRS consolidated financial statements of EU publicly traded companies

8.1 Key points

The consolidated financial statements of EU publicly traded companies appear generally to comply with IFRS across different industries, markets and member states. This assessment is based on an analysis of disclosures in Sample 1 and the associated audit opinions. We relied solely on publicly available information and did not make any inquiries of the companies or auditors concerned.

Of the 200 companies in Sample 1:

- 198 disclose full compliance with IFRS and 2 disclose partial compliance;
- 146 disclose compliance with IFRS-EU only, 31 with both IFRS-EU and IFRS and 23 with IFRS only; and
- none of the 23 financial statements which disclose compliance with IFRS-only indicate that the company is not complying with IFRS-EU.

Compliance with individual standards is separately considered in Chapters 11 to 24.

8.2 Approach

We reviewed the IFRS consolidated financial statements of companies in Sample 1 publicly traded companies. In carrying out our reviews, we relied on the published financial statements and the related audit reports. We did not have access to other information that may have been available to the preparers and the auditors of the financial statements, or to securities regulators in carrying out their reviews of the financial statements. In particular, we did not have access to, or request access to, internal records of the companies or seek clarifications from companies or their auditors. We recognise that the preparers and auditors of the financial statements in Sample 1 had additional information available to them when making judgements about compliance with IFRS.

It is also not the aim of this study to review financial statements in the same level of detail as the reviews carried out by regulators, financial analysts and other researchers. It is in this context that the findings and conclusions need to be understood.

However, in performing our work, we have been able to incorporate information from other surveys and some of the comments of securities regulators into our report. In particular, we have reviewed the correspondence on IFRS consolidated financial statements between the companies and the SEC (see Chapter 5).

8.3 Sample 1 selection

The 200 publicly traded companies in Sample 1 (listed in Appendix 1) were selected in order to achieve coverage of:

- more than 10% of the total capitalisation of the regulated markets in both the EU as a whole and each member state; and
- a significant number of companies that form part of the major stock indices for each market;
- small and medium-sized publicly traded companies; and

- all the major economic sectors (including banking and insurance).

The total sample of 200 companies was allocated initially among EU regulated markets in order to reflect each market's proportion of the total market capitalisation as set out in the Federation of European Stock Exchanges monthly statistics for September 2006 (www.fese.org). This initial allocation was modified in order to ensure adequate representation of all member states (Table 8.1).

Table 8.1: Geographical composition of sample of publicly traded companies

Country	Number	Continuing	Country	Number	Continuing
Austria	5	(4)*	Latvia	2	(2)
Belgium	8	(3)	Lithuania	2	(1)
Cyprus	2	(2)	Luxembourg	3	(1)
Czech Republic	3	(2)	Malta	2	(2)
Denmark	5	(1)	Netherlands	12	(0)
Estonia	2	(2)	Poland	5	(2)
Finland	5	(2)	Portugal	4	(0)
France	24	(0)	Slovakia	2	(2)
Germany	20	(17)	Slovenia	2	(0)
Greece	5	(0)	Spain	18	(0)
Hungary	3	(3)	Sweden	6	(1)
Ireland	5	(0)	United Kingdom	40	(1)
Italy	15	(1)			

*The figures in brackets are the number of continuing IFRS reporters, as analysed in Table 11.1

Of the sample companies, 151 adopted IFRS for the first time in their consolidated financial statements for the first financial years starting on or after 1 January 2005 and 49 companies had used IFRS in the prior period (see Chapter 11). Thus, almost a quarter of the sample companies had previously implemented IFRS. Furthermore, companies in some countries were already following accounting standards which had achieved a high degree of convergence with IFRS. This indicates that countries and companies experienced huge differences in their journey to IFRS compliance. It also means that the IAS Regulation affected companies in different countries in different ways and this has had a pervasive effect on the conduct and result of our study.

8.4 Overall compliance with IFRS

Assessment criteria

We assessed overall compliance with IFRS by considering for each company:

- whether its financial statements included an explicit and unreserved statement of compliance with IFRS-EU or IFRS;
- whether its auditors expressed an unqualified opinion with respect to compliance with IFRS-EU or IFRS; and
- whether its financial statements revealed any apparent material non-compliance with IFRS that was not dealt with in the statement of compliance or the audit report.

Of the Sample 1 companies, 198 disclosed full compliance with IFRS-EU, IFRS or both. All these companies made explicit and unreserved statements of compliance with IFRS-EU or IFRS and their auditors expressed unqualified opinions with respect to compliance.

Non-compliance with IFRS

Two companies, **Lietuvos Dujos** (Lithuania) and **Orco** (Czech Republic), disclosed that they did not comply fully with IFRS-EU and, hence, with IFRS. Neither company made an explicit and unreserved statement of compliance with IFRS. The auditors of **Lietuvos Dujos** expressed a qualified opinion with respect to compliance with IFRS-EU. The auditors of **Orco** expressed an unqualified opinion with respect to compliance with IFRS-EU.

Lietuvos Dujos presented its consolidated financial statements in accordance with IFRS-EU:

> '… except that the date of transition to IFRS as defined in IFRS 1 *First-time Adoption of International Financial Reporting Standards* has been established as the beginning of this financial year – 1 January 2005, and not 1 January 2004 as required by IFRS 1. Due to this, the shareholders' equity as of 1 January 2004 and the depreciation expenses in the 2004 income statement have not been adjusted to comply with IFRS, as disclosed in the accounting policies hereafter.'

Ernst & Young conducted the audit of the IFRS consolidated financial statements of **Lietuvos Dujos** in accordance with International Standards on Auditing (ISAs) and stated in its audit report:

> 'As further discussed in Note 2.1 to the accompanying financial statements, the 2005 financial statements have been prepared referring to IFRS 1 "First-time Adoption of International Financial Reporting Standards," except that the date of transition has been established as the beginning of this financial year – 1 January 2005, and not 1 January 2004 as required by IFRS 1. We are unable to determine the carrying values of non-current assets on 1 January 2004 and what effect this would have on the Company's equity as of 1 January 2004 and the income statement for the year ended 31 December 2004.'

Ernst & Young expressed the opinion that the financial statements present fairly the company's financial position and the results of its operations in accordance with IFRS-EU except for the effect of such adjustments, if any, as might have been disclosed had they been able to determine the carrying value of non-current assets at 1 January 2004.

Orco disclosed that its consolidated financial statements, which had previously been reported under Luxembourg GAAP, have been prepared in accordance with IFRS-EU:

> 'with the exception of the following disclosures for the year ended 2005 together the related comparative information for 2004:
>
> - the reconciliation between tax expense and accounting profit as required by IAS 12 – Income Taxes,
> - the amount of capital expenditures disclosed by geographical segments as required by IAS 14 – Segment Reporting.'

PricewaterhouseCoopers and HRT Révision conducted their audit of the IFRS consolidated financial statements of **Orco** in accordance with ISAs and expressed an unqualified audit opinion. They did however include an emphasis of matter paragraph in their audit report drawing attention to the note that 'mentions the missing disclosures and comparative information, which are required under IFRS'. ISA 700 *The Auditor's Report on Financial Statements* which was applicable to the 2005 audit would have required the

auditors to qualify their audit opinion had they judged the effect of the missing disclosures and comparative information to have been material to the financial statements.

Compliance with IFRS-EU or IFRS

The IAS Regulation requires publicly traded companies to publish consolidated financial statements in accordance with IFRS-EU. A company may comply with IFRS issued by the IASB provided that any IFRS they adopt do not conflict with IFRS-EU.

Table 8.2 shows that 177 companies refer to compliance with IFRS-EU; 31 of these companies also refer to compliance with IFRS issued by the IASB.

Table 8.2: Compliance with IFRS

	Number	Percentage
Compliance with IFRS-EU	146	73
Compliance with both IFRS-EU and IFRS	31	15.5
Total; compliance with IFRS-EU	**177**	**88.5**
Compliance with IFRS only (table 8.3)	23	11.5
Total	**200**	**100**

The financial statements do not indicate why a company might choose to refer to IFRS, to IFRS-EU or to both. From Table 8.3, which covers countries with more than 10 companies in Sample 1, there appears to be some geographical preference for a particular form of disclosure. However, SEC influence may be important as the SEC requires disclosure of compliance with IFRS in order to obtain exemption from presenting two years of comparatives. Where companies did not make this disclosure, the SEC raised it in its comment letters (see Chapter 5).

Table 8.3: Geographical analysis of disclosure of compliance for countries with more than 10 companies

	IFRS	IFRS-EU	Both	Total
France	1	22	1	24
Germany	5	13	2	20
Italy	5	10	-	15
Netherlands	-	8	4	12
Spain	-	18	-	18
UK	2	30	8	40
Total	**13**	**101**	**15**	**129**

Compliance with IFRS only

Disclosure of compliance with IFRS without reference to their adoption by the EU is made by 23 companies (Table 8.4). It is not clear why these companies made explicit reference only to compliance with IFRS. In some cases, additional references in the financial statements could be taken to imply, in context, that compliance with IFRS is for the purpose of meeting EU requirements and in no cases did the financial statements indicate that the company is not complying with IFRS-EU.

Table 8.4: Companies disclosing compliance with IFRS only

Country	Companies
Belgium	Brantano
Czech Republic	CEZ
Finland	Nokia
France	Bic
Germany	Deutsche EuroShop Henkel Mobilcom MTU Schering
Italy	Acea Datalogic Geox L'Espresso Recordati
Latvia	DnB Nord Banka
Poland	Duda
Portugal	Brisa SAG
Slovenia	KRKA Sava
Sweden	Alfa Laval
UK	EMI WSP

The following are examples of disclosures of compliance with IFRS only.

Brantano (Belgium) discloses that its consolidated financial statements have been prepared in accordance with IFRS, but makes no reference to EU endorsement:

> 'The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) and with the Standing Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) of the IASB that are effective as of the balance sheet date.'

Alfa Laval (Sweden) discloses that it applies IFRS and notes subsequently:

> 'All listed companies within the European Union are obliged to change to IFRS as of January 1, 2005.'

EMI (UK) states that:

> 'The consolidated financial information comprises the accounts of the Company and its subsidiaries which have been prepared in accordance with applicable accounting standards. Following a regulation adopted by the European Parliament, the consolidated financial information has been prepared in accordance with International Financial Reporting Standards (IFRS).'

Similarly, **Deutsche EuroShop** (Germany) states:

> 'In accordance with Directive (EC) No 1606/2002 of the European Parliament and the Council dated 19 July 2002, Deutsche EuroShop AG is required to prepare consolidated financial statements in accordance with International Accounting Standards (IASs/IFRSs).'

Compliance with IFRS-EU only

As noted in Table 8.2, 146 companies refer to compliance with IFRS-EU without specifically referring to compliance with IFRS.

The following are examples of disclosures of compliance with IFRS-EU only and clearly reflect the relevant companies' obligations under the IAS Regulation.

Novo Nordisk (Denmark):

> 'The Consolidated financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.'

Vallourec (France):

> 'The versions of the IFRS used are those applicable as at 31 December 2005, as endorsed by the European Commission as at the date the financial statements were prepared.'

Deutz (Germany):

> 'The consolidated financial statements of DEUTZ AG for the 2005 financial year have been prepared for the first time in accordance with the International Financial Reporting Standards (IFRS) applicable throughout the European Union as at 31 December 2005.'

EU carve-out

In November 2004 the European Commission adopted a Regulation endorsing IAS 39 *Financial Instruments: Recognition and Measurement*, with the exception of certain provisions on the use of the full fair value option for liabilities and on hedge accounting. In June 2005 the IASB published an amendment to the fair value option in IAS 39. The amendment limits the ability of an entity to designate any financial asset or financial liability as 'at fair value through profit or loss'. This amendment was subsequently endorsed by the EU and this had the effect of eliminating the fair value carve-out.

For those companies that applied the carved-out version of IAS 39, it is necessary to refer in their accounting policies to IFRS 'as adopted by the EU' and their accounting policy should provide an explanation of how the carve-out has been applied.

Below is a table that contains the companies that used the carved-out version of IAS 39 in their 2005 financial statements.

Table 8.5: Banks using the 'carve-out'

Belgium	France	Germany
Fortis	BNP Paribas	Commerzbank
KBC	Crédit Agricole	
	Société Générale	**Luxembourg**
		Dexia
		Sweden
		Nordea Bank

Four of the companies above stated in the 'Basis of preparation' or at the beginning of the note on significant accounting policies that the consolidated financial statements have been prepared in accordance with IFRS as adopted by the European Union and that for IAS 39 this takes into account the amendments regarding the fair value option as published on 16 June 2005 by the IASB and as adopted by the European Union on 15 November 2005, as well as the exclusion regarding hedge accounting (the so-called 'carve-out') or similar wording that flagged the use of the carve-out at an early stage.

One company stated in its Basis of accounting that because it had included the carve-out its financial statements 'cannot be described as IFRS compliant in the sense of IAS 1 *Presentation of Financial Statements*.'

Four of the companies above stated in the 'Summary of significant accounting policies' in the hedge accounting section, rather than in the 'Basis of preparation', that they had made use of the carved-out version of IAS 39.

In the hedging policy note one company did not use the expression 'carve-out' but referred to IAS 39 as 'partially endorsed by the European Union' and another company stated that its consolidated financial statements were based on IAS 39 'In the version taken over by the EU Commission'.

Compliance with both IFRS-EU and IFRS

As noted in Table 8.2, 31 companies disclose compliance with both IFRS-EU and IFRS. The financial statements do not indicate why reference is made specifically to both IFRS although SEC influence may be relevant in some cases as may a desire to achieve a reputational benefit of being seen to comply with pure IFRS. The form of disclosure varies widely, as the following examples show.

Royal Unibrew (Denmark)

> 'The Annual Report has been prepared in accordance with International Financial Reporting Standards as adopted by the EU … Furthermore, the Annual Report is in compliance with the International Financial Reporting Standards issued by the IASB.'

Hypo Real Estate (Germany)

> '... These financial statements are based on the IFRS rules which have been adopted by the EU Commission as part of the endorsement process ... With the exception of IAS 39, all mandatory IFRS rules have been completely recognised by the EU. Certain regulations of IAS 39, relating to fair value hedge accounting for a portfolio hedge of interest risks, have not been recognised. The Hypo Real Estate Group does not apply this type of hedge accounting, so that the financial statements are accordingly consistent with the entire IFRS and also with the IFRS as applicable in the EU.'

Magyar Telekom (Hungary):

> 'The consolidated financial statements have been prepared … in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union. In Magyar Telekom's case these are identical to the IFRS as issued by the IASB and effective for 2005.'

CRH (Ireland):

> 'The consolidated financial statements of CRH plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted

by the European Union … IFRS as adopted by the European Union differ in certain respects from IFRS as issued by the IASB. However, the consolidated financial statements for the financial years presented would be no different had IFRS as issued by the IASB been applied. References to IFRS hereafter should be construed as references to IFRS as adopted by the European Union.'

Ukios Bankas (Lithuania):

'The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union (the "EU"). IFRS as adopted by the EU do not currently differ from IFRS as issued by the International Accounting Standards Board (IASB), except for portfolio hedge accounting under IAS 39, which has not been adopted by the EU. The Group has determined that portfolio hedge accounting under IAS 39 would not impact the consolidated financial statements had it been adopted by the EU at the balance sheet date.'

ABN Amro (Netherlands):

'The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) and do not utilise the portfolio hedging 'carve out' permitted by the EU. Accordingly, the accounting policies applied by the Group also comply fully with IFRS.'

BG (UK):

'The Financial Statements for the year ended 31 December 2005 have been prepared in accordance with International Financial Reporting Standards (IFRS), and International Financial Reporting Interpretations Committee (IFRIC) interpretations. These include standards and interpretations endorsed by the EU.'

9. IFRS consolidated financial statements of EU non-publicly traded companies

9.1 Key points

Our review of the IFRS consolidated financial statements of a number of EU companies that were not publicly traded indicated that all complied with IFRS-EU. Some companies disclosed compliance with IFRS without reference to their adoption by the EU but there is no indication that any of the IFRS requirements adopted conflicted with IFRS-EU.

The high level review of the financial statements of the companies in Sample 2 (listed in Appendix 2) did not identify any major issues not highlighted by our work in relation to the consolidated IFRS financial statements of publicly traded companies. However, a small number of financial statements were reviewed during this part of our study and therefore conclusions drawn should be treated with caution.

9.2 Approach

We reviewed the IFRS consolidated financial statements of 18 non-publicly traded companies. In carrying out our reviews, we relied on the published financial statements and the related audit reports. We did not have access to other information that may have been available to the preparers and the auditors of the financial statements in carrying out their reviews of the financial statements. In particular, we did not have access to, or request access to, internal records of the companies or seek clarifications from companies or their auditors. We recognise that the preparers and auditors of the financial statements had available to them additional information necessary to make the necessary judgements when determining compliance with IFRS.

As explained below, the sample consists of financial statements identified by accounting firms and others and includes companies from only a few member states. Therefore we did not carry out the same level of review as we did for the IFRS consolidated financial statements of publicly traded companies and we did not include the Sample 2 findings in the technical analysis in Chapters 11 to 24.

9.3 Sample 2 selection

Sample 2 includes:

- companies which were listed on a regulated market for the first time during 2006, that is after their 2005 year ends;
- several companies from the *FT Non-Public 150*; and
- other unlisted companies from member states which allow or require the use of IFRS in all consolidated financial statements.

Our efforts to source this sample were time-consuming and only partly successful. This is principally because neither public authorities nor accounting firms maintain registers of non-publicly traded companies preparing IFRS consolidated financial statements. It was also impractical to search public registers of all companies to identify the sample.

At the roundtables it was noted that voluntary adoption of IFRS was rare due to scarcity of IFRS resources and the cost implications of moving to IFRS.

We sought the help of professional accountancy bodies in other EU member states, the top six accounting firms, other accounting firms with international networks or expertise in

IFRS and our liaison members in each member state. Many of these bodies, firms and members have been unable to help us because they are unaware of companies that fit the sample criteria or because they are precluded by confidentiality requirements from providing information to us. We have also sought help by other means including appeals on our website and in the professional journal *Accountancy*, sent to substantially all ICAEW members.

As a result of our extensive efforts, we identified a small number of financial statements which can be included in this sample. For the most part, the sample consists of financial statements identified by accounting firms and from only some member states. Therefore, the sample is not designed to be representative of wider populations of financial statements either across the EU or within individual member states. Considerable caution must, therefore, be used in interpreting the results drawn from this sample.

The geographical composition of Sample 2 is shown in Table 9.1 and Appendix 2 lists the companies involved.

Table 9.1: Geographical composition of Sample 2 companies

Cyprus	1	Portugal	3
Germany	4	Spain	2
Italy	3	Sweden	2
Netherlands	1	United Kingdom	2

As discussed in Chapter 3, most member states permit non-publicly listed companies to prepare consolidated financial statements in accordance with IFRS. Others do not permit IFRS consolidated financial statements and a few require banks and other financial institutions to prepare consolidated financial statements in accordance with IFRS. As a result the companies in our review are also skewed to certain industries (Table 9.2).

Table 9.2: Analysis by industry of Sample 2 companies

Airport	1	Industrial transportation	1
Banks	7	IT services	1
Electricity	1	Media	1
Electronics and electrical materials	1	Professional services	1
Healthcare equipment and services	1	Real estate	1
Industrial engineering	1	Travel and leisure	1

9.4 Overall compliance with IFRS

Assessment criteria

We assessed overall compliance with IFRS by considering for each company:

- whether its financial statements included an explicit and unreserved statement of compliance with IFRS-EU or IFRS; and
- whether its auditor expressed an unqualified opinion with respect to compliance with IFRS-EU or IFRS.

Overall compliance with IFRS

All the companies disclose full compliance with IFRS-EU, IFRS or both and their auditors all express unqualified opinions.

Compliance with IFRS-EU or IFRS

The IAS Regulation permits member states to allow or require non-publicly traded companies to publish consolidated financial statements in accordance with IFRS-EU. A company may comply with IFRS adopted by the IASB provided that any IFRS not adopted by the EU do not conflict with IFRS-EU.

Five companies disclose compliance with IFRS without reference to their adoption by the EU as shown in Table 9.3.

Table 9.3: Compliance with IFRS

	Number	Percentage
Compliance with IFRS-EU	12	67
Compliance with both IFRS-EU and IFRS	1	5
Total: compliance with IFRS-EU	**13**	72
Compliance with IFRS only	5	28
Total	**18**	100

9.5 Technical review of financial statements

Technical analysis of the companies selected included:

- transition to IFRS;
- review of the completeness of financial statements;
- selection and application of accounting policies; and
- disclosure.

The review did not identify any significant compliance issues. This may in part be due to the fact that some of the companies had used IFRS in the prior period and to the less complex nature of their transactions relative to listed entities.

10. IFRS legal entity financial statements

10.1 Key points

Our review of legal entity financial statements indicated that, where full IFRS financial statements were presented, all complied with IFRS-EU. Some companies disclosed compliance with IFRS without reference to their adoption by the EU but there is no indication that there are any policies adopted which conflict with IFRS-EU.

High level reviews of financial statements of companies in Sample 3 (listed in Appendix 3) did not identify any major issues not highlighted by our work in relation to the consolidated IFRS financial statements of publicly traded companies, except that the consolidated financial statements of a number of UK and Irish companies do not include an income statement and certain other information in their IFRS legal entity financial statements. They disclose that fact and, therefore, do not make explicit and unreserved statements of compliance with IFRS. They explain that the information has been omitted in accordance with exemptions in UK and Irish law.

A small number of financial statements were reviewed during this part of our study and therefore conclusions drawn should be treated with caution.

10.2 Approach

We reviewed the IFRS legal entity financial statements of 50 companies. In carrying out our reviews, we relied on the published financial statements and the related audit reports. We did not have access to other information that may have been available to the preparers and the auditors of the financial statements in carrying out their reviews of the financial statements. In particular, we did not have access to, or request access to, internal records of the companies or seek clarifications from companies or their auditors. We recognise that the preparers and auditors of the financial statements had available to them additional information necessary to make the necessary judgements when determining compliance with IFRS.

As explained below, Sample 3 consists of financial statements identified by accounting firms and others and includes companies from only a few member states. Therefore we did not carry out the same level of review as we did for the IFRS consolidated financial statements of publicly traded companies and we did not include Sample 3 findings in the technical analysis in Chapters 11 to 24.

10.3 Sample 3 selection

Sample 3 is restricted to companies from member states that require or permit the use of IFRS in legal entity financial statements. It includes:

- 32 companies from Sample 1 which publish IFRS legal entity (parent company) financial statements in their annual reports; and
- 18 other companies from member states which allow or require the use of IFRS in legal entity financial statements.

Our efforts to source this sample were time-consuming and only partly successful. This is principally because neither public authorities nor accounting firms maintain registers of companies applying IFRS in their legal entity financial statements. It was impractical to search public registers to identify the sample. We noted at the roundtables that voluntary adoption of IFRS was rare due for example to scarcity of IFRS resources and cost

implications. Additional uncertainties regarding tax and distributable profits may also arise as a result of applying IFRS in legal entity financial statements.

We sought the help of professional accountancy bodies in other EU member states, the top six accounting firms, other accounting firms with international networks or expertise in IFRS and our liaison members in each member state. Many of these bodies, firms and members have been unable to help us because they are unaware of companies that fit the sample criteria or because they are precluded by confidentiality requirements from providing information to us. We have also sought help by other means including appeals on our website and in the professional journal *Accountancy*, sent to substantially all ICAEW members.

As a result of our extensive efforts, we identified a small number of financial statements which can be included in this sample. For the most part, the samples consist of financial statements identified by accounting firms and from only some member states. Therefore, the sample is not representative of wider populations of financial statements either across the EU or within individual member states. Considerable caution must, therefore, be used in interpreting the results drawn from this sample.

The geographical composition of the sample is shown in Table 10.1. Appendix 3 lists the companies.

Table 10.1: Geographical composition of sample of IFRS legal entity financial statements

Cyprus	3	Malta	7
Czech Republic	2	Netherlands	1
Denmark	1	Poland	1
Greece	3	Portugal	4
Hungary	2	Spain	1
Ireland	3	United Kingdom	19
Italy	3		

As discussed in Chapter 3, many member states do not require or in some cases do not permit the use of IFRS in legal entity financial statements. As a result companies in the sample are skewed to certain countries.

Table 10.2: Analysis by industry of sample of IFRS legal entity financial statements

Banks	10	Investment	3
Construction and materials	2	Life insurance	1
Electricity	1	Media	1
Electronics and Electrical materials	1	Mining	3
Fixed line telecommunications	2	Non-life insurance	3
Food producers	3	Oil and gas producers	4
General financial	1	Oil services	1
General industrials	1	Pharmaceuticals and biotechnology	1
General retailers	2	Software and computer services	3
Household goods	2	Support services	1
		Travel and leisure	4

10.4 Overall compliance with IFRS

Assessment criteria

We assessed overall compliance with IFRS by considering for each company:

- whether its financial statements included an explicit and unreserved statement of compliance with IFRS-EU or IFRS; and
- whether its auditor expressed an unqualified opinion with respect to compliance with IFRS-EU or IFRS.

Sample 3 results – overall compliance with IFRS

There were 32 companies that disclosed full compliance with IFRS-EU, IFRS or both and their auditors expressed unqualified opinions with respect to compliance with IFRS.

There were 16 UK and Irish companies that prepared IFRS consolidated financial statements but did not include an income statement and certain other information in their IFRS legal entity financial statements. They disclosed that fact and, therefore, did not make explicit and unreserved statements of compliance with IFRS. They explained that the information had been omitted in accordance with exemptions in UK and Irish law. Neither the *IAS Regulation* nor IFRS include similar exemptions. Therefore, these financial statements do not comply with IFRS-EU or IFRS. The UK Department for Trade & Industry commented on this issue in the October 2004 publication (revised in August 2005), *Guidance for British Companies on changes to the Accounting and Reporting Provisions of the Companies Act 1985*, as follows:

> '4.23 Section 230 of the 1985 Act provides that, where consolidated accounts are prepared, the parent company's individual profit and loss account and related notes may be omitted from the annual report. Companies that prepare group and individual accounts, and present the latter in accordance with IAS, can continue to take advantage of this exemption. The omission of the profit and loss account

(referred to within IAS as the income statement) might be considered to be inconsistent with certain aspects of IAS, for example the requirement in IAS 1 *Presentation of Financial Statements* in relation to a fair presentation. However, IAS does not in itself require the preparation of separate financial statements but permits the omission of certain elements. In other words, the separate financial statements required to be published under the 1985 Act are an extract of the full IAS separate financial statements. This exemption should not affect the ability of a parent company to be treated as a "first-time adopter" and hence to take advantage of exemptions for first time use under the provisions of IFRS 1 *First Time Adoption of International Financial Reporting Standards*. The company will need to provide the disclosure required by section 230(4), ie that advantage has been taken of the publication exemption in section 230(1). Auditors will also need to describe the accounting framework that has been used within their audit reports. In respect of the individual accounts, the reference to the framework will need to make clear that its basis is IAS as adopted for use in the EU and as applied in accordance with the provisions of the 1985 Act.

4.24 The exemption in the 1985 Act relates only to the profit and loss account. By virtue of section 261(2), the exemption also extends to the notes to the profit and loss account. The individual IAS accounts would however still need to include the other primary statements and note disclosures required by IAS, including a cash flow statement and a statement of changes in shareholders' equity.'

Two companies presented only primary statements under IFRS.

Sample 3 results – compliance with IFRS-EU or IFRS

The IAS Regulation permits member states to permit or require companies to publish legal entity financial statements in accordance with IFRS-EU. A company may comply with IFRS adopted by IASB provided that any IFRS not adopted by the EU do not conflict with IFRS-EU.

Ten companies disclosed compliance with IFRS without reference to their adoption by the EU (Table 10.3). None of these companies appear to have used any IFRS requirements that conflict with IFRS-EU. The information presented in the Table is somewhat distorted by the effects of the Irish and UK companies that did not disclose full compliance with IFRS-EU or IFRS.

Table 10.3: Compliance with IFRS

	Number	Percentage
Compliance with IFRS-EU	18	36
Compliance with both IFRS-EU and IFRS	3	6
Total compliance with IFRS-EU	**21**	**42**
Compliance with IFRS only	11	22
Total compliance with IFRS-EU or IFRS	**32**	**64**
Irish and UK companies not presenting income statement	16	32
Companies presenting only primary statements	2	4
Total	**50**	**100**

11. First-time adoption of IFRS

11.1 Key points

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS by an explicit and unreserved statement in those financial statements of compliance with IFRS. Such an entity must apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

We examined how many entities in Sample 1 had not previously presented financial statements under IFRS and how these first-time adopters applied some of the exemptions and exceptions in IFRS 1. A significant finding was that 151 companies had adopted IFRS for the first time as a result of the IAS Regulation and the remaining entities had previously presented their financial statements under IFRS. This suggests that companies will have faced varying challenges in their transition.

We found that first-time adopters used optional exemptions in IFRS 1 in different combinations with the result that the comparability of the financial statements both among first-time adopters and between first-time adopters and continuing IFRS reporters may be impeded. To some extent, the differences will have an effect on future periods.

This chapter includes a detailed analysis of the use of IFRS 1 exemptions by the 151 first-time adopters.

- 149 include the comparative information required by IFRS;
- 91 restated the prior period for IAS 32 *Financial Instruments: Disclosure and Presentation* and 84 restated the prior period for IAS 39 *Financial Instruments: Recognition and Measurement*;
- where applicable, all companies used the exemption for business combinations (IFRS 3);
- 31 used fair value or revaluations as the deemed cost of property, plant and equipment (IAS 16) or investment property (IAS 40), although practice varied over the amounts used as deemed cost and it is unclear whether some comply with IFRS 1;
- no first-time adopters used fair value or revaluations as the deemed cost of intangible assets (IAS 38);
- where applicable, all companies that opted to use the corridor approach for actuarial gains and losses on defined benefit plans recognised all such gains and losses at transition date (IAS 19); and
- where applicable, all companies used the exemptions for cumulative translation differences (IAS 21), compound financial instruments (IAS 32) and share-based payments (IFRS 2).

11.2 First-time adopters of IFRS and continuing IFRS reporters

IFRS requirements

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS by an explicit and unreserved statement in those financial statements of compliance with IFRS. An entity that included an explicit and unreserved statement of compliance with IFRS in its prior period financial statements is not a first time adopter. These companies are referred to in this report as continuing IFRS reporters rather than first time adopters of IFRS.

Sample 1 results – application of IFRS 1

Of the 200 Sample 1 companies whose financial statements we reviewed, 151 adopted IFRS for the first time in their financial statements for the first financial year starting on or after 1 January 2005, in response to the requirements of the IAS Regulation. This demonstrates how the IAS Regulation has had a varying impact on different companies depending on their individual circumstances. Table 11.1 identifies the 49 continuing IFRS reporters. Of these companies some had voluntarily applied IFRS in prior periods while others were required to do so.

Table 11.1: Continuing IFRS reporters

Austria	**Germany**	**Lithuania**
Erste Bank	Allianz	Ukios Bankas
Hirsch Servo	BMW	
Voestalpine	CeWe Color	**Luxembourg**
Wienerberger	Commerzbank	Arcelor
	Deutsche EuroShop	
Belgium	Dyckerhoff	**Malta**
Agfa	Henkel	Maltacom
Belgacom	Hypo Real Estate	Middlesea
GBL	Koenig & Bauer	
	Lufthansa	**Poland**
Cyprus	Metro	Bank BPH
Bank of Cyprus	Mobilcom	TVN
Vassiliko	MTU	
	Munich Re	**Slovakia**
Czech Republic	RWE	Slovnaft
CEZ	Schering	Tatra banka
Komerční Banka	Südzucker	
		Sweden
Denmark	**Hungary**	Telia Sonera
Novo Nordisk	Gedeon Richter	
	Magyar Telekom	**UK**
Estonia	OTP Bank	Kazakhmys
Eesti Telekom		
Harju Elekter	**Italy**	
	Recordati	
Finland		
Nokia	**Latvia**	
Stora Enso	DnB Nord Banka	
	Ventspils nafta	

Some first-time adopters had, in fact, issued IAS or IFRS consolidated financial statements prior to 2005 but had ceased that practice prior to 2005. **Saint-Gobain** (France) and **LVMH** (France) issued IAS financial statements until 1998. **Technip** (France) issued IAS financial statements until 2002. **PKN Orlen** (Poland) issued IFRS consolidated financial statements until 2004 but disclosed non-compliance with specific

aspects of IAS 16 *Property, Plant and Equipment* and IAS 29 *Financial Reporting in Hyperinflationery Economies*. Some other first-time adopters had presented partial IAS/IFRS information in prior periods, for example **Delhaize** (Belgium), **Dexia** (Luxembourg), **OTE** (Greece), **Enel** (Italy), **Fiat** (Italy), **ING** (Netherlands) and **Telefónica** (Spain).

All these companies were first-time adopters in 2005 because they had not included an explicit and unreserved statement of compliance with IFRS in their 2004 financial statements. Therefore, they were required to apply IFRS 1 and were able to make use of the exemptions and exceptions in IFRS 1.

11.3 Restatement of comparative period

IFRS requirements

IFRS 1 requires that an entity's first IFRS financial statements shall include at least one year of comparative information under IFRS. An entity's date of transition to IFRS is the beginning of the earliest period for which it presents full comparative information.

IFRS 1 requires that an entity shall use the same accounting policies in its opening IFRS balance sheet and throughout all periods presented in its first IFRS financial statements. Subject to some exemptions, those accounting policies shall comply with each IFRS effective at the reporting date for its first IFRS financial statements.

In the first IFRS financial statements for accounting periods beginning before 1 January 2006 (which is all the financial statements under review), the comparative information need not comply with IAS 32, IAS 39 or IFRS 4 *Insurance Contracts*. These concessions were intended to assist the timely transition to IFRS for first-time adopters.

Sample 1 results – general requirement for restatement of comparative period

All first-time adopters complied with the general requirement to restate their comparative period, except for **Lietuvos Dujos** (Lithuania) and **Orco** (Czech Republic). **Lietuvos Dujos** did not restate any of their comparative period and **Orco** did not restate one component of an IAS 12 *Income Taxes* requirement and one component of an IAS 14 *Segment Reporting* requirement. Both of these companies disclosed their non-compliance with these requirements and further details and an extract from their disclosures can be found in Chapter 8.

Sample 1 results – exemptions from the requirement to restate comparative information

Almost half the first-time adopters elected to take the exemption to not restate their comparative periods for IAS 32 and IAS 39. Table 11.2 shows whether first-time adopters restated the prior period for IAS 32. Table 11.3 shows whether first-time adopters restated the prior period for IAS 39.

Companies who did not restate the comparative period include several banks for whom the effects of IAS 39 might have been significant, for example **KBC** (Belgium), **BNP Paribas** (France), **Crédit Agricole** (France), **National Bank of Greece** (Greece), **Allied Irish Bank** (Ireland), **Unicredit** (Italy), **ING (**Netherlands), **Nordea Bank** (Sweden), **Lloyds TSB** (UK), **Northern Rock** (UK) and **Royal Bank of Scotland** (UK).

Table 11.2: Restatement of comparative period for IAS 32

	Number	Percentage
Prior period restated to comply with IAS 32	91	60.3
Prior period not restated to comply with IAS 32	60	39.7
Total	**151**	**100**

Table 11.3: Restatement of comparative period for IAS 39

	Number	Percentage
Prior period restated to comply with IAS 39	84	55.6
Prior period not restated to comply with IAS 39	67	44.4
Total	**151**	**100**

As explained in Chapter 18, three insurance companies elected to take the exemption to not restate their comparative periods for IFRS 4: **Irish Life & Permanent** (Ireland), **ING** and **Prudential** (UK). Those banks with insurance activities that did not restate their comparative periods for IAS 39 also did not restate their comparative periods for IFRS 4.

11.4 Optional exemptions from retrospective application of other IFRS

IFRS requirements

IFRS 1 allows exemptions from full retrospective application of some IFRS requirements on first-time adoption of IFRS. The IASB allowed these exemptions because retrospective application might have involved creating data that had not been captured in the past, collecting or estimating information retrospectively, creating significant costs for preparers or failing to deliver any benefits for users. An entity was not required to use any of the exemptions or to justify its use of the exemptions.

Continuing IFRS adopters were not able to use these exemptions.

Sample 1 results – business combinations

IFRS 1 allows a first-time adopter to apply IFRS 3 *Business Combinations* (and related standards) to business combinations occurring on or after its transition date to IFRS (or from an earlier date, subject to conditions).

Where applicable, all first-time adopters used this exemption and, therefore, did not restate all pre-transition date business combinations. A few companies did restate some pre-transition business combinations. **Faurecia** (France) for example applied IFRS 3 from the date of a major acquisition in 2001.

LVMH applied IFRS 3 and related standards to the merger of Moët Hennessy and Louis Vuitton in 1987 and all subsequent acquisitions. In 1987, the merger of Moët Hennessy and Louis Vuitton was accounted for using the pooling of interests method which did not require the determination of the fair values of the acquiree's assets and liabilities or the recognition of any acquired intangible assets and goodwill. **LVMH** explains:

> 'Use of the pooling of interests method is not admitted under IFRS since it is assumed that whatever the nature of a transaction, it is always possible to identify an acquirer and an acquiree. IFRS 3 lists a certain number of indications to help in identifying the acquirer and in particular, the split of voting rights following the transaction. As the previous stockholders of MH controlled approximately 60% of the voting rights of the new group following this transaction, it has been judged that for the purposes of IFRS 3, the transaction consisted in the acquisition of LV by MH and as a result the Louis Vuitton brand has been recognized in the Group's balance sheet.'

LVMH further explains**:**

> 'The difference between the acquisition cost of LV and the corresponding net assets disclosed in LV's accounts, originally recognized as a deduction from stockholders' equity, has been mainly allocated to the Louis Vuitton brand for an amount of 2.1 billion euros (1.3 billion euros net of deferred tax as of January 1, 2004).
>
> 'The Louis Vuitton brand has been valued at an identical amount to that adopted in Christian Dior's consolidated accounts when it acquired LVMH in 1988.'

Sample 1 results – deemed cost of property, plant and equipment

IFRS 1 allows an entity to measure an item of property, plant and equipment at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date. IFRS 1 also allows an entity to use a national GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to IFRS as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to either fair value or cost or depreciated cost under IFRS, adjusted to reflect, for example, changes in a general or specific price index.

Table 11.4 shows the extent to which first-time adopters of IFRS used fair values or other amounts as the deemed cost of items of property, plant and equipment.

Table 11.4: Deemed cost of property, plant and equipment on first time adoption of IFRS

	Number	Percentage
Fair value at transition date (Table 11.5)	18	12.0
Previous GAAP revaluation to fair value (Table 11.6)	13	8.6
Previous GAAP cost adjusted to reflect changes in a general price index	4	2.6
Previous GAAP cost adjusted to reflect changes in a specific price index	1	0.6
Unspecified previous GAAP carrying amounts	3	2.0
No deemed costs	112	74.2
Total	**151**	**100**

Table 11.5 lists the first-time adopters that used fair value at transition date as deemed cost.

Table 11.5: Use of fair value at transition date as deemed cost

Czech Republic	**Lithuania**	**UK**
Orco	Lietuvos Dujos	Northern Rock
		PZ Cussons
France	**Poland**	Royal Bank of Scotland
AXA	PKN Orlen	
Greece	**Slovenia**	
Agrotiki Insurance	KRKA	
	Sava	
Italy		
Datalogic	**Spain**	
Ducati Motor	Ence	
Enel	OHL	
Generali		
L'Espresso		
Marr		

Table 11.6 lists the first-time adopters that used national GAAP revaluations to fair value as deemed cost. The use of this approach by Irish and UK companies is not surprising as Irish and UK GAAP include similar options.

Table 11.6: Use of national GAAP revaluations to fair value as deemed cost

France	**Portugal**
Bic	Brisa
Klépierre	EDP
Société Générale	
Vallourec	**Slovenia**
	Sava
Ireland	
Allied Irish Banks	**UK**
CRH	Cadbury Schweppes
Waterford Wedgwood	Redrow
Italy	
Unicredit	

Generali (Italy) used fair value as the deemed cost for some of its agricultural properties and own-use land and buildings because of 'difficulties' in measuring them at depreciated cost. It used Italian GAAP cost adjusted for changes in prices for other real estate.

Telecom Italia (Italy) uses 'revalued costs' as the deemed cost of assets existing at transition date. No further information is disclosed and the reconciliation of equity at transition date does not include an adjustment for the revaluation of any property, plant

and equipment. The prior period's Italian GAAP financial statements referred only to measurement at cost.

Sample 1 results – deemed cost of intangible assets

IFRS 1 allows an entity to measure an intangible asset at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date. IFRS 1 also allows an entity to use a previous GAAP revaluation of an intangible asset at, or before, the date of transition to IFRSs as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to either fair value or cost or depreciated cost under IFRS, adjusted to reflect, for example, changes in a general or specific price index. IFRS 1 allows this exemption only if the intangible asset meets the recognition and revaluation criteria in IAS 38 *Intangible Assets*.

No companies used fair value or revaluations as the deemed cost of intangible assets. This is consistent with the fact that no companies used the revaluation model for intangible assets (see Chapter 17).

Sample 1 results – actuarial gains and losses

IFRS 1 allows an entity to:

- recognise on its transition balance sheet the net amount of the present value of the defined benefit obligation and the fair value of plan assets; and
- apply the corridor approach (or some other form of deferral and amortisation permitted by IAS 19) from the beginning of its comparative period under IFRS.

All the companies that elected to use the corridor approach used this exemption.

Sample 1 results – cumulative translation differences

IFRS 1 allows an entity to deem the amount of cumulative translation differences included in equity at transition date to be zero. Therefore, these differences will be excluded from the gain or loss reported on the subsequent disposal of any foreign operation held at transition date.

Where applicable, all Sample 1 companies used this exemption.

Sample 1 results – compound financial instruments

IFRS 1 allows an entity not to separate the liability and equity components of compound instruments when the liability component was no longer outstanding at transition date.

Where applicable, all Sample 1 companies used this exemption.

Sample 1 results – share-based payments

IFRS 1 and IFRS 2 *Share-based Payment* allow an entity not to account in accordance with IFRS 2 for:

- equity instruments granted on or before 7 November 2002; and
- equity instruments granted after 7 November 2002 that had vested prior to its transition date.

An entity using these exemptions accounted only for any issue of shares arising from these instruments.

Where applicable, all Sample 1 companies used this exemption.

11.5 Exceptions from retrospective application of other IFRS requirements

On first-time adoption of IFRS, IFRS 1 prohibits retrospective application of some aspects of other IFRS relating to:

- derecognition of financial assets and financial liabilities (IAS 39);
- hedge accounting (IAS 39);
- estimates; and
- assets classified as held for sale and discontinued operations (IFRS 5).

Sample 1 results

All relevant Sample 1 companies appear to have complied with these exceptions and therefore complied with this IFRS 1 requirement.

12. Fair presentation and accounting policies

12.1 Key points

IAS 1 *Presentation of Financial Statements* requires that IFRS financial statements present fairly an entity's financial position, financial performance and cash flows. The 198 companies from Sample 1 that disclose full compliance with IFRS-EU, IFRS or both state that their financial statements present fairly in accordance with IFRS-EU, IFRS or both. The audit reports express the same opinion.

IAS 1 requires an entity to depart from the requirements of an IFRS in extremely rare circumstances in which compliance with the requirement would be so misleading that it would conflict with the objective of financial statements set out in the IASB *Framework*. None of the companies in Sample 1 used this fair presentation override.

IAS 1 requires disclosure of the accounting policies used that are relevant to an understanding of the financial statements. All the companies in Sample 1 disclose their accounting policies, but there is too much standard wording or 'boilerplating' and little evidence of adaptation of accounting policies to suit companies' circumstances. More attention also needs to be paid to the disclosure of judgements made in applying accounting policies, the use of estimates and the impact of new and revised IFRS. Various securities regulators have identified the disclosure of accounting policies as an area of concern.

The IASB generally allows the early adoption of new or revised IFRS that are not mandatory for a period. It also requires an entity to make disclosures about the possible impact of new or revised IFRS that are not yet effective, but have been issued prior to approval of the entity's financial statements. These disclosures should include the possible impact of the new or revised IFRS. The following new or revised IFRS were early adopted:

- 6 companies adopted IFRS 7 *Financial Instruments: Disclosures;*
- 60 companies adopted the amendment to IAS 19 *Actuarial Gains and Losses, Group Plans and Disclosures*;
- 19 companies adopted the amendment to IAS 39 *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*;
- 36 companies adopted the amendment to IAS 39 *The Fair Value Option*;
- 5 companies adopted the amendment to IAS 39 *Financial Guarantee Contracts*;
- 8 companies adopted IFRIC 4 *Determining whether an Arrangement Contains a Lease*; and
- 3 companies adopted IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*.

12.2 Fair presentation

IFRS requirements

IAS 1 requires that IFRS financial statements present fairly the financial position, financial performance and cash flows of an entity. The application of IFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. This fair presentation principle is similar, if not identical, to the requirement in Article 2 of the Fourth Directive that accounts shall give a true and fair view of a company's assets, liabilities, financial position and profit or loss.

Sample 1 results

None of the IFRS consolidated financial statements disclosed that they did not present fairly the financial position, financial performance and cash flows of the company concerned. Indeed, many included a positive statement that they did present fairly the financial position, financial performance and cash flows of the company.

The audit reports on all the IFRS consolidated financial statements include an opinion that the financial statements either presented fairly or showed a true and fair view in accordance with IFRS-EU, IFRS or both IFRS-EU and IFRS (Table 12.1).

Table 12.1: Audit opinions and fair presentation

	Number	Percentage
True and fair view or present fairly in accordance with IFRS-EU	180	90
True and fair view or present fairly in accordance with IFRS	4	2
True and fair view or present fairly in accordance with both IFRS-EU and IFRS	16	8
Total	**200**	**100**

The audit opinions for the financial statements of 156 companies are expressed in terms of ‘a true and fair view’. The audit opinions for the financial statements of 43 companies are expressed in terms of ‘present fairly’. The preponderance of ‘true and fair view’ opinions probably reflects the influence of the Fourth Directive.

Deloitte’s audit opinion on the IFRS consolidated financial statements of **Vodafone** (UK) referred to ‘a true and fair view’ in accordance with IFRS-EU and ‘present fairly’ in accordance with IFRS. The distinction probably reflects the fact that compliance with IFRS-EU is required by the EU IAS Regulation while the US SEC is also interested in compliance with IFRS.

12.3 Fair presentation override

IFRS requirements

IAS 1 requires an entity to depart from the requirements of an IFRS in the extremely rare circumstances in which compliance with the requirement would be so misleading that it would conflict with the objective of financial statements set out in the IASB *Framework.* This ‘fair presentation override’ is similar, if not identical, to the requirement in Article 2 of the Fourth Directive that an entity must depart from a provision of the Directive where, in exceptional cases, its application is incompatible with the obligation to give a true and fair view.

Sample 1 results

None of the Sample 1 consolidated financial statements disclosed the use of the fair presentation override.

In its 2004 annual report, **Danske Bank** (Denmark) indicated its intention to use the fair presentation override in its first IFRS consolidated financial statements in order to use the fair value option in the 2004 version of IAS 39 which, at that time, had not been adopted by the EU and, therefore, conflicted with IFRS-EU. As the EU adopted the revised fair value option in the amendment to the IAS 39 in December 2005, **Danske Bank** was able

to use the amended fair value option in its 2005 IFRS consolidated financial statements without invoking the fair presentation override.

We are unaware of any other instances in which any of the Sample 1 companies considered the use of the fair presentation override in their IFRS consolidated financial statements.

12.4 Disclosure of accounting policies

IFRS requirements

IAS 1 requires the disclosure of the accounting policies used that are relevant to an understanding of the financial statements. When deciding what policies to disclose, an entity should consider the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity.

Sample 1 results

All companies presented a summary of accounting policies. For the substantial majority of companies, these accounting policies are either the repetition of the exact wording in the appropriate IFRS or are standard summaries of that wording. This is sometimes referred to as 'boilerplate' disclosure or 'boilerplating'.

There are numerous instances of companies:

- failing to disclose in their accounting policies how they have applied the principles in the appropriate IFRS; or
- disclosing accounting policies which appear to be irrelevant.

Frequently occurring examples of the problems include:

- revenue recognition accounting policies that summarise IAS 18 *Revenue* rather than explaining how and when the company recognises revenue on its particular transactions;
- hedge accounting policies that summarise IAS 39 *Financial Instruments: Recognition and Measurement* instead of explaining its application by the company (in many cases, the companies appear not to use hedge accounting even though they disclose accounting policies for it);
- accounting policies for financial assets that do not explain what instruments are included in each category or how the balance sheet classifications relate to the four categories in IAS 39;
- accounting policies for available-for-sale financial assets in the financial statements of companies that either do not have such assets or, if they do, do not measure them at fair value or include the unrealised gains and losses in equity;
- accounting policies that explain the treatment of indefinite lived intangible assets in the financial statements of companies that appear not to have such assets; and
- accounting policies that explain the criteria used to capitalise internally generated intangible assets (including development costs) in the financial statements of companies that appear not to undertake such activities.

Securities regulators in the EU, as well as the SEC in the United States, have identified this as a matter of concern. For example, the Finnish regulator FIN-FSA comments in its review of the IFRS consolidated financial statements of Finnish publicly traded companies:

> 'Accounting policy description should be disclosed on issues that are relevant to the company's business. In many financial statements, it remained unclear

whether and how the disclosed accounting policy was relevant to the company's business. Some companies for example presented in the section of accounting policies a definition of investment property although they did not have any assets classified as investment property in their balance sheet.'

In its report on the 2005 IFRS consolidated financial statements of publicly traded companies in the UK, the FRRP observed:

> 'There was also a tendency for companies to include boilerplate descriptions of accounting policies. In some cases, it appeared that the wording of accounting policies had been copied from the relevant standards with no indication of company specific application.
>
> Standardised disclosures have a limited use especially when the policy is prescribed by IFRS. Descriptions of accounting policies are more useful when they identify issues relevant to a company's individual circumstances. For example, revenue recognition policies may need to describe the methods applied to determine the stage of completion of transactions involving the rendering of services. As the methods used will vary according to the nature of the circumstances it is helpful that the policy includes specific relevant details.
>
> …
>
> In other cases, there was also evidence of boilerplating in the accounting policies selected for disclosure. For example accounting policy descriptions were given which, on enquiry, were found to be irrelevant since there were no underlying accounting transactions falling within their scope. This issue arose, in particular, in relation to the descriptions of accounting policies for hedging instruments which appear to have been copied from IAS 39, whether or not such hedges were used in practice.'

The AMF, the French securities regulator, urged French publicly traded companies to improve:

> 'It should be stressed, however, that disclosure presented under the heading significant accounting policy must not simply reproduce the main provisions of the accounting standards in question. This would have little informative benefit and would probably drastically inflate the volume of the notes. Information tailored to the specific characteristics of the entity is of more interest to the user.'

The AMF paper gives revenue recognition as an example of the problem. It suggests: 'A mere mention that revenue is recognised when acquired is too brief to enable the user to understand the major element of the entity's activities.'

While the US SEC has not issued a general statement about the disclosure of accounting policies in IFRS financial statements, many of the comments in its letters to foreign issuers ask for a commitment to improved disclosure in future filings.

The disclosure of accounting policies is clearly an area where there is scope for improvement.

Comments at the roundtables

At the roundtables held in July and August 2007, there was general acceptance that, although there were examples of very good disclosure, boilerplate disclosures of accounting policies were an issue and the following observations were made:

- Preparers' attention had initially focused on what were seen to be more important questions of IFRS implementation. They would now be able to look at this issue and improvement should be possible.
- This process would be helped by the fact that there would now be examples from other companies' financial statements to look at and those from the same sector as the preparer would be especially useful.
- Required disclosures regarding IFRS issued but not yet applicable were unrealistic and so naturally resulted in boilerplate (IAS 8.30).
- Boilerplate disclosures for accounting policies were a problem generally, not just under IFRS.
- Concerns over translation encouraged direct quotation of IFRS requirements.

12.5 Disclosure of judgements and estimates

IFRS requirements

IAS 1 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. It also requires disclosures about key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Sample 1 results

As IAS 1 allows flexibility in the location of these disclosures, the information is sometimes difficult to find. It is also difficult for an external reviewer, who may be unfamiliar with the company, to know what disclosures to expect for a company.

We estimate that between a half and two third of companies make the disclosures in a separate statement that usually follows the statement of accounting policies. Some other companies disclose the information elsewhere. Some appear not to make any disclosures. For those that do make the disclosures there is some evidence of standard wording or 'boilerplating'. This is, therefore, another area where there is scope for improvement.

Securities regulators have also identified this as an area of concern. FIN-FSA (Finland) observes:

> 'More than half of the companies did not disclose information on the key assumptions concerning the future and the key sources of estimation uncertainty. Disclosures of accounting policies of several companies merely contained a short note with estimates and assumptions concerning the future are made when preparing the financial statements and the outcome may differ from the estimates and assumptions.'

The AMF has recommended that entities should 'improve their disclosures of the assumptions and sources of uncertainty relating to estimates made by management as of the balance sheet date whenever there is a significant risk that the estimated amounts will be materially adjusted during the following period.'

The FRRP (UK) commented:

> 'Disclosures [of the judgements that management has to make in applying the accounting policies and the key assumptions concerning the future that have a significant risk of causing a material adjustment to the carrying amount of assets or liabilities in the following year] showed significant variation. Some companies set out clearly both items with details relevant to their particular circumstances. Other companies did not appear to have made any specific disclosure although they may have made similar disclosures with respect to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.'

Comments at the roundtables

At the roundtables held in July and August 2007 it was noted that the requirements for disclosures on key judgements, estimates, and assumptions were new and often commercially sensitive, and so had presented – and continued to present – a real challenge for preparers and even required a change of culture in some jurisdictions.

12.6 Early adoption of IFRS

IFRS requirements

The IASB generally allows, and usually encourages, the early adoption of new or revised IFRS that are not mandatory for a period. It also requires an entity to make disclosures about any new or revised IFRS that have been issued by the IASB prior to the approval of the financial statements, which are not yet effective and which have not been applied by the entity. Such disclosures include the possible impact that the new or revised IFRS will have on the entity's financial statements in the period of initial application.

The EU permits the early adoption of an IFRS which has not yet been adopted by the EU and which, therefore, is not mandatory for a period provided that:

- disclosure is made of the fact that the new or revised IFRS has been adopted prior to its adoption by the EU; and
- the new or revised IFRS does not conflict with EU adopted IFRS.

In their first IFRS consolidated financial statements prepared under the IAS Regulation, companies could have early adopted IFRS 7 *Financial Instruments: Disclosures* and the related amendment to IAS 1, an amendment to IAS 19, three amendments to IAS 39 and (depending on the timing of the publication of the financial statements) up to nine IFRIC interpretations. Many of these other new and revised IFRS, including the new interpretations, were unlikely to have a material effect on many companies (and may therefore not have been early adopted) either because:

- they dealt with specialised circumstances which did not affect many companies; or
- they introduced new optional accounting treatments which many companies might elect not to adopt.

Therefore, an entity could disclose that:

- it had early adopted one or more of these new or revised IFRS notwithstanding that adoption had no effect on their IFRS financial statements; or
- it had not adopted the new or revised IFRS and that it was still considering the possible implications.

Table 12.2 shows the number of Sample 1 companies out of 200 early adopting those IFRS that were not mandatory in the year under review but which were available for early adoption.

Table 12.2: Early adoption of IFRS

Standard	Number	Percentage
IFRS 7 *Financial Instruments: Disclosures* and *IAS 1 Capital Disclosures*	6	3
Amendment to IAS 19 *Actuarial Gains and Losses, Group Plans and Disclosures*	60	30
Amendment to IAS 39 *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*	19	9.5
Amendment to IAS 39 *The Fair Value Option*	36	18
Amendment to IAS 39 *Financial Guarantee Contracts*	5	2.5
IFRIC 4 *Determining whether an Arrangement Contains a Lease*	8	4
IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration, and Environmental Rehabilitation Funds*	3	1.5
IFRIC 6 *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*	0	0
IFRIC 7 *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies*	0	0
IFRIC 8 *Scope of IFRS 2*	0	0
IFRIC 9 *Reassessment of Embedded Derivatives*	0	0
IFRIC 10 *Interim Financial Reporting and Impairment*	0	0
IFRIC 11 IFRS 2 – *Group and Treasury Share Transactions*	0	0
IFRIC 12 *Service Concession Arrangements*	0	0

Sample 1 results – IFRS 7 *Financial Instruments: Disclosures* and IAS 1 *Presentation of Financial Statements* (Capital Disclosures)

IFRS 7 and the related amendment to IAS 1 are effective for accounting periods beginning on or after 1 January 2007. They were issued by the IASB in August 2005 and adopted by the EU in January 2006.

Six companies, including three banks, early adopted IFRS 7 (Table 12.3). The low number is not surprising as IFRS 7 and the related amendment to IAS 1 may have a significant effect on the disclosures in IFRS consolidated financial statements of most of the 200 Sample 1 companies. IFRS 7 does not, however, affect any accounting measurement requirements.

Table 12.3: Early adoption of IFRS 7

Denmark	Sweden	UK
Danske Bank	Nordea Bank	Diageo
Finland		First Choice
Sampo		Vodafone

Sample 1 results – amendment to IAS 19 *Actuarial Gains and Losses, Group Plans and Disclosures*

The amendment to IAS 19 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in December 2004 and adopted by the EU in November 2005. The amendment to IAS 19 allows an additional optional accounting treatment which an entity may or may not choose to apply. Therefore, an entity that disclosed that it has early adopted the amendments could have been:

- using the new optional accounting treatment of recognising all actuarial gains and losses in full and immediately in equity; or
- continuing with its previous, different accounting treatment.

We identified 60 companies (Table 12.4) that early adopted the amendment to IAS 19 (see Table 15.3 – some companies specify that the amendment had been adopted early). Of these 60 companies, 54 (see Chapter 15) used the new optional treatment.

Table 12.4: Early adoption of amendment to IAS 19

Austria	**Netherlands**	Headlam
Voestalpine	Royal Dutch Shell	Inchcape
	Unilever	Jardine Lloyd Thompson
Denmark	Wolters Kluwer	McBride
Møller - Mærsk		Northern Rock
Novo Nordisk	**Portugal**	Provident Financial
	Brisa	Prudential
Finland	EDP	PZ Cussons
Neste Oil		Redrow
	Spain	Rentokil
France	Abertis	Royal Bank of Scotland
AXA	Endesa	Royal & SunAlliance
Cegid		SAB Miller
Gaz de France	**UK**	Tesco
Havas	3i	Tomkins
SCOR	Anglo American	Tribal
	BHP Billiton	Vodafone
Germany	BP	WSP
BASF	British Land	
BMW	BT	
Henkel	Burren Energy	
Hypo Real Estate	Cadbury Schweppes	
Schering	Cobham	
Thiel Logistik	Dairy Crest	
	Diageo	
Ireland	EMI	
Allied Irish Bank	First Choice	
CRH	FKI	
Kerry	Fuller, Smith & Turner	
Waterford Wedgwood	GlaxoSmithKline	

The amendment to IAS 19 incorporates the UK and Irish requirements of FRS 17 *Retirement Benefits* into IFRS, hence its early adoption by virtually all Irish and UK companies is not surprising. The only Irish company that does not early adopt the amendment to IAS 19 is **Irish Life & Permanent** which uses the corridor approach. The only UK companies that have defined benefit plans and which did not early adopt the amendment are **BG**, **British American Tobacco**, **Kazakhmys** and **Lloyds TSB** all of which use the corridor approach.

The following six companies early adopted the amendment to IAS 19 but elected not to include actuarial gains and losses in equity. In other words they did not use the new optional accounting treatment permitted by the amendment: **Novo Nordisk** (Denmark), **Neste Oil** (Finland), **Hypo Real Estate** (Germany), **Royal Dutch Shell** (Netherlands), **Burren Energy** (UK) and **Prudential** (UK).

As explained in Chapter 13, eight companies included actuarial gains and losses in equity but did not present a statement of recognised income and expenses. Therefore, they did not comply with IAS 19 and the consequential amendment to IAS 1.

Sample 1 results – amendment to IAS 39 *Financial Instruments: Recognition and Measurement – Cash Flow Hedge Accounting of Forecast Intragroup Transactions*

The amendment to IAS 39 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in April 2005 and adopted by the EU in November 2005.

Table 12.5 lists the 19 companies that early adopted this amendment to IAS 39. Some of these companies might not use cash flow hedge accounting for forecast intragroup transactions.

Table 12.5: Early adoption of amendment to IAS 39 – *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*

Denmark	**Germany**	**Sweden**
Novo Nordisk	BMW	Telia Sonera
	Deutz	
France	Hypo Real Estate	**UK**
Faurecia		BP
Hermès	**Luxembourg**	Northern Rock
L'Oréal	Dexia	Provident Financial
LVMH		Vodafone
SanofiAventis	**Netherlands**	
Société Générale	Philips	
Vallourec	Royal Dutch Shell	

Sample 1 results – amendment to IAS 39 *Financial Instruments: Recognition and Measurement – The Fair Value Option*

The amendment to IAS 39 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in June 2005 and adopted by the EU in December 2005. The early adoption of this amendment was essential for a company reporting under IFRS-EU that wished to use the fair value option.

Table 12.6 lists the 36 companies that disclosed that they had early adopted the amendment to IAS 39 dealing with the fair value option. An entity could early adopt the change to fair value option and either:

- use the option for the measurement of some financial assets or financial liabilities; or
- not use the fair value option.

Table 12.6 includes 29 banks and insurance companies that use the fair value option. Two banks and two insurance companies disclose early adoption of the amendment but appear not to have used the fair value option in their financial statements. It seems that 12 banks and insurance companies have used the fair value option but have not disclosed their early adoption of the amendment to IAS 39. Further information about the use of the fair value option by banks and insurance companies is included in Chapters 17 and 18.

France Telecom (France) used the fair value option for non-current financial assets that are not held for trading. This appears to include small amounts of loans and receivables.

Wolters Kluwer (Netherlands) used the fair value option for its unsubordinated convertible bond loan instead of treating the convertible bond as a compound financial instrument and measuring the debt component at amortised cost.

Telefónica (Spain) used the fair value option to eliminate or mitigate ‘measurement or recognition inconsistencies’ and for financial assets for which an ‘investment and disposal strategy has been designed based on fair value’.

Novo Nordisk (Denmark), **Royal Unibrew** (Denmark), **Telia Sonera** (Sweden) and **Vodafone** (UK) appear not to have used the fair value option in their financial statements.

Table 12.6: Early adoption of amendment to IAS 39 – *The Fair Value Option*

Country	Companies
Austria	Wiener Staedtische
Belgium	Fortis; KBC
Cyprus	Bank of Cyprus
Denmark	Danske Bank; Novo Nordisk; Royal Unibrew
Finland	Sampo
France	AXA; BNP Paribas; Credit Agricole; France Telecom; Société Générale
Germany	Allianz; Commerzbank; Hypo Real Estate
Greece	National Bank of Greece
Ireland	Allied Irish Bank; Irish Life & Permanent
Italy	Generali; Unicredit
Luxembourg	Dexia
Malta	Middlesea
Netherlands	ABN Amro; ING; Wolters Kluwer
Poland	BPH
Spain	Banco Pastor; Santander; Telefónica
Sweden	Nordea Bank; Telia Sonera
UK	Lloyds TSB; Prudential; Royal Bank of Scotland; Vodafone

Sample 1 results – amendment to IAS 39 *Financial Instruments: Recognition and Measurement – Financial Guarantee Contracts*

This amendment to IAS 39 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in August 2005 and adopted by the EU in January 2006.

Table 12.7 lists the five Sample 1 companies that disclosed that they had early adopted the amendment to IAS 39 dealing with financial guarantee contracts.

Table 12.7: Early adoption of IAS 39 – *Financial Guarantee Contracts*

Country	Companies
Germany	Hypo Real Estate
Sweden	Telia Sonera
UK	Northern Rock; Provident Financial; Vodafone

Sample 1 results – IFRIC 4 *Determining whether an Arrangement Contains a Lease*

IFRIC 4 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in December 2004 and adopted by the EU in November 2005.

Table 12.8 lists the eight companies that disclosed that they had early adopted IFRIC 4.

Table 12.8: Early adoption of IFRIC 4

Czech Republic	**France**	**UK**
Orco	France Telecom	Anglo American BP Northern Rock
Denmark	**Netherlands**	
Novo Nordisk	Philips Royal Dutch Shell	

Orco (Czech Republic) discloses that IFRIC 4 'has no impact on the accounting for any of the Group's current arrangements'.

Novo Nordisk discloses that the adoption of IFRIC 4 did not lead to significant changes in the amounts reported.

Northern Rock (UK) early adopted all possible IFRS but is unlikely to have been affected by IFRIC 4.

France Telecom, **Philips** (Netherlands) and **Royal Dutch Shell** (Netherlands) did not disclose any effects of the adoption of IFRIC 4.

Sample 1 results – IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration, and Environmental Rehabilitation Funds*

IFRIC 5 applies to accounting periods beginning on or after 1 January 2006. It was issued by the IASB in December 2004 and adopted by the EU in November 2005.

Table 12.9 lists the three companies that early adopted IFRIC 5.

Table 12.9: Early adoption of IFRIC 5

UK
Anglo American
BHP Billiton
Northern Rock

Anglo American (UK) made voluntary contributions to controlled funds that were established to meet the cost of some of its decommissioning, restoration and environmental rehabilitation liabilities in South Africa.

BHP Billiton (UK) did not refer to any funds within the scope of IFRIC 5.

Northern Rock early adopted all possible IFRS but is unlikely to have been affected by IFRIC 5.

13. Financial statements presentation

13.1 Key points

IAS 1 *Presentation of Financial Statements* requires that a complete set of IFRS financial statements should consist of six specified components and lays down requirements for each of these component parts of the financial statements.

All 200 companies in Sample 1 presented consolidated financial statements that include the necessary components: a balance sheet, income statement, statement of changes in equity, cash flow statement, statement of accounting policies and notes. There were no instances of material non-compliance except for a number of companies which included actuarial gains and losses in equity but did not present a statement of recognised income and expenses as required by IAS 19 *Employee Benefits*, as amdned, and the related amendment to IAS 1.

Many companies report operating profit, earnings before interest, tax, depreciation and amortisation (EBITDA) or some other measure that they appear to believe better portrays their performance. In many cases, these alternative measures are incorporated onto the face of the income statement. More often, they are presented outside the financial statements. This has attracted some attention from securities regulators who have expressed concern about such disclosure.

13.2 Components of IFRS financial statements

IAS 1 requires that a complete set of IFRS financial statements should consist of:

- a balance sheet;
- an income statement;
- a statement of changes in equity showing either:
  - all changes in equity; or
  - changes in equity other than those arising from transactions with equity holders (known as a statement of recognised income and expense);
- a cash flow statement;
- a summary of significant accounting policies; and
- other explanatory notes.

Sample 1 results

All the companies present financial statements that include the six components. However, as explained below, some companies do not present the correct form of statement of changes in equity.

13.3 Income statement

IFRS requirements

IAS 1 also requires that all items of income and expense recognised in a period shall be included in profit or loss unless another IFRS requirement requires otherwise.

IAS 1 requires the following line items on the face of the income statement:

- revenue;
- finance costs;

- share of profits or losses of associates and joint ventures accounted for using the equity method;
- tax expense; and
- profit or loss.

IAS 1 requires the disclosure of an analysis of expenses using a classification based on either their function or nature, whichever provides information that is reliable and more relevant. Under the function classification, the income statement includes such items as:

- cost of sales;
- gross profit;
- other income;
- distribution costs;
- administrative expenses; and
- other expenses.

An entity using this classification must also disclose depreciation and amortisation expenses and employment benefit expense.

Under the nature classification, the income statement includes such items as:

- change in inventories of finished goods and work in progress;
- raw materials and consumables used;
- employee benefits expense;
- depreciation and amortisation expense;
- other operating expenses;
- other income; and
- other expenses.

Income and expense

All companies included all items of income and expense recognised in the period in profit or loss unless another IFRS requirement required otherwise. We did not identify any material items that were incorrectly excluded from the income statement. IAS 30 *Disclosures in Financial Statements of Banks and Similar Institutions*, contains specific requirements relating to the disclosures in the income statement of relevant entities.

Presentation of income statement

All companies presented income statements that disclosed the required items.

A substantial minority of companies presented a net amount of finance costs. The IASB has confirmed that the gross amounts of finance income and finance expenses should be disclosed on the face of the income statement.

IAS 1 does not require the disclosure of the results of operating activities. However, the 'Basis for Conclusions' to IAS 1 states:

> 'In the Board's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.'

Many companies reported operating profit, earnings before interest, tax, depreciation and amortisation (EBITDA) or some other measure that they appear to believe better portrays their performance. In many cases, these alternative measures were incorporated onto the face of the income statement. In even more cases, they were presented outside the financial statements. In a few cases, these alternative measures affected the disclosure of earnings per share (see below).

We have not analysed or attempted to summarise all the alternative performance measures reported by Sample 1 companies. We are aware, however, that securities regulators are concerned about such disclosures. The SEC regularly comments on them and asks for some to be removed from US filings.

In the UK, the FRRP believes that changes to the minimum presentation of the income statement required by IAS 1 should be justifiable. Following its review of the first IFRS consolidated financial statements of UK publicly traded companies, it drew the attention of companies to the requirement in IAS 1 that additional line items may be included or the items reordered only 'when this is necessary' to explain the elements of financial performance.

In 2004, the French standard setting body Conseil national de la Compatibilité (CNC) issued a recommended income statement format that it believes meets IFRS requirements. It did so because of the lack of a detailed framework for the presentation of financial performance. The CNC's recommendation includes a current operating result that differs from the actual operating results in so far as some operating income and expense items are excluded from it. The AMF, the French securities regulator, has lent its support to the CNC's recommendation because of 'the greater comparability that might result from them' and 'the better definitions of subtotals'.

Sample 1 results – analysis of expenses

Table 13.1 summarises the approaches adopted by Sample 1 companies. In some cases, it is difficult to determine which classification is used. Indeed, the AMF has observed that some companies chose a mixed approach that presented expenses both by nature and by function on the face of the income statement. The AMF believes that IAS 1 does not preclude using a mixed approach but does encourage the use of just one of the two forms of presentation.

The choices made by companies usually reflect practice under prior national GAAP but there is some evidence of companies switching from a nature classification under national GAAP to a function classification under IFRS.

Table 13.1: Disclosure of expenses in the income statement

	Number	Percentage
Function classification	81	40.5
Nature classification	73	36.5
Combination of both classifications	1	0.5
Banks, insurance companies and other financial institutions	45	22.5
Total	**200**	**100**

13.4 Earnings per share

IFRS requirements

IAS 33 *Earnings per Share* requires the disclosure of basic and, if appropriate, diluted earnings per share on the face of the income statement. It prohibits the disclosure of any other earnings per share amounts on the face of the income statement. Such disclosures may be made in the notes provided that they are calculated using the same number of shares.

Sample 1 results – disclosure of basic and diluted earnings per share

All but four companies disclosed basic earnings per share on the face of the income statement and all but five companies disclosed, if appropriate, diluted earnings per share on the face of the income statement (Table 13.2).

Table 13.2 Disclosure of earnings per share

	Number	Percentage
Disclosed in separate statement	1	0.5
Disclosed in notes	2	1
Not disclosed in financial statements	1	0.5
Per share amounts not disclosed on the face of the income statement	**4**	**2**
Basic earnings per share amounts disclosed on the face of the income statement: diluted earnings per share disclosed in notes	1	0.5
Full disclosure on the face of income statement	195	97.5
Total	**200**	**100**

Cegid (France) disclosed per share amounts in a separate table after the cash flow statement and statement of changes in equity but before the notes. As well as earnings per share calculated on consolidated net income (as required by IAS 33), the table includes per share amounts for income from ordinary activities before and after all income taxes. Income from ordinary activities excludes the effects of capital gains and losses on disposals, other operating expense, financial debt expense and other financial expense.

Banco Pastor (Spain) disclosed basic earnings per share in note 3; it did not have any potentially dilutive securities and, therefore, did not need to disclose diluted earnings per share.

Santander (Spain) disclosed basic and diluted earnings per share in note 4.

PKN Orlen (Poland) disclosed an accounting policy for the determination of earnings per share but did not disclose the amounts within its financial statements. Earnings per share, operating cash flow per share, assets per share and equity per share were included in the key financial figures inside the front cover of the annual report.

First Choice (UK) disclosed basic earnings per share on the face of the income statement. Diluted earnings per share were disclosed in note 9.

Sample 1 results – other per share amounts

There are 15 companies that disclosed additional per share amounts on the face of the income statement (Table 13.3). This approach does not comply with IAS 33.

Table 13.3: Disclosure of additional earnings per share amounts

	Number	Percentage
No other per share amounts disclosed on the face of the income statement	181	90.5
Additional per share amounts disclosed on the face of the income statement	15	7.5
Per share amounts not disclosed on the face of the income statement (Table 13.2)	4	2
Total	**200**	**100**

AXA (France) disclosed underlying earnings and adjusted earnings per share. Adjusted earnings are net income before the impact of exceptional operations, the effects of goodwill and intangible assets and profits or losses on some financial assets accounted for using the fair value option. Underlying earnings are adjusted earnings excluding realised capital gains.

L'Oréal (France) disclosed net profit before non-recurrent items per share. Non-recurrent items include capital gains and losses on non-current asset disposals, depreciation of tangible and intangible assets, restructuring costs and the effects of a tax rate change.

Technip (France) disclosed an additional diluted earnings per share which reflects the effects of all equity and compound financial instruments including those which are anti-dilutive.

Vivendi (France) disclosed adjusted earnings per share which excludes the effects of non-recurring and non-operating items such as 'other charges from operating activities'.

Hypo Real Estate (Germany) disclosed earnings per share before the tax effects of tax losses carried forward.

Imtech (Netherlands) disclosed earnings per share before the amortisation and impairment of intangibles and exceptional items.

Vedior (Netherlands) disclosed earnings per share before the effects of the disposal of subsidiaries and associates.

BG (UK) disclosed earnings per share for 'business performance' and 'disposals and re-measurements'.

EMI (UK) disclosed underlying earnings per share. Underlying earnings are earnings before 'operating exceptional items' and the amortisation and impairment of copyrights, intangibles and goodwill.

First Choice disclosed basic earnings per share and basic underlying earnings per share on the face of the income statement. Underlying earnings (a 'non-GAAP measure') exclude the net of tax effects of separately disclosed items, amortisation of business combination intangibles, impairment of goodwill.

Fuller, Smith & Turner (UK) disclosed earnings per share on a 'normalised basis' which excluded the net profit on the disposal of property.

Kazakhmys (UK) disclosed earnings per share based on underlying profit which excludes the effects of 'items which are non-recurring or variable in nature and which do not impact the underlying trading performance of the business.' The excluded items included the recognition of negative goodwill and write-offs of, and losses on, property, plant and equipment.

13.5 Statement of changes in equity

IFRS requirements

IAS 1 requires the presentation of a statement of changes in equity as a separate component of the financial statements. The statement should show:

- the net profit or loss for the period;
- each item of income and expense, gain or loss which is recognised directly in equity;
- the total of income, expenses, gains and losses which are recognised directly in equity; and
- the cumulative effect of changes in accounting policies and the correction of errors that are adjusted against retained earnings.

The statement or the notes should also disclose:

- capital transactions with owners;
- distributions to owners;
- retained earnings at the beginning and end of the period and movements for the period; and
- the carrying amount of each class of equity capital, share premium and each reserve at the beginning and end of the period and each movement in the period.

The statement may be presented as:

- a statement of changes in equity, that is as a reconciliation between the opening and closing balances of each component of shareholders' equity; or
- a statement of recognised income and expenses which is limited to the net profit or loss for the period and those items of income and expense, gain or loss which are recognised directly in equity – with this format, other changes in equity are shown in the notes.

Any entity that includes actuarial gains and losses in equity under the new approach allowed by the amendment to IAS 19 must present a statement of recognised income and expenses.

Sample 1 results

Table 13.4 summarises the approach adopted by companies.

Table 13.4: Presentation of statement of changes in equity

	Number	Percentage
Statement of changes in equity	140	70
Statement of recognised income and expense	47	23.5
Both a statement of changes in equity and a statement of recognised income and expenses	13	6.5
Total	**200**	**100**

There are 54 companies that included actuarial gains and losses in equity under the new approach allowed by the amendment to IAS 19 *Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures*. Of these, 46 companies presented a statement of recognised income and expenses as required by the amendment to IAS 19.

Eight companies included actuarial gains and losses in equity but did not present a statement of recognised income and expenses: **Voestalpine** (Austria)**, Møller - Mærsk** (Denmark)**, AXA, Cegid**, **SCOR** (France)**, Thiel Logistik** (Germany), **Brisa** (Portugal) and **British Land** (UK). Therefore, they did not comply with IAS 19 and the consequential amendment to IAS 1.

13.6 Cash flow statement

IFRS requirements

IAS 7 *Cash Flow Statements* requires the presentation of a cash flow statement that reports cash flows during the period classified by operating, investing and financing activities. Cash flows from operating activities may be reported using either:

- the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
- the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Sample 1 results

All companies presented a cash flow statement and reported cash flows from operating activities using the indirect method.

We have not reviewed the presentation of cash flow statements in detail. However, SEC comment letters highlight a recurring SEC concern about how companies determine cash flows from operating activities under the equity method. Many companies use as a starting point a measure of profit other than profit or loss after tax (the bottom line in the income statement). The SEC disagrees with these approaches. While acknowledging the possible lack of certainty in IAS 7 about the definition of 'profit or loss', the SEC suggests to several issuers that the use of the accounting policies hierarchy in IAS 8 should lead to the definition of 'profit or loss' in IAS 1. The SEC has requested a change in presentation in future financial statements. Companies have agreed to the request. Some have acknowledged a 'growing consensus' in support of the SEC's interpretation.

13.7 Roundtables and other discussions

It was observed that IAS 1 provided companies with more flexibility in their presentation of financial statements as compared with previous national GAAP requirements. Roundtables and other discussions revealed that there is significant interest from users of financial statements in the outcome of the current project being conducted by the IASB on financial presentation.

14. Fair value accounting

14.1 Key points

We found that use of fair value accounting under IFRS is much less extensive than is sometimes assumed to be the case, and is in fact very limited overall. In particular, where companies are given an option as to whether to use a cost or a fair value model, they typically choose a cost model.

Our analysis of the 200 Sample 1 companies found that:

- In addition to the mandatory use of fair value under IAS 39 *Financial Instruments: Recognition and Measurement* for certain financial assets and liabilities, 36 companies used the fair value option in IAS 39 to measure at fair value some financial assets and/or financial liabilities that would otherwise have been measured at amortised cost. 21 were banks and 8 insurers. The option was used selectively: the vast majority of the companies' financial assets and financial liabilities were measured on a historical cost basis.
- 199 held own-use property, plant and equipment. 8 used the revaluation model (fair value) for property, but no companies used it for plant and equipment.
- 81 held investment properties. Of these, 23 used the fair value model.
- No companies used the revaluation model (fair value) for intangible assets.
- 9 companies held biological assets. Of these, 5 used the fair value model.

At the roundtables, concern was expressed at the subjectivity of fair values in the absence of active and liquid markets, at the volatility that fair value can introduce in reported income, and at possible moves towards much greater use of fair value. Recent reports from users and surveys of users' and preparers' views show a significant level of opposition to more extensive use of fair values in IFRS.

14.2 Outline of existing requirements

Under IFRS, fair value is usually defined as:

> 'The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.'

The evolution of this definition and the use of fair values in IFRS are dealt with in D. Cairns (2006) and D. Cairns (2007).

Fair value accounting is not defined in IFRS but is generally understood to mean the measurement of an asset or liability at fair value at each balance sheet date and the inclusion of the resulting gains and losses in profit or loss. There is some concern that IFRS might require:

- the measurement of *all* assets and *all* liabilities at fair value at each balance sheet date; and
- the inclusion of all the resulting gains and losses in profit or loss.

For others, there is more a limited concern that IFRS might require:

- the measurement of *all financial* assets and *all financial* liabilities at fair value at each balance sheet date; and
- the inclusion of all the resulting gains and losses in profit or loss.

Currently, IFRS in fact require that all derivatives, other held-for-trading financial assets and financial liabilities and available-for-sale financial assets should be measured at fair value at each balance sheet date. IFRS allow virtually all other items to be measured at historical cost-based amounts at each balance sheet date.

Fair values are also used in IFRS (and some prior national GAAPs) for:

- on an optional basis – the measurement of property, plant and equipment (see 14.4 below);
- on an optional basis – the measurement of investment property (see 14.5 below);
- on an optional basis – the measurement of intangible assets (see 14.6 below);
- the measurement of biological assets (see 14.7 below);
- the measurement of items on their initial recognition in the financial statements;
- the allocation of compound transactions to their component parts; and
- testing assets for impairment.

Fair values may also be used in IFRS as deemed costs on the transition from prior GAAP to IFRS.

14.3 Financial assets and financial liabilities

IFRS requirements – the use of fair values

IAS requires that financial assets and financial liabilities that are held for trading (including all derivatives) should be measured at fair value at each balance sheet date. The resulting gains and losses are included in profit or loss. Hence, such assets and liabilities are described in IAS 39 as 'at fair value through profit or loss'.

Many of these financial assets and financial liabilities were measured at historical cost-based amounts or, in the case of derivatives, omitted from balance sheets under the prior national GAAP used by first-time adopters and under the Fourth Directive. Under the Bank Accounts Directive and the Insurance Accounts Directive, banks and insurance companies were permitted to measure some of these financial assets at current valuations which may have been equivalent to fair values.

IAS 39 requires that available-for-sale financial assets should be measured at fair value at each balance sheet date. The resulting gains and losses are included in equity until the disposal or impairment of the assets. These financial assets usually include equity and debt securities which are not held for trading.

Many of these financial assets were measured at historical cost-based amounts under the prior national GAAP used by first-time adopters and under the Fourth Directive. Under the Bank Accounts Directive and the Insurance Accounts Directive, banks and insurance companies were permitted to measure some of these financial assets at current valuations which may have been equivalent to fair values.

IAS 39 allows all financial assets that are not classified as held for trading or as available for sale to be measured at historical cost-based amounts (usually amortised cost). Similarly it allows all financial liabilities that are not classified as held for trading to be measured at historical cost-based amounts (usually amortised cost). As will be shown, the use of historical cost-based amounts for the vast majority of these financial assets and financial liabilities is the prevalent practice under IFRS.

These financial assets and financial liabilities were measured at historical cost-based amounts, including amortised cost, under the prior national GAAP used by first-time adopters and under the Fourth Directive, the Bank Accounts Directive and the Insurance

Accounts Directive. However, the determination of the historical cost-based amounts under IFRS, including any impairment losses on financial assets, may differ from the determination of those amounts under the Fourth Directive, the Bank Accounts Directive and the Insurance Accounts Directive and prior national GAAPs.

IAS 39 allows (but does not require) the measurement at fair value of some financial assets and financial liabilities that would otherwise be measured at amortised cost. In such cases the resulting gains and losses are included in profit or loss. This is the fair value option. It allows an entity to designate a financial instrument that would otherwise be measured at amortised cost as 'at fair value through profit or loss'. Under the amendment to IAS 39, an entity may use the fair value option only in specific circumstances where:

- it eliminates, or significantly reduces, a measurement or recognition inconsistency (an 'accounting mismatch');
- a group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel ('group of financial assets or financial liabilities managed on a fair value basis'); or
- it contains one or more embedded derivatives.

Sample 1 results – held-for-trading financial assets and financial liabilities

All companies measured held-for-trading financial assets and financial liabilities (including all derivatives) at fair value at each balance sheet date. For the vast majority of the companies, the carrying amounts of these financial assets and financial liabilities were not large but the effects on profit or loss may have been significant.

Sample 1 results – available-for-sale financial assets

The substantial majority of companies had accounting policies for available-for-sale financial assets. In every case, the policy states that available-for-sale financial assets are measured at fair value at each balance sheet date with the resulting gains and losses included in equity until the disposal or impairment of the assets. However, in many cases there is little evidence of such assets on the balance sheet or in the notes to the financial statements. There is also no evidence of the component of equity that includes the gains and losses. This appears to be an example of companies using standard or 'boilerplate' wording for accounting policies that are not relevant to their financial statements.

No companies had accounting policies that stated that they measured available-for-sale financial assets at historical cost-based amounts at each balance sheet date. Many correctly stated that they used historical cost-based amounts when fair values could be determined reliably, for example in the case of unlisted equity securities. Some appeared to use historical cost-based amounts for all unlisted equity securities without, possibly, considering whether fair values could be reliably determined.

Sample 1 results – fair value option

There are 36 companies that used the fair value option (Table 14.1). The use of the fair value option by banks and insurance companies is dealt with in more detail in Chapters 17 and 18.

Table 14.1: Use of the fair value option for some financial assets and financial liabilities

	Number	Percentage
Fair value option used for some financial assets and financial liabilities:		
Banks (see Chapter 17) (out of 29)	21	10.5
Insurance companies (see Chapter 18) (out of 13)	8	4
Other companies	7	3.5
Total of companies using the fair value option for some financial assets and financial liabilities	**36**	**18**
Fair value option not used	164	82
Total	**200**	**100**

Apart from the 21 banks and eight insurance companies, we found only 7 out of 171 other companies that used the fair value option. Examples of its use are as follows:

- **France Telecom** (France) used the fair value option for non-current financial assets that were not held for trading (small amounts of loans and receivables).
- **Wolters Kluwer** (Netherlands) used the fair value option for its unsubordinated convertible bond loan instead of treating the convertible bond as a compound financial instrument and measuring the debt component at amortised cost. This appears to have reduced equity at the beginning of the period by about 1.5%. The bond represented approximately 25% of the company's debt.
- **Telefónica** (Spain) used the fair value option to eliminate or mitigate 'measurement or recognition inconsistencies' and for financial assets for which an 'investment and disposal strategy had been designed based on fair value'.

It is important to recognise that the fair value option was used very selectively with the result that it applied to very few of the financial assets or financial liabilities of the 36 companies. For example, none of the banks used the fair value option for the major financial assets and financial liabilities on their balance sheets – the ordinary loans and advances to customers and deposits from customers and other banks. Instead these assets and liabilities were measured at amortised cost. Insurance companies and banks that had insurance activities used the fair value option to deal with mismatches that would otherwise occur in the measurement of matched assets and insurance liabilities. They did not use it for other financial assets and liabilities.

The review of the IFRS consolidated financial statements of Sample 1 companies shows that all companies measured the vast majority of their financial assets and financial liabilities at historical cost-based amounts rather than fair value. This does not lessen the burden of determining fair values for those financial assets and financial liabilities that must be measured at fair value – or reduce the volatility in profit or loss that results from some of the uses of fair value.

14.4 Property, plant and equipment

IFRS requirements

IAS 16 *Property, Plant and Equipment* requires that property, plant and equipment should be recognised initially at cost and subsequently measured at each balance sheet date at either:

- cost less accumulated depreciation and any write-down for impairment (cost model); or
- fair value less any subsequent accumulated depreciation and any write-down for impairment (revaluation model).

IAS 16 allows upward revaluations provided that:

- the revaluations are made to fair value;
- the revaluations are kept up to date such that the carrying amount does not differ materially from fair value at the balance sheet date;
- all the items in the same class of property, plant and equipment are revalued at the same time; and
- revaluation surpluses are credited to the revaluation reserve in equity and are not included in any subsequent profit or loss on disposal.

Sample 1 results – cost model or revaluation model

Table 14.2 shows which measurement model was used by Sample 1 of 200 publicly traded companies. The use of the revaluation model excludes the use of fair values or other amounts as deemed cost at the transition date to IFRS. Table 14.3 shows for which items of property, plant and equipment the revaluation model was used. The revaluation model was used rarely and even those companies that used it did so selectively.

Table 14.2: Measurement of property, plant and equipment

	Number	Percentage
Cost model for all property, plant and equipment	191	95.5
Revaluation model for all property, plant and equipment	-	
Revaluation model for all properties; cost model for all plant and equipment	5	2.5
Revaluation model for some properties; cost model for other properties and all plant and equipment	3	1.5
No own use property, plant and equipment	1	0.5
Total	**200**	**100**

Table 14.3: Use of the revaluation model for property, plant and equipment

Company	Revaluation model used for:
Bank of Cyprus	Property
Vassiliko	Land and buildings and Vassiliko Port
LVMH	Vineyard land
Irish Life and Permanent	Freehold and leasehold premises with lease terms over 50 years
Ukios Bankas	Construction in progress
ING	Property
3i	Land and buildings
Royal & SunAlliance	Property

Investment property

IFRS requirements

IAS 40 *Investment Property* defines investment property as 'property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both'. It does not include owner-occupied property, that is property held for use in the production or supply of goods or services or for administrative purposes. It does, however, include land which is held for an indeterminate use.

IAS 40 requires that investment property should be recognised initially at cost and subsequently measured at each balance sheet date at either:

- fair value (fair value model); or
- cost less accumulated depreciation and any write-down for impairment (cost model).

The cost model is identical to the cost model in IAS 16 (see above) but, unlike IAS 16, IAS 40 requires the disclosure of the fair value of property measured using the cost model.

Sample 1 results – measurement basis

Table 14.4 shows the measurement basis used by companies for investment property. Table 14.5 lists those companies that used the fair value model. The use of the fair value model appears to be more prevalent when investment property activities are significant.

Table 14.6 lists those companies that used the cost model. The use of the cost model appears to be more prevalent when investment property activities are incidental to a company's main activities. In this respect, it appears that on transition to IFRS many companies had to reclassify land held for an indeterminate use into investment property. In such cases, it seems likely that the cost model was used as it did not involve a change in accounting policy.

Table 14.4: Measurement basis of investment property

	Number	Percentage
Fair value model (Table 14.5)	23	11.5
Cost model (Table 14.6)	58	29
No investment property	119	59.5
Total	**200**	**100**

Table 14.5: Companies using the fair value model for investment property

Cyprus Bank of Cyprus Vassiliko	**Ireland** Irish Life & Permanent	**Spain** Sol Meliá
Czech Republic Orco	**Latvia** Ventspils nafta	**Sweden** Nordea Bank
Denmark Danske Bank	**Lithuania** Ukios Bankas	**UK** 3i Anglo American British Land Lloyds TSB Prudential Royal Bank of Scotland Royal & SunAlliance Tribal
Germany Deutsche EuroShop Hypo Real Estate	**Malta** Middlesea	
Hungary Gedeon Richter	**Netherlands** ABN Amro ING	

Table 14.6: Companies using the cost model for investment property

Austria	**Germany**	**Poland**
Erste Bank	Allianz	Duda
Hirsch Servo	BASF	KGHM
Voestalpine	Lufthansa	PKN Orlen
Wienerberger	Metro	
Wiener Staedtische	Munich Re	**Portugal**
	RWE	EDP
Belgium		
Dexia	**Greece**	**Slovenia**
Delhaize	Agrotiki Insurance	Sava
Fortis	Blue Star Ferries	
IBA	National Bank of Greece	**Spain**
KBC		Banco Pastor
	Hungary	Endesa
Czech Republic	OTP Bank	Ercros
Komerčni Banka		Inditex
	Italy	Mapfre
Estonia	Acea	OHL
Harju Elekter	Campari	Repsol
	Eni	Santander
Finland	Fiat	Telefónica
Sampo	Telecom Italia	Zeltia
	Unicredit	
France		**UK**
AXA	**Netherlands**	Cobham
Bic	Vedior	Fuller, Smith & Turner
BNP Paribas		Tesco
Carrefour		
Crédit Agricole		
Hermès		
Klépierre		
LVMH		
SCOR		
Société Générale		

14.5 Intangible assets

IFRS requirements

IAS 38 *Intangible Assets* requires that intangible assets should be recognised initially at cost and subsequently measured at each balance sheet date at either:

- cost less any accumulated amortisation and any write-down for impairment (cost model); or
- fair value less any subsequent accumulated amortisation and any write-down for impairment (revaluation model).

IAS 38 allows upward revaluation in very limited circumstances. In particular, the revaluation model may not be used to recognise a previously unrecognised intangible asset, for example an internally generated intangible asset that did not meet the recognition criteria when it was developed.

Sample 1 results

No companies use the revaluation model for intangible assets.

The accounting policies for intangible assets of some companies may imply the use of the revaluation model. However, the companies are confusing the use of fair value to determine the cost of an intangible asset acquired in a business combination with the use of up to date fair values at each balance sheet date.

14.6 Biological assets

IFRS requirements

Biological assets are living animals or plants. IAS 41 *Agriculture* requires that a biological asset that relates to agricultural activity shall be measured at each balance sheet date at either:

- fair value less estimated point-of-sale costs (fair value model); or
- cost less any accumulated depreciation and any accumulated impairment losses (cost model).

IAS 41 allows the use of the cost model only when the presumption that the fair value of the asset can be measured reliably is rebutted on initial recognition and the asset has not previously been measured at fair value.

Sample 1 results – subsequent measurement of biological assets

Table 14.7 shows which measurement model was used by Sample 1 of 200 publicly traded companies. Table 14.8 shows for which biological assets companies used the fair value model.

Table 14.7: Subsequent measurement of biological assets

	Number	Percentage
Fair value model (Table 14.8)	5	2.5
Cost model for some or all biological assets	4	2
Companies with no recognised biological assets	191	95.5
Total	**200**	**100**

Table 14.8: Biological assets – measurement at fair value

Company	Fair value model used for:
Anglo American	Forests
Campari	Fruit bearing and mature vines
Diageo	Grape vines and grapes on the vine
Stora Enso	Forests
Unilever	Tea bushes and oil palm trees

14.7 Comments at the roundtables

At the roundtables, significant concerns were expressed about the use of fair value. These fell broadly into three categories, of which the third seems to be by far the most significant:

- some participants drew attention to the subjectivity of fair values in the absence of active and liquid markets;
- others expressed concern about the inclusion of changes in fair value in profit or less and the volatility this produced (or would produce) in reported income although there was also a view that this concern might be addressed if the income statement separated out changes in fair value; and
- a high level of concern was evident at several of the roundtables about the future direction of IFRS and whether it would involve far greater use of fair value. It is possible – and this thought was expressed at one of the roundtables – that the first two concerns listed above were, in part at least, articulated in the context of the future direction of IFRS rather than by reference to actual experience of IFRS to date.

14.8 User and preparer views

In considering whether there ought to be more extensive use of fair value in IFRS, users' and preparers' views are clearly very important. Some users have recently addressed this question and, in general, analysts and other users of financial statements appear to question the desirability of greater use of fair value. For example, B. Gandy, O. Sonola and J. Burke argue in a study for Fitch Ratings:

> 'It seems unlikely, however, that a full fair value model will evolve given the scepticism of credit and equity analysts to the theoretical market-based values when no markets exist, and given the costs preparers would need to bear to establish measurements for all assets and liabilities that could be checked by auditors and regulators.'

S. Cooper in a study for UBS acknowledges the current use of historical cost and argues against the extension of fair value to non-financial assets and liabilities:

> 'In analysing operating activities, investors are primarily interested in profit, cash flows and transactions of the business rather than the current valuation of individual assets. Business value is estimated by capitalising periodic profit or cash flow measures, or by discounting forecasts of these items rather than summing current values of the assets that are recognised in a balance sheet. Although the current, predominantly historical cost-based measurement approach has limitations, it is well understood and in most cases yields useful and relevant

> measures of operating performance. We do not believe that a convincing case has been made for comprehensive application of any other measurement basis for operating activities.'

Cooper supports the use of fair value for non-operating assets and investments 'where the primary focus is generally on the actual or estimated market value of the individual assets'.

These comments from individual analysts are consistent with the findings of a recent survey of 50 analysts and investors in Europe and North America. This found that:

> 'respondents … question the relevance of current value measures for a number of assets that are "operational" in nature…[They are also] concerned about managements' ability to provide reliable estimates of current value and the potential for changes in current value estimates to mask operating performance, given the current presentation of the income statement.'
> (PricewaterhouseCoopers, *Measuring Assets and Liabilities: Investment Professionals' Views*, February 2007.)

As regards preparers, a recent survey looked at the views of 78 senior finance executives in FTSE 350 companies in the UK. It found that:

> 'Opposition to the spread of fair values seems to be strengthening. Three-quarters of respondents (74%) now oppose the trend towards the greater use of fair values in the primary statements, far more than last year when 52% said they opposed the trend. Similarly, this year just 13% support the trend towards greater use of fair values, while 28% did so last year.' (PricewaterhouseCoopers, *Has the Dust Settled Yet?*, June 2007.)

It will be noted that this survey takes it as given that there is a trend towards greater use of fair value in the primary financial statements. This is consistent with the concerns expressed at the roundtables about greater use of fair value in the future. A general review of the arguments for and against fair value accounting, and the desirability of a possible move towards a single basis of measurement in financial reporting is provided in *Measurement in Financial Reporting* (ICAEW, 2006).

14.9 Summary of Sample 1 evidence

Our reviews show that there is very extensive use of historical cost accounting in the IFRS consolidated financial statements of all publicly traded companies. The historical cost model is used by:

- 169 out of 200 companies for all their financial assets and financial liabilities other than held-for-trading financial assets and liabilities (including derivatives) and for available-for-sale financial assets;
- the remaining 31 companies for the significant majority of their financial assets and financial liabilities other than held-for-trading financial assets and liabilities (including derivatives) and available-for-sale financial assets;
- 191 out of 200 companies for all their own use property, plant and equipment;
- 58 out of 81 companies for investment property; and
- 4 out of nine companies for biological assets.

Fair values at each balance sheet date are used by:

- all companies for held-for-trading financial assets and liabilities (including derivatives) and for available-for sale financial assets other than some equity investments in unlisted companies;

- 21 banks, 8 insurance companies and 7 other companies for some other financial assets or financial liabilities – these assets and liabilities are almost always a small proportion of their total financial assets and financial liabilities;
- 8 companies for some of their own use property, plant and equipment;
- 23 out of 81 companies for investment property; and
- 5 out of 9 companies for biological assets.

The use of fair values is, of course, widespread:

- for the initial measurement of non-cash transactions, for example the cost of share-based business combinations, exchanges of non-monetary assets etc;
- for the allocation of compound transactions to their components, for example separable assets and liabilities in business combinations, convertible debt and complex revenue transactions etc; and
- when testing assets for impairment.

The use of fair values in such circumstances is, in fact, a vital part of historical cost accounting. It is not fair value accounting in the sense of requiring annual revaluations and the inclusion of unrealised gains and losses in profit or loss. Similarly, IFRS requirements to keep estimates of non-financial liabilities up to date are not fair value accounting.

14.10 Policy issues

There does appear to be a widespread fear that the IASB will extend the use of fair value accounting to all financial assets and all financial liabilities and even to all assets and liabilities, and serious doubts over whether the resultant information will improve the quality of financial reporting. The general question of the basis of measurement in financial reporting is being reviewed by the IASB and FASB as part of their joint conceptual framework project. While there is some concern that this process may lead to greater use of fair value, no relevant decisions have yet been taken by the IASB or FASB, which are still at an early stage in developing a comprehensive consultation paper on measurement.

While this is a matter for the IASB, rather than the European Commission, it might be helpful if the Board could make it very clear that it does not have an ‘agenda’ of moving financial reporting towards significantly greater use of fair value. Such a clarification may seem to prejudge the outcome of the IASB’s and FASB’s review of measurement bases, but in our view it might be sensible to rule out a move of this kind even though the review of measurement bases is at an early stage. At the moment, the continuing perception that the IASB is reluctant to commit itself on this point seems to leave open the possibility that a review of concepts might well lead to radical changes to actual practice. We do not believe that radical changes on the basis of conceptual analysis would be appropriate or that it would be damaging for the IASB to make its position on this issue abundantly clear ahead of the review.

Where fair values have been introduced into financial reporting there is a need for better understanding of:

- how they are used by different classes of users;
- whether they are more useful than measurements on alternative bases; and
- how (if at all) they affect management behaviour.

Although there is some research on these issues (often not based on EU experience), they are all questions on which further research would be useful.

15. The use of other options in IFRS

15.1 Key points

This chapter analyses the use of optional accounting treatments, other than measurement options, in the IFRS consolidated financial statements of the companies in Sample 1. The areas examined include actuarial gains and losses, borrowing costs and joint venture entities.

When accounting for post-employment benefit plans, 73 out of 200 companies recognise all actuarial gains and losses immediately and in full. 54 of these 73 companies use the new option that allows them to include these items in equity rather than profit or loss; 8 of the 54 companies do not present the required statement of recognised income and expense.

The corridor approach is used by 88 out of 200 companies to account for actuarial gains and losses. All except 6 of the 88 defer and amortise the actuarial gains and losses that lie outside the corridor. All first-time adopters used the IFRS 1 option to recognise all actuarial gains and losses in the balance sheet and in equity at the transition date.

When utilising the options available in IAS 23 *Borrowing Costs* relating to borrowing costs on qualifying assets, 51 out of 200 companies capitalised these costs and 149 expensed them.

There were 101 companies with interests in joint ventures. 60 of these companies use the option in IAS 31 *Interests in Joint Ventures* to apply proportionate consolidation and 41 use the equity method.

15.2 Actuarial gains and losses

IFRS requirements

IAS 19 *Employee Benefits* allows three main approaches:

- the immediate recognition of all actuarial gains and losses in the balance sheet and in the income statement;
- the immediate recognition of all actuarial gains and losses in the balance sheet and in equity (provided that the entity presents a statement of recognised income and expense);
- recognition of a portion of actuarial gains and losses in the balance sheet and in the income statement. As a minimum an entity must recognise the cumulative unrecognised gains and losses at the end of the previous reporting period that fall outside a "corridor", amortised over the expected average remaining working lives of the employees. However, a company may adopt any systematic method that results in faster recognition, including gains and losses within the corridor, provided the basis is consistently applied from period to period.

As explained in Chapter 11, first-time adopters using either the deferral and amortisation approach or any of the corridor approaches may elect to:

- recognise all actuarial gains and losses in the balance sheet and in equity at transition date; and
- apply the deferral and amortisation approach or corridor approach only to actuarial gains and losses arising after transition date.

Sample 1 results – actuarial gains and losses

Table 15.1 shows the main approach adopted by the 200 publicly traded companies. Tables 15.2 and 15.3 list the companies adopting the immediate recognition approaches. Table 15.4 provides the sub-analysis of the corridor approach.

As explained in Chapter 12, the amendment to IAS 19 incorporates the UK and Irish requirements in FRS 17 *Retirement Benefits* into IFRS, allowing companies to recognise actuarial gains and losses immediately within equity. Hence it is not surprising that the amendment has been adopted by virtually all UK and Irish companies. The only Irish company that does not use the amendment to IAS 19 is **Irish Life & Permanent** which uses the corridor approach. The only UK companies that have defined benefit plans and which do not use the amendment are **BG**, **British American Tobacco**, **Kazakhmys** and **Lloyds TSB** all of which use the corridor approach.

As explained in Chapter 13, eight companies that include actuarial gains and losses in equity do not present a statement of recognised income and expense and, therefore, do not comply with IAS 19 and the consequential amendment to IAS 1.

Table 15.1: Recognition of actuarial gains and losses

	Number	Percentage
All actuarial gains and losses recognised immediately in the balance sheet and in the income statement (Table 15.2)	19	9.5
All actuarial gains and losses recognised immediately in the balance sheet and in equity (Table 15.3)	54	27
Total of companies recognising all actuarial gains and losses immediately	**73**	**36.5**
All actuarial gains and losses deferred and amortised in both the balance sheet and income statement over the expected average remaining working lives of employees or a fixed number of years	1	0.5
Actuarial gains and losses recognised using corridor approaches (Table 15.4)	88	44
Companies with no defined benefit obligations	38	19
Total	**200**	**100**

Table 15.2: Immediate recognition of all actuarial gains and losses in the income statement

Austria Hirsch Servo	**Greece** Blue Star Ferries	**Slovakia** Slovnaft
Estonia Eesti Telekom	**Italy** Autostrada Campari Datalogic Geox Recordati Telecom Italia	**Slovenia** KRKA
France Crédit Agricole Pharmagest		**Spain** Mapfre Ercros
Germany CeWe Color	**Poland** KGHM PKN Orlen	**UK** Prudential

Table 15.3: Immediate recognition of all actuarial gains and losses in equity

Country	Companies
Austria	Voestalpine
Denmark	Møller - Maersk
France	AXA Cegid Gaz de France Havas SCOR
Germany	BASF BMW Henkel Schering Thiel Logistik
Ireland	Allied Irish Bank CRH Kerry Waterford Wedgwood
Netherlands	Unilever Wolters Kluwer
Portugal	Brisa EDP
Spain	Abertis Endesa
UK	3i Anglo American BHP Billiton BP British Land BT Cadbury Schweppes Cobham Diary Crest Diageo EMI First Choice FKI Fuller, Smith & Turner GlaxoSmithKline Headlam Inchcape Jardine Lloyd Thompson McBride Northern Rock Provident Financial PZ Cussons Redrow Rentokil Royal Bank of Scotland Royal & SunAlliance SAB Miller Tesco Tomkins Tribal Vodafone WSP

Table 15.4: Application of corridor approach

	Number	Percentage
Gains and losses outside the corridor recognised immediately in the balance sheet and the income statement	6	6.8
Gains and losses outside the corridor recognised in the balance sheet and income statement over expected average working lives of employees	82	93.2
Gains and losses outside the corridor recognised in the balance sheet and income statement spread over other specified periods of time	-	-
Total (Table 15.5)	**88**	**100**

Table 15.5: Recognition of actuarial gains and losses outside the corridor

Country	Companies
Austria	Erste Bank Wienerberger Wiener Staedtische
Belgium	Agfa Belgacom Brantano Delhaize Fortis GBL KBC
Cyprus	Bank of Cyprus
Denmark	Danske Bank H+H Novo Nordisk
Finland	Aspo Neste Oil Nokia Sampo Stora Enso
France	Bic BNP Paribas Bouygues Carrefour Faurecia France Telecom Hermès Klépierre L'Oréal LVMH Saint-Gobain Sanofi-Aventis Société Générale Technip Total Vallourec Vivendi
Germany	Allianz Commerzbank Deutz Dykerhoff Hypo Real Estate Koenig & Bauer Lufthansa Metro Mobilcom MTU Munich Re RWE Südzucker
Greece	OTE National Bank of Greece Info-Quest
Ireland	Irish Life & Permanent
Italy	Acea Ducati Motor Enel Eni Fiat Generali L'Espresso Marr Unicredit
Luxembourg	Arcelor Dexia SES Global
Netherlands	ABN Amro Batenburg Beheer Heineken Imtech ING KPN Philips Royal Dutch Shell Stork Vedior
Portugal	Banco Comercial Portugues
Spain	Banco Pastor Gas Natural Santander Repsol
Sweden	Alfa-Laval Bergman & Beving Ericsson Telia Sonera
UK	BG Group British American Tabacco Kazakhmys Lloyds TSB

15.3 Borrowing costs

IFRS requirements

IAS 23 requires that borrowing costs on qualifying assets, that is those assets that take a substantial period to get ready for their intended use should be either:

- added to the cost of those assets (capitalisation); or
- recognised as an expense.

Qualifying assets may include property, plant and equipment. IAS 23 includes requirements about the determination of the borrowing costs that should be capitalised and the commencement and cessation of capitalisation.

The IASB has recently issued a revised version of IAS 23 which will remove this option by requiring the capitalisation of borrowing costs on qualifying assets. The revised Standard applies to accounting periods beginning on or after 1 January 2009.

Sample 1 results

Table 15.6 shows how companies account for borrowing costs. Practice tends to follow prior national GAAP for first-time adopters but a small number elected to expense borrowing costs under IFRS when they had capitalised borrowing costs under their national GAAP.

Table 15.6: Borrowing costs

	Number	Percentage
Capitalised	51	25.5
Expensed	149	74.5
Total	**151**	**100**

While only a quarter of companies capitalise borrowing costs, it is usually impossible to ascertain from financial statements whether those companies that expense borrowing costs did, in fact, have any qualifying assets or any borrowing costs that could have been capitalised.

15.4 Joint venture entities

IFRS requirements

IAS 31 requires an entity to account for interests in jointly controlled entities in consolidated financial statements using either:

- proportionate consolidation; or
- the equity method.

Sample 1 results – use of proportionate consolidation and the equity method

Table 15.7 shows how companies account for interests in jointly controlled entities. All companies that use proportionate consolidation combine their shares of each of assets, liabilities, income and expenses with similar items, line by line, in their financial statements. None report separate line items for their shares of the assets, liabilities, income and expenses of jointly controlled entities.

Table 15.7: Joint venture entities

	Number	Percentage
Proportionate consolidation	60	30
Equity method	41	20.5
No jointly controlled entities	99	49.5
Total	**200**	**100**

Practice tends to follow national GAAP for first-time adopters. However, while the use of proportionate consolidation is not permitted by national accounting standards in Ireland and the UK, one Irish company (**CRH**) and four UK companies (**Diageo**, **Prudential**, **Royal Bank of Scotland** and **Vodafone**) have elected to use it in their IFRS consolidated financial statements.

CRH switched from the equity method to proportionate consolidation for a significant investment that was classified under Irish GAAP as a joint venture. It explains that this is in line with the 'benchmark methodology' in IAS 31. **Royal Bank of Scotland** notes that the definitions of joint ventures under UK GAAP and IFRS are 'similar' but elects to use proportionate consolidation under IFRS.

The change for both **Diageo** and **Vodafone** arises in conjunction with the reclassification of subsidiaries under UK GAAP as joint ventures under IFRS. This issue is dealt with under de facto control in Chapter 16. **Prudential** appears to have had the same issue.

16. Consolidated financial statements

16.1 Key points

We analysed the application of IFRS on the following technical issues:

- consolidated financial statements, including the concepts of de facto and legal control; and
- business combinations, goodwill and intangible asset impairment.

Sample 1 companies appeared to consolidate all material subsidiaries including those with dissimilar activities and special purpose entities. They also:

- used the purchase method to account for all business combinations except those which were common control transactions;
- allocated the cost of the business combination to the acquiree's identifiable assets, liabilities and contingent liabilities and sought to measure them at their fair values;
- recognised as goodwill any excess of the cost of the business combination over the aggregate fair values of the acquiree's identifiable assets, liabilities and contingent liabilities; and
- carried out annual impairment tests, rather than amortising, goodwill.

There may be diverse practices with respect to the detailed application of the purchase method and in applying the control definition, particularly when de facto control is involved or there are significant minority interests.

Findings from external studies and reviews by securities regulators on disclosures relating to business combinations, goodwill and asset impairment have been included in this chapter. The general view is that additional disclosures on business combinations and impairment testing of goodwill are needed to comply with IFRS 3 *Business Combinations*.

16.2 Scope of consolidation

IFRS requirements

IAS 27 *Consolidated and Separate Financial Statements* requires that consolidated financial statements should report the financial position, performance and cash flows of a group as if the group were a single entity without regard for the boundaries of the separate legal entities.

SIC 12 *Consolidation – Special Purpose Entities* requires that an SPE shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. SIC 12 applies the principles of control in IAS 27.

The development of IAS 27 was influenced by the EU Seventh Directive. In particular, the former IASC based the definition of control in IAS 27 on the equivalent definition in the Seventh Directive with the result that the text of IAS 27 follows closely the language of the Directive (Cairns 2002, Van Hulle and van der Tas 2002). Therefore, there should have been few changes in the scope of consolidation on the transition to IFRS from prior national GAAP that complied with the Seventh Directive. Changes were likely for:

- subsidiaries with dissimilar activities – IAS 27 requires consolidation but the Seventh Directive, in principle, did not permit consolidation;

- special purpose entities – there was no equivalent to SIC 12 in the Seventh Directive or the national GAAP in many EU member states; and
- venture capital investments – non-consolidation was common under IFRS and probably the Seventh Directive but IASB revised IAS 27 in 2004 to clarify that consolidation is required when there is a control relationship.

IAS 27 defines a subsidiary as:

> 'A *subsidiary* is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).'

IAS 27 defines control as:

> '*Control* is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.'

Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

- power over more than half of the voting rights by virtue of an agreement with other investors;
- power to govern the financial and operating policies of the entity under a statute or an agreement;
- power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

Sample 1 results – scope of consolidation

All the companies appeared to have consolidated all subsidiaries that were material to the reporting entity including those with dissimilar activities and special purpose entities. As explained below, there may be diverse practices in applying the control definition, particularly when de facto control is involved or there are significant minority interests.

Sample 1 results – de facto control and related issues

The phrase *de facto control* is used to describe circumstances when control exists in practice but there may be obstacles to, or a lack of, legal control. Article 1 of the Seventh Directive clearly requires consolidation in such circumstances. In October 2005, the IASB noted that interpretation of the requirements of IAS 27 on this point was not consistent, and made it clear that, in its view, the control concept in IAS 27 includes de facto control.

Sample 1 includes several companies in which de facto control has been an issue. The clearest case is that of **Eni** (Italy) (see example 16.1). **Eni** consolidated its 43.2% interest in Saipem under Italian GAAP and, hence, the Seventh Directive. It concluded initially that a 'restrictive interpretation' of IAS 27 precluded consolidation in such circumstances. Following an announcement by the IASB in October 2005 (IASB 2005), it concluded that IAS 27 does require consolidation when de facto control exists notwithstanding that legal control may not exist.

Example 16.1 De facto control

Eni

As regards to the information reported in the reports of the year 2005, the following restatements and reconciliations have been modified to include the recent guidelines of the International Accounting Standards Board (IASB), relating to the concept of "de facto" control and providing the inclusion in the scope of the consolidation of the Saipem SpA and its subsidiaries.

Saipem SpA, in which Eni held a 43.2% share of voting stock as of December 31, 2005, was excluded from consolidation due to a restrictive interpretation of the provisions of IAS 27 *Consolidated Financial Statements and Accounting for Investment in Subsidiaries*, according to which full consolidation is admissible only if the parent company holds the majority of voting rights exercisable in ordinary shareholders' meetings, or failing this, when there exists an agreement among shareholders or other situations that give to the parent company the power to appoint the majority of the Board of Directors. Under this interpretation Saipem SpA, despite being controlled by Eni in accordance with article 2359, paragraph 2 of the Italian Civil Code, was accounted for under the equity method.

IASB is reviewing the requirements of IAS 27; in October 2005, *IASB Update* published a statement indicating that the concept of control as defined by IAS 27 included the situation as described by article 2359, paragraph 2 of the Italian Civil Code, despite the fact that the lack of precise indications allows also for a different interpretation of this standard. IASB declared its intention to provide more detailed indications on the exercise of control in its new version of IAS 27. In consideration of the intention expressed by IASB, Eni included Saipem SpA and its subsidiaries in consolidation under IFRS starting January 1, 2004, with the aim of giving an economic and financial state of the Group more consistent with its commercial situation.

In example 16.2, **Bouygues** (France) explains in detail its reasons for concluding that it has control and, therefore, rebutting the IAS 27 presumption that its interest is insufficient to give control. There is no reference to the IASB's statement.

Example 16.2 De facto control

Bouygues

Bouygues holds 42.89% of the capital and 42.94% of the voting rights of TF1, and according to a ruling by the Conseil de la Bourse des Valeurs of 11 February 1994 is regarded as acting in concert with Société Générale, a fellow-shareholder of TF1, under the terms of a shareholders' agreement.

Exclusive control by Bouygues over TF1 is demonstrated by the fact that:

- Bouygues has consistently and regularly held a substantial majority of the voting rights exercised at TF1 shareholders' meetings;
- no other shareholder directly or indirectly controls a higher share of voting rights than Bouygues.

Bouygues has clearly had exclusive power to determine decisions at TF1 shareholders' meetings during at least two consecutive financial years (article L233-16 II of the Commercial Code).

Other factors indicating the existence of exclusive control include:

- the predominance of Bouygues among the group of shareholders acting in concert;
- the large number of seats on the TF1 Board of Directors allocated to Bouygues;
- the role of Bouygues in appointing key executives of TF1.

All these factors clearly establish that Bouygues exercises exclusive control over TF1.

The relationship between Bouygues and TF1 also meets the criteria stipulated in articles L233-3 I & II of the Commercial Code relating to *de facto* control by one company over another.

- Companies under the joint control of more than one shareholder are consolidated by the proportionate consolidation method, based on the percentage of control held.
- Companies over which Bouygues exercises significant influence are consolidated by the equity method.

Other continental European companies that consolidate when they have de facto control include **Klépierre** (France) and **LVMH** (France).

Examples 16.3 and 16.4 suggest that a different approach, and possibly a different interpretation of IAS 27, is being adopted in the UK. We are also aware of other similar examples among non-survey companies in the UK.

Diageo (Example 16.3) concludes that it had control over its 50% interests in Malaysia and Singapore under UK GAAP, and hence the Seventh Directive, but not under IFRS. **Vodafone** (Example 16.4) concludes that it had control over its 76.8% investment in Vodafone Italy under UK GAAP and, hence, the Seventh Directive but not under IFRS. In its case, **Vodafone** has to demonstrate it does not have control, in other words it has to rebut the presumption in IAS 27 that with a 76.8% interest it does have control. Both **Diageo** and **Vodafone** conclude that these investments are joint ventures, rather than subsidiaries, under IFRS. Both opt to use proportionate consolidation under IFRS (which was not permitted by their prior UK GAAP). Both used the equity method for US GAAP purposes.

Example 16.3 De facto control

Diageo

Under IFRS, the legal and contractual power to control or significantly influence is the key consideration when determining whether an entity is a subsidiary, joint venture or associate. Under UK GAAP, consideration was given to the control or significant influence actually exercised in practice when making this decision. A review of investments concluded that the group's beer interests in Malaysia and Singapore, classified as subsidiaries under UK GAAP, should be classified as jointly controlled entities under IFRS. As a consequence, these entities previously fully consolidated (with a minority interest) under UK GAAP are proportionately consolidated under IFRS. This adjustment did not affect the retained profit of the group.

IAS 31 *Interests in Joint Ventures* defines a jointly controlled entity as an entity where all parties enter into a contractual arrangement that specifies joint control, by unanimous consent, of all strategic financial and operating decisions. IFRS allows the group to adopt either proportionate consolidation or the equity method when

consolidating jointly controlled entities. Diageo has adopted proportionate consolidation as its group policy. This has resulted in some group entities, previously equity accounted under UK GAAP, being proportionately consolidated under IFRS.

Example 16.4 De facto control

Vodafone (IFRS presentation, 2005)

IAS 31 Interests in Joint Ventures defines a jointly controlled entity as an entity where unanimous consent over the strategic financial and operating decisions is required between the parties sharing control. Control is defined as the power to govern the financial and operating decisions of an entity so as to obtain economic benefit from it.

The Group has reviewed the classification of its investments and concluded that the Group's 76.8% interest in Vodafone Italy, currently classified as a subsidiary undertaking under UK GAAP, should be accounted for as a joint venture under IFRS. … The Group has adopted proportionate consolidation as the method of accounting for these six entities.

Under UK GAAP, the revenue, operating profit, net financing costs and taxation of Vodafone Italy are consolidated in full in the income statement with a corresponding allocation to minority interest. Under proportionate consolidation, the Group recognises its share of all income statement lines with no allocation to minority interest. There is no effect on the result for a financial period from this adjustment…

Under UK GAAP, the Group fully consolidates the cash flows of Vodafone Italy, but does not consolidate the cash flows of its associated undertakings. The IFRS consolidated cash flow statements reflect the Group's share of cash flows relating to its joint ventures on a line by line basis, with a corresponding recognition of the Group's share of net debt for each of the proportionately consolidated entities.

The IFRS consolidated balance sheet as at 1 April 2004 reflects the proportionate consolidation on a line by line basis of the balance sheets of the operations listed above. Accordingly, the UK GAAP minority interest balance in respect of Vodafone Italy [is] … eliminated from the consolidated balance sheets.

16.3 Business combinations

IFRS requirements

IFRS 3 requires that all business combinations should be accounted for using the purchase method. In broad terms, under that method the acquirer:

- measures the cost of a business combination at the fair values, at the date of exchange, of the consideration given plus any directly attributed costs;
- allocates the cost of the business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities;
- measures these assets, liabilities and contingent liabilities at their fair values;
- recognises as goodwill any excess of the cost of the business combination over the aggregate fair values of the acquiree's identifiable assets, liabilities and contingent liabilities.

Under IFRS 3, goodwill is recognised as an asset. It is not amortised. It is tested for impairment in each period.

IFRS 3 includes detailed requirements on the application of these broad principles. IAS 36 *Impairment of Assets* includes detailed requirements on impairment testing of

goodwill. IAS 38 *Intangible Assets* includes detailed requirements on the recognition of intangible assets which are acquired in business combinations.

The purchase method had been widely used by companies prior to their adoption of IFRS. However, the requirements of IFRS 3, IAS 36 and IAS 38 are probably more extensive and detailed than both the prior GAAP followed by first-time adopters and earlier IFRS followed by continuing IFRS reporters.

Sample 1 results – business combinations

We did not carry out a detailed review of Sample 1 companies' accounting for business combinations and goodwill. However, we are satisfied that companies:

- used the purchase method to account for all business combinations except those which were common control transactions;
- allocated the cost of the business combination to the acquiree's identifiable assets, liabilities and contingent liabilities;
- sought to measure these assets, liabilities and contingent liabilities at their fair values; and
- recognised as goodwill any excess of the cost of the business combination over the aggregate fair values of the acquiree's identifiable assets, liabilities and contingent liabilities.

We identified some instances in which companies appeared not to comply with all the detailed requirements of IFRS 3. For example, some companies appeared to recognise provisions for restructuring costs as acquired liabilities when those costs were not a liability of the acquiree. In a few cases, companies appeared to delay accounting for business combinations until the beginning of a later accounting period or quarter.

It also appears that there are inconsistencies in the extent to which different companies attribute part of the cost of acquisition to acquired intangible assets. Some attribute very little to acquired intangible assets and recognise a substantial amount of goodwill. In apparently similar circumstances, other companies attribute large amounts to intangible assets and recognise very little goodwill. Understanding the reasons for this is difficult as few companies make the required disclosures about the reasons for goodwill. Comments at our roundtables on this topic are referred to in Chapter 21.

In addition to our limited reviews of the financial statements, we have considered an extensive study by Glaum, Street & Vogel as well as other reviews by accounting firms and consultants and the comments of three securities regulators.

Glaum, Street & Vogel analysed the IFRS consolidated financial statements of 357 companies from 17 countries (16 EU member states plus Switzerland). They carried out an in-depth analysis and evaluation of disclosures related to acquisitions undertaken in 2005 as well as disclosures related to goodwill, other intangible assets and impairment testing. They identified several key findings about the accounting for business combinations:

- the vast majority of their sample companies disclose the cost of their acquisitions but one third do not provide a description of the components of the cost of the business combination;
- about a quarter of the companies do not provide information regarding the classes of acquired assets, liabilities and contingent liabilities while in other instances the information on the purchase price allocation is limited in content;
- in most cases the values assigned to goodwill represented 50% or more of the total cost of the acquisitions with only about 40% of the companies providing a rationale for the recognition of goodwill and then only vaguely; and

- less than a quarter of the companies provided pro-forma disclosures showing the effects of the acquisitions.

In its study of 65 large companies, Ernst & Young report low levels of disclosure about the factors that contributed to goodwill. Only 5 out 17 companies with large acquisitions and 8 out of 27 companies with small combinations made the disclosure. The most common reason given related to synergies.

The AMF, the French securities regulator, complains of a considerable number of missing disclosures on business combinations including those relating to:

- the nature of the businesses acquired;
- the cost of acquisition and its components;
- the amounts allocated to each category of assets, liabilities, and contingent liabilities;
- a description of those items that contributed to goodwill;
- an explanation of any negative goodwill; and
- an indication of the impact of the acquisition on the current period's income statement.

FIN-FSA noted that information on the factors affecting the recognition of goodwill was in short supply in the financial statements. More than 50% of the Finnish companies in its survey made superficial mention of future synergy benefits or did not refer to any factors affecting the measurement of goodwill.

The FRRP in the UK also observed that the requirement to explain the factors giving rise to goodwill, including a description of intangible assets that were not recognised and why their value could not have been reliably measured, was not always met or was limited to a bland statement with little specific information content.

Sample 1 results – impairment of goodwill

We did not carry out a detailed review of Sample 1 companies' impairment tests for goodwill. However, we are satisfied that companies:

- carried out annual impairment tests, rather than amortising, goodwill;
- allocated goodwill to cash generating units; and
- used either or both value in use or fair value less costs to sell in order to determine the recoverable amount of goodwill.

In addition to our limited reviews of the financial statements, we have again considered an extensive study by Glaum, Street & Vogel as well as the comments of three securities regulators.

The findings of Glaum, Street & Vogel on impairment testing and impairment losses address both the determination of recoverable amount and the related disclosures. They observe that:

- goodwill tends to be concentrated in a number of cash generating units with most companies allocating goodwill to cash generating units at the highest level allowed by IFRS (primary or secondary segment reporting format);
- most companies performed the annual goodwill impairment test at, or shortly before, the balance sheet date;
- 80% of companies with goodwill balances disclosed the method used to measure the recoverable amount of cash generating units for which the carrying amount of goodwill is significant;

- most companies determined the recoverable amount of goodwill using value in use rather than fair value less costs to sell;
- approximately 70% of the companies reported impairment losses with about one third recognising impairment charges associated with goodwill; and
- a similar number reported impairment of intangible assets with definite lives but impairment of intangible assets with indefinite lives is rare.

For companies using the value in use to determine recoverable amount, Glaum, Street & Vogel note that the assumptions about the cash flow planning horizon, growth rates of terminal values and the discount rates vary greatly. They also point out that a significant number of companies do not provide all the prescribed disclosures and some do not provide any.

The absence of disclosures about impairment losses is a common theme among the comments of securities regulators. FIN-FSA believes that the information disclosed by Finnish companies on impairment tests of goodwill did not always meet the requirements of IFRS with the result that users of the financial statements possibly lack material information for assessing the reliability of impairment tests and impairment sensitivity of goodwill.

The FRRP noted that the degree of compliance by UK companies with the disclosure requirements for the impairment of goodwill was 'variable'. Some companies provided detailed explanations. Others omitted specific disclosure required by IAS 36, for example disclosures of the estimates used to measure recoverable amounts of cash generating units containing goodwill or intangible assets with indefinite useful lives.

17. Banks

17.1 Key points

Overall, the transition to IFRS by banks was carried out to a high standard. Whilst comparability was not assisted by the options available on first time application in IFRS 1 *First-Time Adoption of International Financial Reporting Standards*, diversity of practice was reduced by the application of IAS 32 *Financial Instruments: Presentation and Disclosure* and IAS 39 *Financial Instruments: Recognition and Measurement* to the 2005 financial statements.

Our work was directed at the disclosure of accounting policies; the use of the fair value option for financial assets and financial liabilities; hedge accounting; the EU carve-out; impairment of financial assets; and presentation and disclosure issues.

All 29 banks in Sample 1 disclosed their principal accounting policies, but some did not disclose policies for all relevant financial instrument issues, such as revenue recognition for interest income and fee and commission income.

Under IAS 39, an entity may use the fair value option only where: it eliminates, or significantly reduces, a measurement or recognition inconsistency (an 'accounting mismatch'); a group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis; or a financial instrument contains one or more embedded derivatives. We found that 21 out of 29 banks in Sample 1 used the fair value option.

Hedge accounting is allowed for three types of hedging relationships. This chapter analyses the use of hedge accounting for each type of relationship by the 29 Sample 1 banks. We found that:

- 25 used hedge accounting for fair value hedges of the exposure to changes in the fair value of all or a portion of a recognised asset or liability or an unrecognised firm commitment;
- 24 used hedge accounting for cash flow hedges of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction; and
- 16 used hedge accounting for hedges of a net investment in a foreign operation in relation to the exposure to changes in the entity's share of the net assets of a foreign operation.

Our analysis of these banks also showed that eight used the EU carve-out with respect to hedge accounting in IAS 39. The EU carve-out allows banks to apply fair value hedge accounting for hedges of the interest rate risk of their portfolio of demand or core deposits and to ease the strict IAS 39 effectiveness requirements for some hedges.

IAS 39 requires an assessment at each balance sheet date of whether there is any objective evidence that individual financial assets or groups of assets are impaired. Where there is such evidence, the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) is discounted at the effective interest rate at the time of initial recognition and recognised as a loss. The carrying amount of the asset is reduced either directly or through an allowance account. With one exception, all banks in Sample 1 determined impairment losses based on both an individual and collective assessment. Some related disclosures are unclear in that it is not possible to determine the credit impairment charge separately from impairment of other assets because impairment is presented as one line in the income statement. Moreover, for those banks that disclosed

an impairment allowance account, the income statement charge was not always apparent.

IAS 32 requires disclosure of the fair value of each class of financial asset and liability in a way that permits comparison with its carrying value. Most banks presented this information in tabular form but seven banks in Sample 1 appeared not to provide all the required fair value disclosures. IAS 32 also requires disclosure of risk management policies and various types of risk. Banks have always provided disclosures that are broadly consistent with these requirements and all Sample 1 banks provided risk disclosures. Three early adopted IFRS *7 Financial Instruments: Disclosures* which contains more demanding requirements in this area.

17.2 Banks in Sample 1

The banks included in Sample 1 are set out below**.**

Table 17.1: Banks in Sample 1

Austria Erste Bank	**Germany** Commerzbank Hypo Real Estate	**Netherlands** ABN Amro
Belgium Fortis KBC	**Greece** National Bank of Greece	**Poland** Bank BPH
Cyprus Bank of Cyprus	**Hungary** OTP Bank	**Portugal** Banco Comercial Portugues
Czech Republic Komerčni Banka	**Ireland** Allied Irish Bank	**Slovakia** Tatra banka
Denmark Danske Bank	**Italy** Unicredit	**Spain** Banco Pastor Santander
Finland Sampo	**Latvia** DnB Nord Banka	**Sweden** Nordea Bank
France BNP Paribas Crédit Agricole Société Générale	**Lithuania** Ukios Bankas **Luxembourg** Dexia	**UK** Lloyds TSB Northern Rock Royal Bank of Scotland

17.3 Disclosure of accounting policies

IFRS requirements – disclosure of accounting policies

- IAS1 *Presentation of Financial Statements* requires disclosure of significant accounting policies.

- IAS 32 *Financial instruments: Disclosure and Presentation* requires an entity to disclose, for each class of financial asset, financial liability and equity instrument, the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.
- IFRS 7 includes a similar requirement.

Disclosure of accounting policies

All the banks disclose their principal accounting policies. However, some banks do not report policies for all issues relating to financial instruments, for example their policies for:

- revenue recognition for interest income and fee and commission income;
- recognition and derecognition of financial assets including the use of trade date or settlement date;
- sale and repurchase agreements; and
- offset of financial assets and financial liabilities.

Thirteen banks did not disclose an accounting policy in relation to offsetting of financial assets and liabilities in accordance with the IAS 32.42 requirements for offset.

Sixteen banks disclosed an accounting policy for the classification of an instrument as debt or equity. Accounting policy notes tended to state the IAS 32 definition of a financial liability without further elaboration. All had liabilities that had previously been classified as equity. One bank reported in equity a financial instrument that had previously been reported as a liability.

17.4 The fair value option

IFRS requirements – the fair value option

The fair value option in IAS 39 allows an entity subject to certain conditions to designate a financial instrument that would otherwise be measured at amortised cost as at fair value through profit or loss. The effect of this designation is that the financial instrument is measured at fair value at each balance sheet date instead of wholly or partly at amortised cost. The changes in fair value are included in profit or loss.

Under the amendment to IAS 39, an entity may use the fair value option only in specific circumstances:

- it eliminates, or significantly reduces, a measurement or recognition inconsistency (an 'accounting mismatch');
- a group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel ('group of financial assets or financial liabilities managed on a fair value basis'); or
- it contains one or more embedded derivatives.

Twenty-one banks use the fair value option (Table 17.2). Sixteen banks disclose in their accounting policies the instruments for which they use it. Eleven of these banks disclose that they have early adopted the amended fair value option which is necessary to comply with IFRS-EU. Five banks disclose an accounting policy for the use of the fair value option and disclose the relevant financial instruments in the notes. The impact of the option is not always visible in the income statement as the changes in fair value are often aggregated with other items.

Nine banks do not disclose an accounting policy for the use of the fair value option and do not appear to use the option. Of these nine banks, one disclosed that it had early adopted the amended fair value option.

Frequent use is made of the fair value option for reporting insurance and investment contract assets. Banks that use the fair value option to manage interest rate risk in relation to own debt issues do not disclose credit risk.

Table 17.2: Banks using fair value option for financial assets and financial liabilities

Bank	Reason	Instruments
Belgium		
Fortis	Accounting mismatch Group of financial assets or liabilities managed and evaluated on a fair value basis	Selected contracts with government
	Contract contains one or more embedded derivatives	Structured loans and contracts
KBC	Accounting mismatch Contract contains one or more embedded derivatives	CDOs with loan portfolio and swaps
Cyprus		
Bank of Cyprus	Group of financial assets or liabilities managed and evaluated on a fair value basis	Venture capital investments
Denmark		
Den Danske Bank	Accounting mismatch	Mortgage loans and bonds issued
Finland		
Sampo	Accounting mismatch	Investments related to unit linked insurance and related liabilities
	Group of financial assets or liabilities managed and evaluated on a fair value basis	Debt securities used in managing the collateral and liquidity portfolio
France		
BNP Paribas	Group of financial assets or liabilities managed and evaluated on a fair value basis	Assets related to unit-linked business
	Contract contains one or more embedded derivatives	Structured issues containing significant embedded derivatives
Crédit Agricole	Group of financial assets managed and evaluated on a fair value basis	Mainly assets backing unit-linked business
Société Générale	Accounting mismatch	Insurance assets
Germany		
Commerzbank	Accounting mismatch Group of financial assets or liabilities managed and evaluated on a fair value basis	Funds securities
Hypo Real Estate	Accounting mismatch Group of financial assets or liabilities managed and evaluated on a fair value basis	Fixed income securities managed on portfolio basis
Greece		
National Bank of Greece	Accounting mismatch	Debt instruments

Bank	Reason	Instruments
Italy		
Unicredit	Accounting mismatch Group of financial assets or liabilities managed and evaluated on a fair value basis	Debt positions
Ireland		
Allied Irish Bank	Accounting mismatch Contract contains one or more embedded derivatives	Unit linked insurance liabilities
Luxembourg		
Dexia	Accounting mismatch Group of financial assets and liabilities managed and evaluated on a fair value basis Contract contains one or more embedded derivatives	Assets and liabilities of unit linked insurance policies
Netherlands		
ABN Amro	Accounting mismatch Group of financial assets and liabilities managed and evaluated on a fair value basis Contract contains one or more embedded derivatives	Unit linked investments Private equity and US mortgages Structured notes
Poland		
Bank BPH	Accounting mismatch	Debt securities
Spain		
Banco Pastor	Group of financial assets and liabilities managed and evaluated on a fair value basis Contract contains one or more embedded derivatives	Insurance assets and liabilities
Santander	Group of financial assets and liabilities managed and evaluated on a fair value basis Contract contains one or more embedded derivatives	Insurance liabilities
Sweden		
Nordea Bank	Group of financial assets and liabilities managed and evaluated on a fair value basis	Bonds and mortgages
United Kingdom		
Lloyds TSB	Accounting mismatch Contract contains one or more embedded derivatives	Mainly debt-securities and equities
Royal Bank of Scotland	Accounting mismatch	Policyholders' assets

17.5 Hedge accounting

IASB requirements – hedge accounting

IAS 39 allows, subject to conditions, hedge accounting for three types of hedging relationships:

(a) fair value hedges: hedges of the exposure to changes in the fair value of all or a portion of a recognised asset or liability or an unrecognised firm commitment;
(b) cash flow hedges: hedges of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction; and
(c) hedge of a net investment in a foreign operation: hedges of the exposure to changes in the entity's share of the net assets of a foreign operation.

However certain banks were accustomed to hedging interest rate risk in a different way from that allowed by IAS 39. Some banks adjusted their hedging policy to fall within the confines of IAS 39 whilst others did not. Hence, the EU carved out part of IAS 39 primarily to allow banks to apply fair value hedge accounting to hedges of the interest rate risk of their portfolio of demand or core deposits. The 'carve-out' was perceived to be necessary because the fair value of core deposits approximates to their carrying value. The use of fair value hedge accounting in such circumstances is not permitted by IAS 39 since there is no exposure to changes in fair value. In addition, the' carve-out' removed the need for banks to recognise the consequences of hedge ineffectiveness in the income statement that may arise as a result of under-hedging in fair value hedges for a portfolio hedge of interest rate risk.

Fair value hedges

Fair value hedge accounting was used by 25 banks mainly for hedges of the fair value risk in fixed-income securities. A few banks used it for hedges of issues of own debt.

Insofar as it was possible to ascertain from disclosures, 14 banks used macro fair value hedge accounting primarily for hedges of portfolios of fixed interest rate loans.

EU carve-out

Eight banks used the EU carve-out in order to apply hedge accounting to hedges of core deposits. Chapter 8 discusses how these banks disclosed their compliance with IFRS-EU and their reference to the carve-out in either their 'Basis of preparation' or 'Significant accounting policies'. Table 8.5 lists the banks who used the carve-out. One bank explained the carve-out without explaining how it was applied in its financial statements.

Cash flow hedging

Cash flow hedge accounting was used by 24 banks mainly for hedges of variable rate financial assets and liabilities and expected transactions. They did not describe the hedged items, in the former case.

Hedges of net investments in foreign operations

Sixteen banks disclose that they use this form of hedge accounting. The hedging instruments are foreign currency derivatives and foreign currency borrowings. There was a lack of detail in the accounting policies as to the foreign exchange contracts that are used other than foreign currency borrowings in some cases. There are almost no disclosures of hedge ineffectiveness in this area.

Economic hedging

Sixteen banks explain that they entered into derivatives transactions that manage risks and that these relationships do not qualify for hedge accounting under IAS 39, for example, because of the difficulty in demonstrating that the hedging relationship will be highly effective. An example of this is the use of credit derivatives for managing portfolio credit risk. However, it is not possible to identify the amounts charged/credited to profit or loss for this type of hedge because gains and losses and hedge ineffectiveness tend to be reported in one line of the income statement.

Disclosure and presentation

All banks engaging in hedging activity that qualified for IAS 39 hedge accounting treatment, tended to include 'boiler plate' accounting policy descriptions. Frequently the IAS 39 wording was reproduced in their accounting policies. Overall, there was a lack of detail as to what financial instrument within a classification was being hedged.

Banks report hedging derivatives in the balance sheet as either:

- separate lines;
- within trading items;
- at fair value through profit or loss but separately from trading items; and
- in other assets and liabilities.

The resulting gains and losses were reported in either:

- trading profit;
- results from non-trading derivatives;
- results from financial instruments at fair value through profit or loss; or
- within other operating income.

In some cases, the gains were not separately disclosed.

17.6 Impairment of financial assets

IFRS requirements – impairment of financial assets

An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.

An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

Impairment of loans

With one exception, all banks determined both individual and collective impairment allowances for loan losses. Loan impairment policy was consistent among banks but some provided more information with regard to what was considered to be 'significant' for individual assessment. Overall, there was a lack of sufficient detail in relation to loan loss impairment methodology.

Twelve banks did not mention the discount unwind of the allowance being reported in interest income. Few banks disclosed the amount of the discount unwind.

The loan impairment expense was disclosed by 26 of the 29 banks. Loan impairment expense was presented in varying positions in the income statement. Some banks reported it immediately after net interest income, but the majority presented it as immediately before profit before tax as possible. It was presented with other impairment losses on financial assets and, in some cases, with impairment losses on goodwill and intangible assets. It was variously described as:

- risk provision for loans and advances;
- loan impairment and other credit risk provisions;
- changes in impairments;
- provision for bad and doubtful debts;
- cost of risk;
- risk related costs;
- provision for possible loan losses;
- additions to the provisions for loan losses;
- impairment charges; and
- impairment losses.

Loans are written off when:

- they are not collectible;
- the borrower is unable to fulfil obligations;
- they are unrecoverable;
- recovery is remote;
- there is no real prospect of recovery;
- the allowance is 100%; and
- recovery is considered unlikely.

Clearly, early write-off leads to less provision coverage in the balance sheet but lack of detailed disclosure in this area and an apparently inconsistent approach did not aid comparability.

Two banks used the concept of suspended interest without explaining how this related to the discount unwind in interest income.

On loan impairment, a PwC survey suggested that the most striking difference between the surveyed banks 'was the breakdown in the allowance for loans that are assessed for impairment on an individual versus a collective basis'. The collective allowance as a percentage of the total allowance ranged from between 5% and 76%.

Impairment of other financial assets

Most banks had an accounting policy dealing with the impairment of financial assets other than loans. For equity investments, impairment was deemed to have occurred after a prolonged and significant decline in value. They used IAS 39 wording to describe the reversal of impairment losses.

Impairment losses on financial assets other than loans were reported in the income statement either:

- as a separate line on the face of the income statement;
- within loan loss impairment (with analysis in a note);
- within goodwill and intangible asset impairment (with analysis in a note); or
- in other operating expenses (with analysis in a note).

There was little impairment in this area. Impairment of equity was more common than impairment of debt securities, with changes in the fair value of the latter being attributable to movements in market rates of interest.

17.7 Presentation of financial statements

IFRS requirements

IAS 30 *Disclosures in the Financial Statements of Banks and Similar Institutions* sets out the requirements for reporting in the income statement and the balance sheet. The standard does not prescribe formats nor does it state what should be on the face of the primary statements. This leaves it to the reporting entity to decide where to report the necessary information.

Balance sheet

All the banks in Sample 1 presented their balance sheets in order of liquidity.

Descriptions of financial assets varied. Some banks showed the full IAS 39 classifications on the face of the balance sheet. Others used different classifications with the IAS 39 description detailed in notes. For example, the IAS 39 item 'At fair value through profit or loss' on the face of the asset section of the balance sheet may be disaggregated in a note into:

- trading assets;
- derivatives used for hedging;
- non-hedging derivatives; and
- designated at fair value other than trading.

All banks presented separately on the face of the balance sheet loans and advances to banks and to customers and deposits by banks and customers.

For financial liabilities, a similar scenario to that for financial assets was found to be the case ranging from minimal disclosure on the face of the balance sheet with all the detailed headings in notes to all the detailed headings reported on the face.

Income statement

Trading income was reported on the face of the income statement by 27 banks although some banks used the description 'gains/losses arising on items at fair value through profit or loss' with a note that analysed this into trading result, fair value hedging result and designated at fair value through profit or loss result.

All banks reported interest income. For some banks interest income included trading interest income. Others restricted it to banking book items. Similarly all banks reported interest expense.

Of the 29 Sample 1 banks, 23 reported dividend income on the face of, or as a note to, the income statement. Only 18 banks report 'Gains less losses arising from dealing in foreign currencies'. While 11 banks for which the item was applicable did not disclose this amount.

Disclosure

Three banks early adopted IFRS 7 *Financial Instruments: Disclosures*. All the other banks applied IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 30 *Disclosures in Financial Statements of Banks and Similar Institutions*.

All banks reported risk disclosures. Four banks dedicated a separate section of the report to these disclosures which did not form part of the audited financial statements but included a cross-reference to bring the section within the scope of the financial statements. The remaining banks reported risk disclosures in the notes to the financial statements.

The following disclosures were not always made:

- concentrations of assets and liabilities (four banks);
- significant net foreign currency exposures (10 banks); and
- maximum credit risk disclosure for each class of financial asset (13 banks).

Seven banks did not appear to disclose the fair value and carrying amount for each class of financial asset and liability. Most banks reported this information in a table.

Insurance activity

IFRS 4 *Insurance Contracts – Appendix A* contains a definition of an insurance contract. This has led to the reclassification of many life assurance contracts as investment contracts because they do not contain significant insurance risk.

Another change triggered by IFRS reporting was the move from historical cost to fair value for financial assets. Banks with insurance activities report financial assets in the IAS 39 classifications for both insurance and investment contracts.

Liabilities are reported as:

- insurance liabilities when there is significant insurance risk; and
- investment contracts when there is not deemed to be significant insurance risk.

The descriptions of these liabilities varied and included:

- actuarial reserve;
- liabilities under investment contracts, insurance;
- liabilities arising from insurance and investment contracts;
- liabilities to policy holders;
- technical reserves of insurance companies;
- insurance company technical reserves;
- underwriting reserves of insurance companies;
- insurance related reserves and liabilities;
- other liabilities – insurance reserves; and
- insurance and investment contract liabilities.

These liabilities were also included in provisions for liabilities and charges.

17.8 Other surveys

Ernst & Young analysed the 2005 IFRS consolidated financial statements of the 24 largest European banks. It concluded that the goal of consistency in reporting had not been completely achieved because of the difficulties of interpreting IAS 32 and IAS 39, the more complex provisions of which had undoubtedly been the subject of varying implementations.

PwC reviewed the IFRS consolidated financial statements of 20 banks of which 19 were from Europe and 13 were included in our survey. It concluded that the introduction of

IFRS only marginally improved the comparability of key measures of credit risk between banks as provisioning practices still varied. The expectation was that disclosures under IFRS 7 and Basel II should help to enhance comparability by providing increased transparency and consistent disclosure of the risk profile.

The European Central Bank noted in 2006 that IFRS financial information published so far by financial institutions has not resulted in any significant changes. It warned, however, that the long term impact of IFRS should not be underestimated and that temporary local transitional measures may blur the analysis.

SEC *Staff Observations in the Review of IFRS Financial Statements* stated that, inter alia, a number of companies had been asked to provide additional information or disclosure about the significant terms of financial instruments, including derivatives, their effect on future cash flow and the recognition and measurement criteria the company applied. In addition it was questioned whether various banks complied with IAS 39 in determining loan impairment and that discussions on this topic were ongoing.
Two SEC published comment letters to banks requested future filings to disclose more clearly some classifications within available-for-sale assets.

18. Insurance companies

18.1 Key points

In relation to the 13 specialist insurance companies in Sample 1, our analysis showed that overall the large multinational companies did a good job in complying with IFRS, in particular with IFRS 4 *Insurance Contracts,* including its disclosure requirements. By comparison, the disclosures of other insurance companies were of a lower standard.

Of the 13 companies in Sample 1, three were continuing IFRS reporters and had presented IFRS financial statements in prior periods and 10 were first-time adopters. Seven first-time adopters restated the comparative period to comply with IFRS 4 and three availed themselves of the exemption in IFRS 1 which allowed them to apply IFRS 4 from 1 January 2005 without restating the 2004 comparative information.

Appendix A of IFRS 4 contains a definition of an insurance contract which requires it to contain significant insurance risk. This led to the reclassification of many life assurance contracts as investment contracts under IAS 39 because they did not contain significant insurance risk. This definition issue led to the reclassification of some contracts by two out of three continuing IFRS reporters, as well as many of the first-time adopters.

We found that eight of the 13 insurance companies in Sample 1 used the fair value option for some financial assets and financial liabilities.

All the insurance companies in Sample 1 appeared to carry out the liability adequacy test required by IFRS 4. This involves the company in assessing at each reporting date whether the insurance liabilities recognised are adequate using current estimates of future cash flows under its insurance contracts.

In relation to discounting, IFRS 4 allows insurers to continue using some existing practices. Among these, it allows an insurer to measure insurance liabilities on an undiscounted basis. However, an insurer may not adopt an undiscounted basis if it previously used a discounted basis although it may change from an undiscounted basis to a discounted basis. We noted that only one out of the 13 insurance companies in Sample 1 discounted non-life provisions.

IFRS 4 does not permit the recognition of catastrophe provisions and equalisation provisions and, as a result, seven of the Sample 1 insurance companies eliminated such provisions.

We noted that seven insurance companies in Sample 1 continued to use shadow accounting as permitted by IFRS 4. Shadow accounting arises where realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities, related deferred acquisition costs and related intangible assets. The insurer changes its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) is recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity.

18.2 Implementation of IFRS

The 13 specialist insurance companies in the study are set out in Table 18.1. Three of these companies, **Allianz** (Germany), **Munich Re** (Germany) and **Middlesea** (Malta), had presented IFRS financial statements in prior periods.

Table 18.1: Insurance companies in Sample 1

Austria Wiener Staedtische	**Greece** Agrotiki Insurance	**Netherlands** ING
France AXA SCOR	**Ireland** Irish Life & Permanent	**Spain** Mapfre
Germany Allianz Munich Re	**Italy** Generali	**UK** Prudential Royal & SunAlliance
	Malta Middlesea	

The analysis that follows indicates that overall the large multinational insurance companies did a good job in complying with IFRS, in particular with IFRS 4 including its disclosure requirements. By comparison, the disclosures of other insurance companies were of a lower standard.

18.3 Insurance contracts

IFRS requirements – insurance contracts

IFRS 4 defines an insurance contract as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. IFRS 4 applies to all insurance contracts (subject to some exceptions).

Sample 1 results – insurance contracts

First-time adopters were affected by any differences between the IFRS 4 definition of an insurance contract and the treatment of the contracts under their prior national GAAP. The new definition causes some contracts that were previously classified as insurance contracts to be reclassified as investment contracts under IAS 39 *Financial Instruments: Recognition and Measurement*

The new definition also affected two continuing IFRS reporters. **Allianz** and **Middlesea** had to reclassify certain contracts that had previously been classified as insurance contracts under IFRS (pre-IFRS 4) as investment contracts. For **Munich Re**, the adoption of IFRS 4 did not have a significant effect on classifications.

IFRS requirements

As explained in Chapter 11, IFRS 1 *First-time Adoption of International Financial Reporting Standards* requires that an entity's first IFRS financial statements shall include at least one year of comparative information under IFRS. In the first IFRS financial statements for accounting periods beginning before 1 January 2006 (which is all the financial statements under review), the comparative information need not comply with IFRS 4. **Irish Life & Permanent** (Ireland), **ING** (Netherlands) and **Prudential** (UK) use this exemption. The other seven first-time adopters restated the prior period for IFRS 4.

18.4 The fair value option

IAS 39 requirements

The fair value option in IAS 39 allows an entity to designate a financial instrument that would otherwise be measured at amortised cost as at fair value through profit or loss. The effect of this designation is that the financial instrument is measured at fair value at each balance sheet date instead of wholly or partly at amortised cost. The changes in fair value are included in profit or loss.

Under the amendment to IAS 39, an entity may use the fair value option only in specific circumstances:

- it eliminates, or significantly reduces, a measurement or recognition inconsistency (an 'accounting mismatch');
- a group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel ('group of financial assets or financial liabilities managed on a fair value basis'); or
- it contains one or more embedded derivatives.

Use of the fair value option

Seven insurance companies clearly use the fair value option, mainly to avoid an accounting mismatch for investment contracts (such as index linked and unit linked contracts) backing insurance provisions where the investment risk is borne by the policyholders (Table 18.2). Typically, the fair value option is applied for life products, to the extent that they fall to meet the definition of investment contracts. All of these companies disclose that they have early adopted the amended fair value option.

Middlesea has an accounting policy for the fair value option but there are no indications of the use of the option.

No non-life insurance companies elected to use the fair value option.

Table 18.2: Use of the fair value option by insurance companies

Company	Reason	Instruments
Austria		
Wiener Staedtische	Group of financial assets and liabilities managed and evaluated on a fair value basis	Bonds, structured loans, shares and unit funds
France		
AXA	Group of financial assets and liabilities managed and evaluated on a fair value basis	
Germany		
Allianz	Accounting mismatch Group of financial assets and liabilities managed and evaluated on a fair value basis	
Ireland		
Irish Life & Permanent	Accounting mismatch	Insurance assets
Italy		
Generali	Accounting mismatch	
Malta		
Middlesea	Group of investments managed on a fair value basis	
Netherlands		
ING	Accounting mismatch	Insurance assets
United Kingdom		
Prudential	Accounting mismatch Contract contains one or more embedded derivatives	

18.5 Insurance liabilities

Liability adequacy test

IFRS 4 requires an insurer to assess at each reporting date whether the amount of insurance liabilities recognised are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of insurance liabilities is inadequate, the company is required to recognise the entire deficiency as an increase in the liability and an expense in profit or loss.

All the companies appear to carry out the liability adequacy test and measure insurance liabilities at amounts which reflect current estimates of future cash flows under their insurance contracts. We did not identify any understated liabilities but their existence might not be clear from the financial statements.

Discounting

IFRS 4 allows an insurer to continue using some existing practices. Among these, it allows an insurer to measure insurance liabilities on an undiscounted basis. However, an insurer may not adopt an undiscounted basis if it previously used a discounted basis. It may change from an undiscounted basis to a discounted basis.

In national GAAP, discounting is almost universally used in the calculation of life insurance provisions. Therefore all the companies measured life insurance liabilities on a discounted basis.

Only one insurance company (**Royal & SunAlliance** (UK)) discounted non-life insurance liabilities. It discounted selected long tailed non-life business (asbestos, environmental, disability) when a suitable claims payment pattern existed from which to calculate the discount. All the other 12 companies continued to measure non-life insurance liabilities on an undiscounted basis.

Catastrophe provisions and equalisation provisions

IFRS 4 prohibits the recognition as a liability of any provisions for possible future claims, if those claims arise under insurance contracts that were not in existence at the reporting date. Therefore, IFRS 4 does not permit the recognition of catastrophe provisions and equalisation provisions.

Seven companies were required to remove catastrophe provisions, equalisation provisions and similar amounts from their balance sheets on the implementation of IFRS 4 (Table 18.3). One company, **Middlesea**, was a continuing IFRS reporter. The other six companies were first-time adopters of IFRS.

Table 18.3: Elimination of catastrophe and equalisation provisions of first-time adoption of IFRS

Company	Nature of provisions
Austria	
Wiener Staedtische	Property/casualty equalisation reserve and catastrophe reserve
France	
AXA	Equalisation provisions (non-life)
SCOR	Equalisation and catastrophe provisions
Italy	
Generali	Equalisation and catastrophe provisions
Malta	
Middlesea	Equalisation provision regulated by the Insurance Business Act 1998
Spain	
Mapfre	Stabilisation and catastrophe provisions
United Kingdom	
Royal & SunAlliance	Equalisation provisions for future catastrophe and other unusual losses

18.6 Shadow accounting

IFRS 4.30 deals with shadow accounting. 'In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity. This practice is sometimes described as 'shadow accounting'.'

Seven companies (**AXA** (France), **Generali** (Italy), **ING**, **Mapfre** (Spain), **Prudential**, **SCOR** (France) and **Wiener Staedtische** (Austria)) continued to use shadow accounting. No Sample 1 companies commenced using shadow accounting on the transition to IFRS.

18.7 Impairment of reinsurance assets

IFRS 4.20 requires a reduction in the carrying amount of reinsurance assets when there is objective evidence that a company may not receive all the amounts due to it under the terms of the reinsurance contract and the event that gives rise to the evidence has a reliably measurable impact on the amounts that can be recovered from the reinsurer.

For most companies it is not evident from their disclosures whether reinsurance assets were tested for impairment.

18.8 Other surveys

Ernst & Young analysed the 2005 IFRS consolidated financial statements of 18 insurers including three bancassurers, two reinsurance entities and 13 life and non-life insurers. 16 were based in the European Union. Nine of the companies were included in this survey.

Ernst & Young observed that few insurance groups fundamentally reengineered their financial statements when they made the transition to IFRS and that, therefore, a strong national GAAP heritage remained in the presentation of those financial statements. There was a notable increase in the extent of narrative disclosures and, as predicted, a number of new disclosures. However, according to Ernst & Young, some financial statements appear to have been drafted simply with a view to meeting the minimum disclosure requirements under IFRS, rather than providing useful insight as to where value in their insurance business was being created and how the risks were being managed.

KPMG analysed the 2005 IFRS consolidated financial statements of 47 life companies, general companies and composites from 17 countries including 10 EU member states. The survey suggested that insurers carried out considerable work to facilitate the IFRS conversion process but the companies felt that they had derived few benefits from the effort. The majority of respondents to the survey noted that implementing IFRS had increased financial reporting risk due to the technical complexities of IFRS and the reliance of organisations on manual procedures.

PwC surveyed the 2005 consolidated financial statements of 26 large insurance groups. Among the key findings were the following observations:

> ‘Key findings
>
> - The insurance industry has overcome an enormous implementation challenge in moving to IFRS. The most significant developments range from extensive new disclosure requirements to the first internationally agreed definition of an insurance contract.
> - The financial statements are considerably longer and provide valuable new information for users of accounts. However, the wide degree of discretion in the format of presentation has made them harder to compare.
> - The financial statements tend to be less clear and are harder to follow than before as a result of the differing approaches in this first year. Some financial statements seemed better structured and more intelligible than others.
> - Insurers still have some way to go to satisfy users of accounts’ demands for greater quality, clarity and comparability in their disclosure. Peer group comparison, greater cooperation to enhance consistency and more active engagement with (and by) the International Accounting Standards Board (IASB) would be invaluable in achieving this.’

19. Extractive industries

19.1 Key points

IFRS 6 *Exploration for and Evaluation of Mineral Resource* was mandatory only from 2006, but could be applied on a voluntary basis in 2005 by entities operating in the oil and gas and mining sectors. The standard introduces only limited improvements to accounting in this key sector, and allows the continuation of some existing national requirements that may conflict with usual IFRS principles.

Our work indicated that major companies involved in this sector made few changes when accounting for the costs of exploration for, and evaluation of, mineral resources on the transition from national GAAP to IFRS. We conclude tentatively that the adoption of IFRS is unlikely to have any significant effect on accounting by EU extractive industries before the implementation of new requirements. The absence of a comprehensive standard in this area was identified at our roundtables as a weakness in IFRS, albeit one of which the IASB is well aware.

There is some evidence relating to companies outside of Sample 1 of a shift from full cost to successful efforts accounting on adoption of IFRS 6. This observation might warrant further investigation as part of the IASB's long-term project now that IFRS 6 is fully in force.

19.2 Features of IFRS 6

IFRS 6 provides, for the first time in IFRS, guidance on accounting for exploration and evaluation expenditures. IFRS 6 applies to accounting periods beginning on or after 1 January 2006: that is, a year after the first IFRS financial statements prepared in accordance with the IAS Regulation.

Early adoption of IFRS 6 was essential for any entity with exploration and evaluation assets that wished to avoid the application of the IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* hierarchy in its accounting policies for the recognition and measurement of those assets. IFRS 6 requires improved disclosures for exploration for and evaluation of mineral resources and makes modest improvements to recognition and measurement practices in relation to mineral resources, particularly with respect to testing exploration and evaluation assets for impairment. However, these are limited improvements, and the standard allows the continuation of some existing national requirements despite the fact that they may conflict with usual IFRS principles.

The exemption from applying the accounting policy hierarchy in IAS 8 to accounting policies for the recognition and measurement of exploration and evaluation assets means that an entity may capitalise costs that would not meet the criteria for capitalisation in IAS 16 *Property, Plant and Equipment* and, in particular, IAS 38 *Intangible Assets*.

IFRS 6 marks only the initial phase of the IASB's project on extractive activities, pending a comprehensive review of all the relevant issues. The IASB project team currently estimates that a discussion paper will be published in mid-2008, with a minimum of two and a half years required after that before a comprehensive standard can be in place. Based on this timetable and the evidence outlined below relating to early adopters among Sample 1 companies, it might be expected that the adoption of IFRS would be unlikely to have any very significant effect on accounting by oil and gas and mining companies in the near future.

19.3 Early adoption of IFRS 6

Sample 1 results – early adoption of IFRS 6

Of the 200 Sample 1 companies, 10 companies involved in the exploration for, and evaluation of, mineral resources, early adopted IFRS 6 (Table 19.1).

Table 19.1: Early adoption of IFRS 6

France	Netherlands	UK
Total	Royal Dutch Shell	Anglo American BG
Italy	**Spain**	BHP Billiton
Eni	Repsol	BP Burren Energy Kazakhmys

CEZ (Czech Republic), **PKN Orlen** (Poland) and **Slovnaft** (Slovakia) which appear to have exploration or evaluation activities did not early adopt IFRS 6.

CEZ disclosed that IFRS 6 was 'most relevant' to its activities and that it was assessing its impacts. Its financial statements did not refer to any exploration and evaluation assets. Its adoption of IFRS 6 in its 2006 IFRS consolidated financial statements did not result in a change in accounting policy.

PKN Orlen stated that IFRS 6 'might have an impact' on its financial statements. There is no reference to IFRS 6 or changes in its accounting policies in the 2006 IFRS consolidated financial statements.

Slovnaft did not expect any material effect from its adoption of IFRS 6, an expectation which was confirmed in its 2006 IFRS consolidated financial statements.

19.4 Exploration and evaluation assets

Sample 1 results – accounting methods for exploration and evaluation assets

There are two main methods of accounting for the exploration for, and evaluation of, mineral resources as follows:

- Under **successful efforts** accounting, costs of successful projects (i.e. that lead directly to the discovery of reserves) are capitalised, while costs of unsuccessful projects are charged immediately to expense. Capitalised costs applicable to producing properties are amortised based on the amount of reserves.
- Under **full cost** accounting, all costs incurred in searching for, acquiring, and developing reserves in a cost centre such as a country or continent are capitalised, irrespective of whether an individual project was or was not successful. The capitalised cost is then amortised against the reserves in that cost centre.

In practice there are many variations on the successful efforts and full cost methods: for example, in relation to depreciation and impairment of capitalised costs and provision for future site clean-up costs.

Table 19.2 shows how the seven oil and gas companies that early adopted IFRS 6 accounted for exploration and evaluation expenditure. Six companies use successful efforts; one company uses full cost.

Table 19.2: Accounting by oil and gas companies for exploration and evaluation expenditure

Company	
France	
Total	Successful efforts
Italy	
Eni	Successful efforts
Netherlands	
Royal Dutch Shell	Successful efforts
Spain	
Repsol	Successful efforts
United Kingdom	
BG	Successful efforts
BP	Successful efforts
Burren Energy	Full cost

Of those using successful efforts, none has changed its accounting policies on the adoption of IFRS 6. For example, **Eni** (Italy) states that it continued to use the existing accounting policies for exploration and evaluation assets previously applied under national GAAP. **BG** (UK) discloses that it continues to use the accounting policies applied immediately before adopting IFRS as a result of which 'the adoption of IFRS 6 has had no impact on BG's financial statements'.

Burren Energy (UK) continued to use full cost, but with certain modifications to its previous policies in order to comply with IFRS 6.

In the course of discussions with industry experts, we were advised that the oil and gas companies in Sample 1 may not be representative in relation to the number of companies adopting full cost, at least in the UK. Our attention was drawn to the accounting policies of three other companies that had used full cost in 2004: Cairn, Premier Oil and SOCO. Both Cairn and Premier Oil switched to successful efforts on transition to IFRS in their 2005 financial statements. SOCO continued with full cost, but, as in the case of Burren Energy with modifications to the policies previously adopted under national GAAP in order to comply with IFRS 6.

Anecdotally, we understand that there may be some movement away from full cost accounting by at least UK-listed explorers and producers, perhaps because the successful efforts approach presents fewer accounting difficulties under IFRS 6. In the context of this general study of IFRS implementation and in view of the voluntary nature of IFRS 6 application in 2005 it was not considered necessary or appropriate to pursue this further. However, given that such UK-listed companies represent a significant proportion of the European oil and gas sector, and our understanding that many North American companies tend to adopt full cost, this issue might warrant further study as the IASB's long-term project progresses.

Mining companies included in Sample 1 also report an absence of change. **Anglo American** (UK) discloses that IFRS 6 did not impact its existing policy for exploration and evaluation expenditure. **BHP Billiton** (UK) states that its adoption of IFRS 6 enabled its existing UK GAAP policies to apply under IFRS. **Kazakhmys** (UK) applied IFRS 6 for all

periods since 1 January 2002 which is the beginning of the earliest period presented in its September 2005 prospectus.

19.5 Other surveys

In a 2006 study of the implementation of IFRS by 65 European and other companies, Ernst & Young analyses the financial statements of five companies involved in mining and five companies in the oil and gas sector. It notes *inter alia* different practices with respect to exploration costs and variations in the level of disclosures related to drilling costs. It also records that all the oil and gas companies reviewed continued to apply successful efforts-based capitalisation policies, but, in support of our tentative observations above, notes that IFRS 6 in general appears to have encouraged companies to discontinue full cost accounting and to change to a successful efforts approach.

19.6 Roundtables

The absence of a comprehensive standard in this area was identified at our roundtables as a weakness in IFRS, albeit one of which the IASB is well aware and which it is currently addressing.

20. Service concessions

20.1 Key points

Service concessions are arrangements between public sector bodies and private sector entities for the provision of public services. Such arrangements are now of major economic importance, but there has been wide diversity in how they have been accounted for.

IFRIC 12 *Service Concession Arrangements* was issued in November 2006 after all the relevant companies had issued the IFRS financial statements under our review. Assuming IFRIC 12 is endorsed for use in the EU, companies are likely to continue with their existing practices for the time being, and financial reports on an IFRIC 12 basis are unlikely to be common before 2009. It is therefore too early to draw any firm conclusions about the implementation of IFRS in this area. Indeed, out of the 200 Sample 1 companies, six of the seven companies that disclose the existence of service concessions apply IFRS without reference to the draft of IFRIC 12 rather than anticipate its requirements.

20.2 National GAAP and IFRIC 12

IFRIC 12 *Service Concession Arrangements* was issued in November 2006 and becomes effective for annual periods beginning on or after 1 January 2008, subject to the EU endorsement process. Companies were, however, aware of the proposals in the exposure draft that preceded IFRIC 12.

Service concessions are arrangements whereby a government or other public sector entity grants contracts for the supply of public services (such as roads, airports, prisons, energy and water supply and distribution facilities) to private sector entities (the operator). Control of the assets remains in public hands but the operator is responsible for construction activities, as well as for operating and maintaining the public sector infrastructure. Such arrangements are now of major economic importance, but there has been wide diversity in how they have been accounted for.

Under IFRIC 12, the operator may receive either:

- a financial asset being an unconditional contractual right to receive cash or another financial asset from the sponsor (generally a government) in return for constructing or upgrading the public sector asset; or
- an intangible asset being the right to charge for use of the public sector asset that it constructs or upgrades.

The operator does not recognise on its balance sheet any right to use assets granted to it by the government entity. It does not recognise the constructed asset as property, plant and equipment.

Sample 1 results

Table 20.1 shows the accounting treatment adopted by the seven companies that disclose the existence of service concessions. Only **Bouygues** (France) uses the IFRIC 12 approach. It discloses that the impact of accounting in accordance with IFRS for service concession arrangements in a number of companies in which it has equity interests is not material. However, a new contract in a fully-consolidated company ‘is accounted for using the “financial asset” model, based on the draft IFRIC interpretation.’

The other six companies apply IFRS without reference to the draft of IFRIC 12. Accounting treatments adopted include the recognition of property, plant and equipment and, in some cases, the assets assigned by the government and provisions for future replacement and maintenance expenditure. **Gas Natural** (Spain) includes some concession assets in intangibles and some in property, plant and equipment.

Table 20.1: Accounting for concession assets

Company	
France	
Bouygues	Financial asset model
Gaz de France	Assets financed by the company and those provided by third parties and concession grantors are included under non-current assets and measured at cost less amortisation
Italy	
Acea	Asset constructed by company recognised as separate non-current asset measured at cost less amortisation
Autostrada	Asset constructed by company included in property, plant and equipment and measured at cost less depreciation. Provision for repair and replacement
Portugal	
Brisa	Asset constructed by company included in tangible fixed assets at cost less depreciation
Spain	
Abertis	Asset constructed by company included in fixed assets and measured at cost less depreciation. Provisions are included for future investments in replacement and substitution
Gas Natural	Concession assets included in intangibles and in property plant and equipment

Background to IFRIC 12

As identified by the IFRIC, and acknowledged by the European Financial Reporting Advisory Group (EFRAG) in its letter endorsing IFRIC 12, there is widespread uncertainty as to how IFRS should be applied to service concession arrangements, with a correspondingly wide diversity of practice.

Six of the companies in Table 20.1 adopt some variation on the depreciated asset model, with further provisions recognised in two cases. These treatments are not available under IFRIC 12.

21. Intangible assets

21.1 Key points

IAS 38 *Intangible Assets* requires that intangible assets should be carried at cost or fair value less any amortisation and any impairment losses.

Amongst the 200 companies in Sample 1, our analysis indicates that the level of disclosure surrounding useful lives and amortisation rates was inconsistent, with some companies not providing full analysis of the useful lives selected where there was a range of different intangible assets.

Of the 200 companies, 20 were chosen for more detailed analysis in order to highlight any specific issues relating to the disclosures around impairment and business combinations. The majority of these companies disclosed sufficient information on impairment to comply with the requirements of IAS 36 *Impairment of Assets*. However, there is scope for improving disclosures that relate to allocation of goodwill to Cash Generating Units and sensitivity analysis.

One expectation for business combinations under IFRS is that more intangible assets will be recognised and reported and that additional information about the residual cost recognised as goodwill will be disclosed. However, it was noted that within 20 companies selected for more detailed analysis, examples were found where the additional disclosures required by IFRS 3 *Business Combinations* were not provided. Doubts were expressed at the roundtables about the value of the new information on intangibles required under IFRS 3.

21.2 Measurement

IAS 38 requires that intangible assets should be recognised initially at cost and subsequently measured at either:

- cost less any accumulated amortisation and any write-down for impairment; or
- fair value less any subsequent accumulated amortisation and any write-down for impairment.

Across the 200 Sample 1 companies all intangible assets were measured on the basis of cost.

IAS 38 requires that assets are classified according to whether they are expected to have a finite or an indefinite life. Assets with an indefinite life are those for which there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. However, the term ‘indefinite life’ does not imply ‘an infinite life’. Assets with a finite life are those for which there is a limited period of benefit to the entity. IAS 38 requires that the amortisation method should allocate the depreciable amount over the item’s useful life. The method should reflect the pattern in which the asset’s economic benefits are consumed.

Sample 1 results – indefinite and finite lived assets

Table 21.1 shows whether Sample 1 companies have intangible assets with finite lives or indefinite lives or both.

Table 21.1: Distribution of finite and indefinite lived assets

	Number	Percentage
All intangible assets have finite lives	167	83.5
Intangible assets have both finite and indefinite lives	29	14.5
All intangible assets have indefinite lives	0	0
No intangible assets	4	2
Total	**200**	**100**

Indefinite-lived intangibles principally comprise brands and trademarks. For those companies in possession of large numbers of brands, chiefly consumer orientated companies, brands may have either indefinite or finite useful lives.

For example, **L'Oréal**, (France) the cosmetics company, states that:

> 'Local trademarks which are to be gradually replaced by an international trademark already existing inside the group are trademarks with a finite life span.
>
> They are to be depreciated over a life span, which is estimated at the date of acquisition.
>
> International trademarks are trademarks with an indefinite life span. They are subjected to impairment tests if an unfavourable event occurs, and at least once a year, during the fourth quarter. The impairment test consists of calculating the recoverable value of the trademark based on the model adopted when the acquisition takes place.'

LVMH (France), the luxury goods group, generally classifies brands or trade names as an asset with an indefinite life based on the following criteria:

- the brand or trade name's positioning in its market, expressed in terms of volume of activity, international presence and notoriety;
- its expected long term profitability;
- its degree of exposure to changes in the economic environment;
- any major events within its business segment liable to compromise its future development; and
- its age.

SES Global (Luxembourg), which operates satellites, lists orbital slot licence rights as intangible assets and states that:

> 'The Group believes that it has a high probability of being able to achieve the extension of these rights as the current agreements expire and hence these assets are not amortised but rather are held on the balance sheet at acquisition cost.'

Sample 1 results – indefinite lived assets

Table 21.2 analyses the nature of the indefinite lived intangible assets in the 29 companies in Sample 1 that have such assets.

Table 21.2: Distribution of indefinite lived assets

	Number	Percentage
Trademarks, trade names, service marks, collective marks and certification marks	24	73
Newspaper mastheads and frequencies	1	3
Customer contracts and the related customer relationships	1	3
Lease agreement	2	6
Licensing rights	1	3
Orbital slot licence rights	1	3
Unspecified	3	9
Total	**33**	**100**

L'Espresso (Italy), the media group, lists publications' mastheads, certain trademarks and broadcasting frequencies as indefinite lived intangible assets.

Sample 1 results – finite lived assets

Of the 200 companies in Sample 1, a representative sample of 20 with intangibles with finite lives was selected for further detailed analysis (Table 21.3).

Table 21.3: Sample of 20 companies

Belgium
IBA

Denmark
Møller – Mærsk

France
L'Oréal
LVMH
Vivendi

Germany
BASF
Deutz

Ireland
Allied Irish Bank

Italy
Datalogic
L'Espresso

Luxembourg
SES Global

Netherlands
Unilever

Spain
Iberia
Repsol

Sweden
Ericsson

UK
Anglo American
British American Tobacco
Cadbury Schweppes
GlaxoSmithKline
Vodafone

Table 21.4 records the results of an analysis of a representative sub-set of 20 of the companies from Sample 1 that disclose intangibles with finite lives.

Table 21.4: Examples of finite lived assets

	Number	Useful life-years*
Trademarks, trade names,	5	7
Commercial facility	1	10
Oil and gas industry specific	1	*Case by case basis*
Concessions	5	5 to 10
Permits, patents and licences	8	3 to 25
Computer software	13	3 to 8
Development costs	5	0 to 5
Total	**38**	

*Useful lives are an indication of the range of those reported in the sample of 20 financial statements.

Two companies did not state explicitly the useful lives or the amortisation rates for all of their intangible assets. Other companies gave a useful life for some classes of intangible assets but not others.

21.3 Impairment

Intangible assets with finite lives

IAS 36 *Impairment of Assets* deals with impairment. IAS 36.9 requires an entity at each reporting date to assess whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

Impairment of intangible assets was recognised and explained by **Møller - Mærsk** (Denmark) as follows:

'Following the takeover and based on recent development a review of the acquired interests [intangible concession rights] has shown that a lower net profit than expected is probable.'

Goodwill

From the sample of the 20 companies referred to above, 18 reported an amount for goodwill either on the face of the balance sheet or in a note to the financial statements.

Iberia (Spain), one company with no goodwill on its balance sheet, stated in its reconciliation to IFRS notes that:

> 'This goodwill [on acquisition] was attributed basically to the value of market presence, size and image of Aviación y Comercio, S.A. ….Since it was not possible to reasonably allocate these items to a single cash-generating unit on the basis of which to evaluate possible changes in value in the future, the Company opted to write this goodwill off against the reserves for first-time application of IFRSs.'

Deutz (Germany) mentions goodwill in the 'Principles of Consolidation' policy but none appears in the balance sheet or in the intangible assets note.

Accounting policy

IAS 36.10(a) requires an entity to test for impairment annually an intangible asset with an indefinite life or an intangible asset not yet available for use irrespective of whether there is any indication of impairment. IAS 36.10(b) requires an entity to test for impairment annually goodwill acquired in a business combination.

Those companies in the sample of 20 reporting goodwill explained the policy of annual impairment testing in the significant accounting policy note to the financial statements.

Allocation to Cash Generating Units (CGUs)

IAS 36.80 requires goodwill acquired in a business combination to be allocated to CGUs from the acquisition date.

Detail of how the goodwill was allocated to CGUs was reported by the 20 companies in the intangible assets note. The allocation was described with varying degrees of detail ranging from a statement to the effect that allocation had taken place to significant detail.

Vodafone (UK) (illustrated below) and **Vivendi** (France) allocate goodwill between reportable segments in a table. This approach was adopted in less detail by other companies in the sample.

	Germany	Italy	Japan	Spain	UK	Other mobile operations	Other operations Germany	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cost:								
31 March 2005	35,765	19,812	8,295	10,399	713	6,449	41	81,474
Reclassification as held for sale	-	-	-8,295	-	-	-	-	-8,295
	35,765	19,812	-	10,399	713	6,449	41	73,179
Exchange movements	595	330	-	172	-	192	2	1291
Arising on acquisition	-	15	-	-	3	2,784	-	2802
Disposals	-	-	-	-	-	-1,142	-	-1142
31 March 2006	36,360	20,157	-	10,571	716	8,283	43	76,130
Accumulated impairment losses:								
31 March 2005	-	-	-	-	-	475	-	475
Exchange movements	442	82	-	-	-	-11	-	513
Impairment losses	19,400	3,600	-	-	-	515	-	23,515
Disposals	-		-	-	-	-979	-	-979
31 March 2006	19,842	3,682	-	-	-	-	-	23,524
Net book value								
31 March 2006	16,518	16,475	-	10,571	716	8,283	43	52,606
31 March 2005	35,765	19,812	8,295	10,399	713	5,974	41	80,999

Methodology to ascertain the recoverable amount

IAS 36.33 contains requirements, *inter alia*, for the estimation of future cash flows to be based on the most recent financial budgets/forecasts. IAS 36.55 contains requirements as to the discount rate to be used in the value in use calculation. IAS 36.134(f) requires disclosures that relate to a reasonably possible change in a key assumption.

Methodology was explained in detail by 8 companies from the sample of 20. Most were using management budgets of 5 years as a basis with a specified growth rate where appropriate and a stated discount factor.

Allied Irish Bank (Ireland) used a different approach, thereby explaining that no impairment needs to be recognised, as follows:

> 'The market value at 31 December 2005 of the shareholding in BZWBK S.A. of €1.9bn exceeds the carrying amount including goodwill of the investment by €0.6bn.'

Material goodwill impairment was recognized and explained by **Vodafone** as follows:

> 'The carrying value of goodwill of the Group's mobile operations in Germany and Italy, with each representing a reportable segment, has been impaired due to Vodafone having revised its view of longer term trends for these businesses given certain developments in the current markets.'

Unilever (Netherlands) explains:

> 'However, the 2005 impairment review of the global *Slim-Fast* business resulted in an impairment charge of €363 million due to the continued decline of the weight management sector.'

Effect of reasonably possible changes in key assumptions

5 of the 20 sample companies did not mention sensitivity analysis, presumably because there would be no effect on reported amounts from reasonably possible changes in key assumptions. Two examples of disclosures of sensitivity analysis are set out below.

Repsol (Spain)

> 'Repsol considers that, based on current knowledge, the reasonably possible changes in key assumptions for determining fair value, on which the determination of recoverable amounts was based, will not cause the carrying value of the cash-generating units to exceed the recoverable amounts at 31 December 2005.'

Ericsson (Sweden)

> 'A number of tests of sensitivity have been made, for example the effect of growth of just one percent. None of these tests indicate requirement of impairment write-down.'

21.4 Business combinations

IFRS requirements

IFRS 3 *Business Combinations:*

- requires the separate recognition of the acquiree's intangible assets if they can be measured reliably (IFRS 3.37c);
- provides extensive examples of items acquired in a business combination that meet the definition of an intangible asset (IFRS 3 IE);
- requires disclosure in the financial statements that are presented following the acquisition of the amount recognised for these intangible assets together with the carrying amounts before the acquisition (IFRS 3.67f);

- requires the recognition of goodwill acquired in a business combination as an asset (IFRS 3.51a);
- requires goodwill to be measured initially at cost being the excess of the purchase consideration over the acquirer's interest in the net fair value assets (IFRS 3.51b); and
- requires a description of the factors that contributed to a cost that results in the recognition of goodwill (IFRS 3.67h).

In addition, IAS 38 *Intangible assets*:

- provides guidance on determining the fair values of intangible assets acquired in business combinations; and
- states that these intangible assets can normally be measured with sufficient reliability to be recognised separately from goodwill (IAS 38.35).

From the sample of 20, 9 companies reported acquisitions in the year. One of these companies judged its acquisition to be immaterial and provided basic disclosure in a brief note. The remaining 8 companies reported an acquisition fair value table to comply with IFRS 3.67f.

One company recognised intangible assets on acquisition but reported them together with tangible assets in the acquisition fair value table. It was not possible to derive the separate amounts from the movement schedule reported for intangible assets. However, the information was provided in narrative form in the intangible asset note to the financial statements.

Two of the companies provided the description for goodwill required in IFRS 3.67h, as follows:

GlaxoSmithKline (UK)

> 'The goodwill arising on the acquisition results from benefits which cannot be separately quantified and recorded, including immediate access to additional 'flu vaccines manufacturing capacity, particularly in the event of a pandemic, a skilled workforce and good relations with the US and Canadian governments regarding the supply of 'flu vaccines.'

Vodafone

> 'The goodwill is attributable to the profitability of the acquired business and the synergies expected to arise within those businesses after the Group's acquisition of ClearWave N.V.'

One company reported 'negative goodwill', as follows:

Anglo American (UK)

> 'Net assets acquired in the transaction were $191 million. $14 million of negative goodwill arising on acquisition of the minorities was written back to the income statement as a special operating item in accordance with IFRS 3.'

Views from the roundtables

Serious concerns were raised by several participants – including users, auditors and preparers – at the roundtables over IFRS 3's requirements in relation to intangible assets. Whilst it was not denied that the separation of some intangibles is important, it was felt that the benefits of identifying and reporting a wider range of intangible assets did not

justify the substantial cost and efforts involved, especially in relation to the recourse to external valuers.

It was also reported that boards often lack confidence in the externally-derived numbers, and that there is inconsistency in the types of asset reported.

22. Defined benefit pension plan disclosures

22.1 Key points

Accounting for pensions is recognised as complex, and the nature of the defined benefit plans falling within the scope of IAS 19 *Employee Benefits* varies significantly from relatively straightforward provisions for severance pay to the complex plans of global groups.

IAS 19 has a number of specific disclosure requirements. It would appear from the sample of companies reviewed that some of these disclosures were not provided and, in the case of the actuarial assumptions used, disclosures were often poor.

IAS 19's general requirement to disclose information to enable users of the financial statements to evaluate the nature of the defined benefit plans and the financial impacts of changes in those plans is hindered by lack of consistency in the layout and location of the pension disclosures. Given the range of accounting options available, the lack of detail provided in the notes in some cases further inhibits the ability of users to evaluate the impact of the companies' defined benefit plans.

22.2 Scope of detailed analysis

Of the 200 companies in Sample 1, 162 had defined benefit plans. A sample of 20 was selected for further detailed analysis of their defined benefit pension plan disclosures.

Table 22.1: Defined benefit plan disclosures – sample of 20 companies

Austria Hirsch Servo*	**Italy** Datalogic* Unicredit	**Spain** Endesa
Belgium GBL	**Netherlands** ABN Amro Vedior	**UK** Anglo American Cobham Jardine Lloyd Thompson Royal & SunAlliance Tesco
Denmark Novo Nordisk	**Portugal** EDP	
France Bic Total	**Slovakia** Slovnaft*	
Germany Deutz Schering	**Slovenia** KRKA*	

*The defined benefit plans of **Hirsch Servo**, **Datalogic**, **Slovnaft** and **KRKA** are provisions for severance compensation and service anniversary bonuses which are defined benefit obligations under IAS 19. These plans tend to be unfunded.

22.3 General disclosure requirements

The amendment to IAS 19 in December 2004 introduced a new general disclosure requirement under IAS 19.120 that: 'An entity shall disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and financial effects of changes in those plans during the period.'

Levels of disclosure varied from a brief paragraph to four pages of the notes to the financial statements. Reasons for differing levels of disclosure include:

- materiality;
- different levels of complexity of the plans;
- funded versus unfunded plans;
- different levels of geographical analysis; and
- the level of detail provided on actuarial assumptions.

There was substantial variation in where the disclosure information was included in the financial statements, particularly as regards the use of the accounting policy note (see below) and information relating to the charge to the income statement.

22.4 Specific disclosure requirements

IAS 19 has many specific disclosure requirements under IAS 19.120A and some of the key disclosures are listed below:

- the entity's accounting policy for recognising actuarial gains and losses;
- a general description of the type of plan;
- a reconciliation of opening and closing balances of the present value of the defined benefit obligation;
- analysis of the defined benefit obligation into amounts arising from plans that are wholly unfunded and amounts arising from plans that are wholly or partly funded;
- a reconciliation of opening and closing balances of the fair value of plan assets;
- a reconciliation of the present value of the defined benefit obligation and the fair value of the plan assets to the assets and liabilities recognised in the balance sheet;
- the total expense recognised in profit or loss;
- the amount recognised in the statement of recognised income and expense;
- for each major category of plan assets – which shall include, but is not limited to, equity instruments, debt instruments, property, and all other assets – the percentage or amount that each major category constitutes of the fair value of the total plan assets;
- a narrative description of the basis used to determine the overall expected return on plan assets, including the effect on the major categories of plan assets;
- the actual return on plan assets;
- the principal actuarial assumptions; and
- the employer's best estimate of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date (additional disclosure introduced in 2004 amendment).

We did not perform a detailed review of all the specific disclosure requirements, but focused on those items which in our view are likely to have a significant impact on the amounts reported in the financial statements.

Disclosure of accounting policy

IAS 19.120A (a) requires companies to disclose their accounting policy for recognising actuarial gains and losses. All companies in the sample met this requirement.

IAS 19 does not specify under which line items the amounts attributable to pension costs should be included in the income statement, only that companies should disclose the line items in which they are included. Five companies in the sample specified as a matter of accounting policy the classification of pension costs, in particular the classification of the expected return on plan assets and the interest cost. **Total** (France) specified that all pension costs were included in operating expenses whereas UK companies **Anglo American**, **Cobham**, **Jardine Lloyd Thompson** and **Tesco** specified that the costs were split between operating and financing.

Accounting policy notes varied significantly in length as some companies used the note to provide details of the plans and also the basis for the selection of assumptions or the assumptions themselves – details which other companies provided elsewhere in the notes to the financial statements.

Recognition/disclosure in the income statement

IAS 19.120A (g) requires the disclosure of the total expense recognised in profit or loss for various items, including each of the following, and the line items in which they are included:

- current service cost;
- interest cost;
- expected return on plan assets; and
- actuarial gains and losses.

Actuarial gains and losses can be:

- recognised immediately in the income statement; or
- recognised immediately in the statement of recognised income and expense; or
- amortised through the income statement.

The options for the recognition of actuarial gains and losses and variations in the classification of interest expense/expected returns and in the display of the income statement charge do not facilitate assessment of the impact of pension costs on the company's performance.

Table 22.2 shows companies' policies for the accounting treatment of actuarial gains and losses and the classification of expected return and interest cost.

Table 22.2: Defined benefit plans – key accounting treatments and classifications

Company	Accounting treatment for actuarial gains and losses			Classification of expected return and interest cost	
	Immediate to income statement	Immediate to equity	Deferred recognition	Operating	Finance
Hirsch Servo	✓			✓	
GBL			✓	✓	
Novo Nordisk			✓	✓	
Bic			✓	✓	
Total			✓	✓	
Deutz			✓		✓
Schering		✓			✓
Datalogic	✓				✓
Unicredit			✓	✓	
ABN Amro			✓	✓	
Vedior			✓	✓	
EDP		✓		✓	
Slovnaft	✓			✓	
KRKA	✓			✓	
Endesa		✓			✓
Anglo American		✓			✓
Cobham		✓			✓
Jardine Lloyd Thompson		✓			✓
Royal & SunAlliance		✓		✓	
Tesco		✓			✓

Recognition/disclosure in the balance sheet

IAS 19 does not require separate disclosure of net defined benefit plan assets or liabilities on the face of the balance sheet. Fourteen companies presented the net asset or liability separately on the face of the balance sheet or combined it with other post retirement benefits or provisions for other employment benefits. Five companies in the sample aggregated retirement benefit provisions together with other provisions on the face of the balance sheet. One company had a zero balance.

In some cases the volume of information and presentation of information made it difficult to reconcile the provision on the face of the balance sheet to the analysis in the notes (eg, **Deutz** (Germany), due to a split between 'within one year' and 'after one year', although this is not required by IAS 19, and **ABN Amro** (Netherlands), due to its adding back of the pension fund asset as IAS 19 restricts the offset of pension fund assets and liabilities to limited circumstances).

Specific disclosures of actuarial assumptions

IAS 19.120A (n) requires disclosure of the principal actuarial assumptions used at the balance sheet date, including when applicable:

- discount rates;
- expected rates of return on plan assets for periods presented; and
- expected rates of salary increases.

All companies in the sample disclosed a discount rate. These varied from 2% to 12%. Of the 20 companies reviewed, 12 provided one discount rate, seven gave a range analysed by geographic region, and one company (**Novo Nordisk** (Denmark)) gave a range of discount rates with no further analysis.

Of the 20 companies subject to detailed analysis, five (**Hirsch Servo** (Austria), **Datalogic** (Italy), **Slovnaft** (Slovakia), **KRKA** (Slovenia) and **Endesa** (Spain)) have unfunded schemes and therefore do not provide an expected return on plan assets. Fifteen companies identified expected returns varying from 1% to 12.45%, of which six gave a more detailed analysis by class of asset and/or geographically.

Expected rates of salary increases were clearly identified by 17 companies. Two companies (**Unicredit** (Italy) and **Endesa**) gave disclosure linked to inflation and expected increases in future pensions. **KRKA** gave no such information.

Other disclosures of actuarial assumptions

In addition to the actuarial assumptions cited above, IAS 19.120A (n) requires disclosure of 'any other material actuarial assumptions used'.

IAS 19 specifies that in the measurement of the present value of defined benefit obligations and current service cost 'it is necessary to … make actuarial assumptions'. Actuarial assumptions comprise (IAS 19.73):

- demographic assumptions about the future characteristics of current and future employees such as mortality and rates of employee turnover; and
- financial assumptions such as discount rates, future salary and benefit levels, and the expected return on plan assets.

It is at the discretion of the company to determine which material actuarial assumptions require disclosure, but it is a widely expressed view that estimates on mortality are likely to have a material impact on the defined benefit obligation.

The vast majority of the companies reviewed did not provide any information on expected mortality rates. Four companies (**Schering** (Germany), **EDP** (Portugal), **Slovnaft** and **Endesa**) provided the sources used by the actuary to determine mortality rates, one company (**Jardine Lloyd Thompson** (UK)) provided estimates of life expectancy, and two companies (**Royal & SunAlliance** (UK) and **Tesco** (UK)) provided both the estimates and the source.

23. Share-based payments

23.1 Key points

IFRS 2 *Share-based Payment* requires companies to reflect in the income statement and balance sheet the effects of share-based payment transactions. The focus of reporting in this area is the amount charged as an expense as a result of awards to employees.

In reviewing the financial statements of companies within Sample 1 we noted that:

- it was sometimes difficult to locate the income statement charge information required by IFRS 2, particularly when this could only be done by adding together several numbers contained in the narrative of a note to the financial statements;
- the 'Black-Scholes model' was used most frequently to measure the fair value of equity-settled awards at the date of grant but, in the absence of a specific disclosure requirement in IFRS 2, the reasons for the model's suitability were not clear;
- whilst complex disclosures are unavoidable for companies with multiple schemes because IFRS 2 requires details of each scheme if they are different, greater use of tables would be helpful in improving transparency; and
- clearer reporting of the location of both the expense and the corresponding credit to equity would assist understanding of the effect of share-based payments on the financial statements.

23.2 Scope of detailed analysis

As shown in Table 23.1, the financial statements of 76% of the 200 Sample 1 companies made reference to share-based payment transactions. From these 151 companies, a sample of 20 companies (shown in Table 23.2) was selected for detailed analysis.

Table 23.1: Companies with share-based payment transactions

	2005	
	Number	**Percentage**
Yes	151*	76
No	49	24
Total	**200**	**100**

* 20 of these companies’ financial statements have been chosen for more detailed analysis.

Table 23.2: Share-based payments – sample of 20 companies

Belgium	**Italy**	**Spain**
Agfa	Fiat	Iberia
	Telecom Italia	Repsol
France	Unicredit	
Bic		**UK**
Bouygues	**Luxembourg**	British Land
Carrefour	Orco	Cadbury Schweppes
		EMI
Germany	**Netherlands**	Tesco
BASF	Heineken	
Mobilcom	Royal Dutch Shell	
Munich Re		

23.3 Measurement and disclosure

The objective of IFRS 2 is to specify the accounting for share-based payment transactions. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions.

IFRS 2 applies to all share-based payment transactions including payments settled with shares or cash and situations that allow the entity or the supplier a choice of settlement in return for goods or services. IFRS 2.10 requires that the goods and services for equity-settled share-based payment transactions be measured with reference to the fair value of the equity instruments granted. IFRS 2.30 requires the goods and services acquired and the liability to be stated at fair value until the liability is settled; it is required to be re-measured at each reporting date.

The key disclosure requirements in the standard are as follows.

- Information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period (IFRS 2.44);
- The general terms and conditions of each arrangement, such as vesting requirements (IFRS 2.45);
- Information that enables users of the financial statements to understand how the fair value during the period was determined (IFRS 2.46);
- The option pricing model used to determine fair value including the inputs to that model (IFRS 2.47a);
- Information that enables users to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position (IFRS 2.5);
- The total expense recognised for the period arising from share-based payment transactions (IFRS 2.51a); and
- For liabilities arising from share-based payment transactions, the total carrying amount at the end of the period (IFRS 2.51b).

Our overall observations, based on the detailed analysis that follows, is that:

- It was difficult in some cases to locate the information required by IFRS 2.

- The most difficult numbers to locate were the income statement charge which in some cases had to be derived from summing several figures embedded in the narrative that comprised the share-based payment note to the financial statements.
- Complex disclosures are unavoidable for companies with multiple schemes as the standard requires disclosures for each scheme if they are all different.
- In some cases transparency could be improved by clearer reporting of the location of both the expense charged to income and the corresponding credit in equity. In both cases this could be achieved by disclosing a separate line or reference in staff costs together with a summary of the expense attributable to each type of scheme.
- Greater use of tables for different types of scheme wherever possible would improve transparency.

23.4 Method of settlement

Share-based payment arrangements are settled either in shares, cash or a combination of these. The method of settlement affects the accounting. Equity settled transactions result in a charge to income and a corresponding credit to equity (classification within equity for this entry is not specified in IFRS 2). Cash settled transactions result in a charge to income and a corresponding credit to a provision in the balance sheet that is updated to reflect changes in the entity's share price at each balance sheet date.

Share-based payment arrangements almost always contain non-market conditions that need to be satisfied before final vesting of the instrument. These conditions also affect the accounting in that the expense is based on the number of shares that are expected to vest at the end of the vesting period. An adjustment is made at each accounting period to reflect any changes in this expectation.

Of the 20 companies subject to detailed analysis, 18 disclosed equity-settled transactions and four disclosed cash-settled transactions. Some companies disclosed both types of transaction.

Disclosure of significant accounting policies

All but two companies disclosed an accounting policy note to the effect that their share-based payment expense had been measured at fair value at the date of grant and that this fair value had been allocated over the vesting period. Fourteen companies mentioned the use of valuation models to ascertain the fair value of the awards. Eight companies stated that they had applied the transitional arrangements in IFRS 2 to apply the standard to equity-settled awards granted after 7 November 2002 that had not vested on or before 1 January 2005.

Where relevant those companies that did not disclose transitional information and the use of models in the policy note provided this information in the note on share-based payment in the financial statements.

In their significant accounting policies note, 18 companies explained the accounting in relation to their share-based payment schemes. The remaining two companies with no policy note, disclosed detailed share-based payment notes from which the accounting had to be derived.

Notes to the financial statements

All companies in the sample disclosed a share-based payment note that in most cases was as detailed as it needed to be given the multiplicity of the schemes and their complexity.

Equity settled plans – companies that disclosed more than one type of share-based payment plan had lengthy disclosures as a result of the detailed requirements of IFRS 2.

Cash-settled plans – as can be seen from Table 23.3 below, there were four instances of grants of cash-settled awards. For example:

Repsol (Spain)

> 'The beneficiaries under these plans are entitled to remuneration in cash on the basis of the appreciation of Repsol YPF, S.A. shares in the Spanish stock markets with respect to specific values and of the number of shares received. This plan does not confer its beneficiaries any rights on shares or options on shares of Repsol YPF, S.A.'

The four companies that reported cash settled scheme details disclosed the amount of the liability at the balance sheet date. One of these companies disclosed the amount separately in a note of liabilities whilst the remaining three had presumably included it in 'other' liabilities or 'other' provisions.

Determination of fair value

The following is a summary of the type of option pricing model used by companies in the sample of 20.

Table 23.3: Valuation models used

Model	Equity settled	Cash settled
Black-Scholes	12	1
Binomial	4	1
Trinomial	2	0
Monte Carlo	4	0
Market value of underlying shares	0	1
Model not stated	1	1
TOTAL	**23**	**4**

The Black-Scholes method is by far the most used model. In all but one case, those companies that used different models for their various schemes (for example, restricted share awards, savings-related share option schemes and long-term incentive awards) provided no explanation for the choice of model. One company out of the 20 provided disclosures relating to the choice of model:

Cadbury Schweppes (UK)

> 'The fair value is measured using the valuation technique that is considered to be the most appropriate to value each class of award: these include Binomial models, Black-Scholes calculations and Monte Carlo simulations. These valuations take into account such factors as non-transferability, exercise restrictions and behavioural considerations.'

IFRS 2 B6 specifies the minimum inputs to the option pricing model, being:

- exercise price of the option;
- life of the option;

- current price of the underlying shares;
- expected volatility of the share price;
- dividends expected on the shares (if appropriate); and
- risk-free interest rate for the life of the option.

Most companies disclosed the inputs information in narrative descriptions when providing the IFRS 2 disclosure requirements for each type of scheme. Four companies did not provide disclosure regarding inputs to the model.

Cadbury Schweppes analysed key assumptions in a table that details the inputs applicable to each type of award, as follows:

					2005
	BSRP	LTIP	DSOP	ISAP	Sharesave
Expected volatility	n/a	22%	22%	n/a	22%
Expected life	3 yrs	3 yrs	#	1-3 yrs	Vesting + 5months
Risk free rate	4.5%	n/a	4.8%	4.3%	4.3%-4.4%
Expected dividend yield	2.5%	3.0%	3.0%	2.3%-2.5%	2.2%-2.3%
Possibility of ceasing employment before vesting	-	-	14%	-	12%-32%
Expectations of meeting performance criteria	40.0%	70%	85-100%	n/a	n/a
Fair value per option	92.6%	91.6% UEPS	23%	93.3%-97.8%	23.3%-35.3%
		49.6% TSR			

The fair value calculation of a discretional share option uses an expected life to the point of expected exercise. This is determined through analysis of historical evidenced exercise patterns of option holders.

Expected volatility is a key input in determining the value of the share options and is covered by the following provisions in IFRS 2:

- IFRS 2.47 (a) (ii) requires disclosure of how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility.
- Appendix B Application Guidance B22 states that expected volatility is a measure of the amount by which a price is expected to fluctuate during a period.
- B25 contains factors to consider when measuring expected volatility.

Of the 20 companies subject to detailed analysis, 13 companies disclosed volatility ranging from the lowest at 22% to the highest at 55%. All 13 disclosed the basis of historical volatility used. Examples are given below:

Royal Dutch Shell (Netherlands): for the Shell Canada plan

> 'Volatility is defined as the three-year historical volatility of the Shell Canada share price.'

EMI (UK)

> 'Expected volatility is the measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share. For each grant the assumed volatility has been calculated over a

period prior to the grant commensurate with the expected life of the award. Adjustments have been made for historic events that are unlikely to recur in the future.'

Unicredit (Italy) explains the calculation of the parameter of volatility as 'historical daily average volatility for a time-length equal to the vesting period.'

IFRS 2 does not provide guidance on which equity item should be used for recognition of the other entry for share-based payment expense. As a result, several equity classifications were used, for example:

- retained earnings;
- fair value reserves;
- share premium;
- capital reserve; and
- other equity reserves.

In most financial statements the effect of share-based payment arrangements on the income statement for the accounting period was clearly disclosed. Most companies disclosed the expense effect for the period by disclosing it as part of staff costs.

One company mentioned the effect of social security charges on exercise of options and the need to provide for this cost over the vesting period, as follows:

Ericsson (Sweden)

> 'When shares are matched, social security charges are to be paid in certain countries on the value of the employee benefit. The employee benefit is generally based on the market value of the shares at the matching date. During the vesting period, estimated social security charges are accrued.'

The following table illustrates the variety of disclosure within the sample.

Table 23.4: Location of disclosure of share-based payments

Accounting entries									
Income statement				Equity					
Expenses in staff costs	Expenses in share-based payment note	Not visible	Total	Retained earnings	Other reserve	Capital reserve	Share-based payment reserve	Not visible	Total
13	6	1	20	6	1	4	3	6	20

24. Financial instruments

24.1 Key points

We reviewed the implementation of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* by Sample 1 companies other than banks and insurance companies. Our work was directed at the reporting of financial assets and liabilities in the balance sheet; classification of certain financial instruments as liabilities and/or equity; hedge accounting; and disclosures relating to financial risk.

We noted in particular that:

- Classification of financial assets and liabilities was mainly presented in notes to the balance sheet. The classification of investment financial assets varied in clarity. In some cases it was not possible to ascertain the type of available-for-sale assets.
- Derivatives reporting was on the whole clear and it was apparent that companies had concentrated on providing comprehensive disclosures that distinguished between IAS 39 hedging derivatives and economic hedging derivatives.
- Impairment of IAS 39 financial investments was not visible in most of the financial statements. This could account for the lack of accounting policy statements in this area. For non-bank entities the main reporting focus does not tend to be on financial instruments other than for risk management purposes.
- Financial risk disclosures were as comprehensive as required given the size of the reporting entity. The focus was on interest rate, foreign exchange and credit risk.

24.2 Scope of detailed analysis

Of the 200 companies in Sample 1, 29 are banks and 13 are insurance companies. From the remaining 157 companies, a sample of 20 companies (Table 24.1) was selected for detailed analysis of their treatment of financial instruments.

Table 24.1: Financial instruments – sample of 20 companies

Austria Voestalpine	**Germany** BMW MTU Aero Engines	**Netherlands** Wolters Kluwer
Belgium Brantano	**Greece** Blue Star Ferries	**Spain** Jazztel Zeltia
Finland Neste Oil	**Ireland** Waterford Wedgwood	**Sweden** Alfa Laval
France Gaz de France L'Oréal** Technip	**Italy** Datalogic Recordati	**UK** Diageo * GlaxoSmithKline Rentokil Vodafone * **

* Adopted IFRS 7 *Financial Instruments: Disclosures*

** Adopted IAS 39 amendment *Cash Flow Hedge Accounting of Forecast Intra-group transactions.*

24.3 Financial assets

IAS 39.9 defines four categories of financial assets:

- held-to-maturity investments;
- available-for-sale financial assets;
- loans and receivables; and
- held for trading.

IAS 1.68 provides a list of items to be presented on the face of the balance sheet. This includes financial assets and liabilities. In addition IAS1.51 requires presentation of current and non-current assets and liabilities.

In the absence of more detailed requirements regarding presentation, the majority of companies presented financial instruments as follows:

- Assets

  Non-current assets
  - Other investments
  - Trade and other receivables
  - Derivative financial instruments

  Current assets
  - Trade and other receivables
  - Derivative financial instruments
  - Cash and cash equivalents

- Liabilities

  Current liabilities
  - Trade and other payables
  - Bank and other short-term borrowings
  - Derivative financial instruments

  Non-current liabilities
  - Bonds
  - Bank and other long-term borrowings

In the notes to the financial statements, companies disclosed the appropriate IAS 39 classifications:

- None of the companies classified financial assets as held-to-maturity.
- Three companies reported as trading assets investments in a fund, bank commercial paper, government and fixed income investments.
- Two companies reported trading derivatives and one company described some derivatives as 'non-hedge'.
- 17 companies disclosed available-for-sale securities. These consisted mainly of equities which did not fall to be classified as associates or joint ventures.
- Six companies reported debt securities under the available-for-sale classification.

Impairment of financial assets

IAS 39.58 requires an entity to assess whether objective evidence of impairment exists at each balance sheet date.

Ten companies disclosed an accounting policy for impairment that was applicable to financial assets.

Disclosure was scant in this area but there were few cases where impairment of available-for-sale assets was reported.

Zeltia (Spain) provided a detailed accounting policy note:

> 'At the balance sheet date, the Group assesses whether there is objective evidence that a financial asset or group of financial assets have been impaired. To determine whether available-for-sale financial assets have been impaired, a significant or prolonged decline in the fair value of the asset below its cost is considered. If there is any evidence of this type of available-for-sale financial assets, the accumulated loss determined as the difference between the acquisition cost and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss, is eliminated from equity and recognised in profit or loss. Impairment losses recognised in profit or loss for equity instruments classified as available for sale are not reversed through profit or loss.'

Where applicable, all companies reported provisions for bad debts in relation to trade receivables.

24.4 Fair value measurement

IAS 32.61 requires disclosure of trade or settlement date for purchases and sales of financial assets. Three companies reported using trade date and two companies used settlement date.

IAS 39.48 refers to Appendix A AG69-AG82 which contain guidance as to how to determine fair value. Six companies explained the fair value methodology used in their accounting policy note. Nine companies stated in their accounting policy note that for those financial asset investments that did not have a quoted market price in an active market and whose fair value cannot be reliably determined, cost was used:

Wolters Kluwer (Netherlands):

> 'The shares of Sdu Uitgevers bv, that are classified as being available-for-sale, do not have a quoted market price in an active market, the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed. Consequently these shares are measured at cost.'

IAS 32.86 requires the disclosure of fair values of all financial instruments.

Six companies presented fair value information compared with carrying value of financial instruments in the form of a table.

For those companies that did not adopt this form of presentation, a brief note to the effect that carrying amounts approximated to fair value was disclosed in the appropriate notes to the financial statements.

Financial instruments measured at fair value through profit or loss

IAS 39.9 defines this category of financial instruments:

- Trading – one company used this classification for investments.
- Designated – two companies disclosed use of the fair value option.

Wolters Kluwer:

> 'IAS 39 fair value option amendment: The Group opted to recognise its unsubordinated convertible bond loan at fair value through profit or loss instead of treating the convertible bond as a compound financial instrument and recognizing the debt component at amortised cost.'

One company reported securities at fair value through profit or loss without stating whether they are trading instruments or designated.

Financial liabilities at amortised cost

All 20 companies used the amortised cost measurement basis for the majority of their financial liabilities. Of these, 17 companies disclosed use of the effective interest rate method for financial assets and/or liabilities as required by IAS39 for all financial assets liabilities at amortised cost.

24.5 Debt/equity classification

IAS 32.11 defines a financial liability as a contractual obligation to deliver cash. Therefore, compound instruments have to be split between the liability and equity components. Of the 20 companies studied, 16 did not mention this issue in their accounting policy note:

Gaz de France (France) reported irredeemable securities and minority put options as liabilities.

> *'Irredeemable securities*
> These securities are measured at their amortised cost. As they did not meet criteria defining an equity instrument, they were classified as debt/financial liabilities. Financial debt also includes the amount of minority interests, which the Group is committed to repurchase.'

Technip (France) reported convertible bonds separated into their liability and equity component.

> 'The debt component is measured at the amortised cost (amortisation of the difference with the redemption amount at maturity as per the effective interest rate method). As per IAS 32, the part accounted for in equity corresponds to the difference between the fair value of the debt (without option of conversion) that the Group would have initially issued on the market, and the debt measured at its price of issue (split accounting).'

24.6 Hedge accounting

IAS 39 has specific requirements that relate to hedging and identifies three types of hedging relationships:

- fair value hedges;

- cash flow hedges; and
- net investment hedges.

Fifteen companies in the sample reported economic hedging arising as a result of having entered into derivatives transactions that do not qualify for hedge accounting or have not been designated as hedging instruments.

Table 24.2: Disclosure of hedging in sample of 20 companies

IAS 39					
Type of hedge	**Fair Value**	**Cash flow**	**Net investment**	**Economic**	**None**
Total	13	14	9	15	3

- Disclosure in this area varied from the comprehensive to a statement that, for example, there was an interest rate hedge of long-term debt.
- Two companies disclosed that fair value changes in hedging derivatives were taken to equity leaving it to be deduced that they had cash flow hedges in place.
- Derivatives used as hedging instruments were as follows:

  - interest rate swaps;
  - cross currency swaps;
  - forward foreign exchange contracts;
  - currency options; and
  - forward rate agreements.

Not surprisingly there was an emphasis on hedging foreign exchange risk for most of the companies in the sample. Those companies with foreign operations used on balance sheet borrowings and foreign exchange derivatives in IAS 39 compliant net investment hedges:

GlaxoSmithKline (UK):

> '*Cash flow hedges*
> The group has entered into a cross currency swap and designated it a cash flow hedge converting fixed Euro coupons, payable annually to fixed Yen payments. The bond matures in 2009. The risk being hedged is the variability of cash flows arising from currency fluctuations.
>
> *Fair value hedges*
> Foreign exchange contracts, designated as fair value hedges, have been entered in order to hedge the foreign currency risk associated with intercompany loans and deposits, commercial paper borrowings and other liabilities.
> The Group has designated interest rate swaps and the interest elements of cross currency swaps as fair value hedges. The risk being hedged is the variability of the fair value of the bonds arising from interest rate fluctuations.
>
> *Net investment hedges*
> Foreign exchange contracts and the currency element of cross currency swaps have been designated as net investment hedges in respect of the foreign currency translation risk arising on consolidation of the Group's net Investment in its US dollar, Euro and Yen foreign operations.'

Most companies hedging interest rate risk used interest rate swaps. Four companies mentioned on balance sheet asset and liability management to achieve their hedging objective.

24.7 Financial risk disclosures

IAS 32.56 requires disclosure of financial risk management policies.

Two companies early adopted IFRS 7 *Financial Instruments: Disclosures*. Most of the remaining companies referred to IFRS 7 in the accounting policy note in the future accounting standards section to the effect that its impact on the financial statements would not be significant given that it is a disclosure standard.

Interest rate risk

IAS 32.67 requires disclosure of information about exposure to interest rate risk.

Of the 20 companies studied, 13 explained that they managed interest rate risk by using interest rate swaps mostly to comply with IAS 39 *Financial Instruments: Recognition and Measurement* hedging rules;

Rentokil (UK):

> *'Cash flow interest rate risk*
> The group's interest rate risk arises from its Medium Term Note borrowings. Borrowings issued at variable rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed rates expose the group to fair value to interest rate risk.
> The group manages its interest rate exposure by converting fixed rate debt into floating rate debt in the currency required to fund the group's activities through the use of interest rate and cross currency swaps. Fair value hedge accounting is sought for these relationships.
> The group's floating interest rate profile is then managed through the use of forward rate agreements for which hedge accounting is not sought.
> Occasionally, the group also enters into fixed-to-floating interest rate swaps to hedge the fair value interest rate risk arising where it has borrowed at fixed rates.'

One company stated explicitly that it did not use derivatives to manage interest rate risk.

Foreign exchange risk

All of the companies referred to foreign exchange risk management as a major factor in their financial risk management. Mitigation and management of this risk was achieved by the use of various derivatives such as forward foreign exchange contracts and cross currency swaps.

Seven companies explained their policy with regard to net investment hedges but it was not always clear which derivatives were being used in this type of hedge.

Two companies stated that they used on balance sheet borrowings to form net investment hedges.

Liquidity risk

Out of the 20 companies studied, 16 provided disclosures regarding liquidity risk. These ranged from the provision of a maturity profile of the carrying amount of financial liabilities to narrative statements.

Since IAS 32 is not explicit in this area as to the form of disclosures, it is to be expected that the level and volume of disclosure varies considerably;

Blue Star Ferries (Greece):

> '*Liquidity risk*
> The liquidity risk is at a very low level because the Group maintains sufficient cash and also has a high credit rating from banks.'

GlaxoSmithKline:

> '*Liquidity*
> The Group operates globally, primarily through subsidiary companies established in the markets in which the Group trades. Due to the nature of the Group's business with patent protection on many products of the Group's portfolio, the Group's products compete largely on product efficacy rather than on price. Selling margins are sufficient to exceed normal operating costs and the Group's operating subsidiaries are substantially cash generative.
> Operating cash flow is used to fund investment in the research and development of new products as well as routine outflows of capital expenditure, tax, dividends and repayment of maturing debt. This Group may, from time to time, have additional demands for finance, such as for share purchases and acquisitions.'

Credit risk

IAS 32.76 requires disclosure of the amount that best represents the company's maximum credit risk exposure together with significant concentrations of credit risk.

Disclosures in this area were provided by 13 of the 20 companies studied. Almost all of these stated that there was no significant concentration of credit risk and that the quality of counterparties is monitored:

Rentokil:

> '*Credit risk*
> The Group has no significant concentrations of credit risk. It has policies in place to ensure that sales of goods and services are made to customers with an appropriate credit history. Derivative counterparties and cash transactions are limited to high-credit-quality financial institutions. The maximum credit risk exposure of the group's financial assets at the end of the period is represented by the amounts reported under the corresponding balance sheet headings.'

For non-bank reporters credit risk is focused mainly on trade receivables hence the references to customer credit worthiness. Most companies made references to the sufficiency of the level of bad debt provision.

Appendix 1: Sample 1 companies

Company	Country of origin	Primary listing	Industry
Erste Bank	Austria	Vienna	Banks
Hirsch Servo	Austria	Vienna	Chemicals
Voestalpine	Austria	Vienna	Industrial Metals
Wiener Staedtische	Austria	Vienna	Nonlife Insurance
Wienerberger	Austria	Vienna	Construction and Materials
Agfa	Belgium	Euronext Brussels	Electronic & Electrical Equipment
Belgacom	Belgium	Euronext Brussels	Fixed Line Telecoms
Brantano	Belgium	Euronext Brussels	General Retailers
Delhaize	Belgium	Euronext Brussels	Food & Drug Retailers
Fortis	Belgium	Euronext Brussels	Banks
GBL	Belgium	Euronext Brussels	General Financial
IBA	Belgium	Euronext Brussels	Health Care Equipment & Services
KBC	Belgium	Euronext Brussels	Banks
Bank of Cyprus	Cyprus	Nicosia	Banks
Vassiliko	Cyprus	Nicosia	Construction & Materials
CEZ	Czech Republic	Prague	Electricity
Komerční Banka	Czech Republic	Prague	Banks
Orco	Czech Republic	Prague	Real Estate
Danske Bank	Denmark	Copenhagen	Banks
H+H	Denmark	Copenhagen	Construction & Materials
Møller - Mærsk	Denmark	Copenhagen	Industrial Transportation
Novo Nordisk	Denmark	Copenhagen	Pharmaceuticals & Biotechnology
Royal Unibrew	Denmark	Copenhagen	Beverages
Eesti Telekom	Estonia	Tallinn	Mobile Telecoms
Harju Elekter	Estonia	Tallinn	Technology Hardware & Equipment
Aspo	Finland	Helsinki	Support Services

Company	Country of origin	Primary listing	Industry
Neste Oil	Finland	Helsinki	Oil & Gas Producers
Nokia	Finland	Helsinki	Technology, Hardware & Equipment
Sampo	Finland	Helsinki	Banks
Stora Enso	Finland	Helsinki	Forestry & Paper
AXA	France	Euronext Paris	Nonlife Insurance
Bic	France	Euronext Paris	Household Goods
BNP Paribas	France	Euronext Paris	Banks
Bouygues	France	Euronext Paris	Construction Materials
Carrefour	France	Euronext Paris	Food & Drug Retailers
Cegid	France	Euronext Paris	Software & Computer Services
Crédit Agricole	France	Euronext Paris	Banks
Faurecia	France	Euronext Paris	Automobiles & Parts
France Telecom	France	Euronext Paris	Fixed Line Telecoms
Gaz de France	France	Euronext Paris	Gas, Water & Multiutilities
Havas	France	Euronext Paris	Media
Hermès	France	Euronext Paris	Personal Goods
Klépierre	France	Euronext Paris	Real Estate
L'Oréal	France	Euronext Paris	Personal Goods
LVMH	France	Euronext Paris	Personal Goods
Pharmagest	France	Euronext Paris	Software & Computer Services
Saint-Gobain	France	Euronext Paris	Construction & Materials
Sanofi-Aventis	France	Euronext Paris	Pharmaceuticals & Biotechnology
SCOR	France	Euronext Paris	Nonlife Insurance
Société Générale	France	Euronext Paris	Banks
Technip	France	Euronext Paris	Oil Equipment, Services & Distribution
Total	France	Euronext Paris	Oil & Gas Producers
Vallourec	France	Euronext Paris	Industrial Engineering

Company	Country of origin	Primary listing	Industry
Vivendi	France	Euronext Paris	Media
Allianz	Germany	Frankfurt	Nonlife Insurance
BASF	Germany	Frankfurt	Chemicals
BMW	Germany	Frankfurt	Automobiles & Parts
CeWe Color	Germany	Frankfurt	Support Services
Commerzbank	Germany	Frankfurt	Banks
Deutsche EuroShop	Germany	Frankfurt	Real Estate
Deutz	Germany	Frankfurt	Automobiles & Parts
Dyckerhoff	Germany	Frankfurt	Construction & Materials
Henkel	Germany	Frankfurt	Household Goods
Hypo Real Estate	Germany	Frankfurt	Banks
Koenig & Bauer	Germany	Frankfurt	Industrial Engineering
Lufthansa	Germany	Frankfurt	Travel and Leisure
Metro	Germany	Frankfurt	General Retailers
Mobilcom	Germany	Frankfurt	Mobile Telecoms
MTU	Germany	Frankfurt	Aerospace and Defence
Munich Re	Germany	Frankfurt	Nonlife insurance
RWE	Germany	Frankfurt	Gas, Water & Multiutilities
Schering	Germany	Frankfurt	Pharmaceuticals & Biotechnology
Südzucker	Germany	Frankfurt	Food Producers
Thiel Logistik	Germany	Frankfurt	Support Services
Agrotiki Insurance	Greece	Athens	Nonlife insurance
Blue Star Ferries	Greece	Athens	Travel & Leisure
Info-Quest	Greece	Athens	Software & Computer Services
National Bank of Greece	Greece	Athens	Banks
OTE	Greece	Athens	Fixed Line Telecoms
Gedeon Richter	Hungary	Budapest	Pharmaceuticals & Biotechnology

Company	Country of origin	Primary listing	Industry
Magyar Telekom	Hungary	Budapest	Fixed Line Telecoms
OTP Bank	Hungary	Budapest	Banks
Allied Irish Bank	Ireland	Dublin	Banks
CRH	Ireland	Dublin	Construction & Materials
Irish Life & Permanent	Ireland	Dublin	Life Insurance
Kerry	Ireland	Dublin	Food Producers
Waterford Wedgwood	Ireland	Dublin	Household Goods
Acea	Italy	Milan	Gas, Water & Multiutilities
Autostrada	Italy	Milan	Industrial Transportation
Campari	Italy	Milan	Beverages
Datalogic	Italy	Milan	Technology, Hardware & Equipment
Ducati Motor	Italy	Milan	Automobiles & Parts
Enel	Italy	Milan	Electricity
Eni	Italy	Milan	Oil & Gas Producers
Fiat	Italy	Milan	Automobiles & Parts
Generali	Italy	Milan	Nonlife Insurance
Geox	Italy	Milan	Personal Goods
L'Espresso	Italy	Milan	Media
Marr	Italy	Milan	Food Producers
Recordati	Italy	Milan	Pharmaceuticals & Biotechnology
Telecom Italia	Italy	Milan	Fixed Line Telecoms
Unicredit	Italy	Milan	Banks
DnB Nord Banka	Latvia	Riga	Banks
Ventspils nafta	Latvia	Riga	Oil Equipment, Services & Distribution
Lietuvos Dujos	Lithuania	Vilnius	Gas, Water & Multiutilities
Ukios Bankas	Lithuania	Vilnius	Banks
Arcelor	Luxembourg	Luxembourg	Industrial Metals

Company	Country of origin	Primary listing	Industry
Dexia	Luxembourg	Luxembourg	Banks
SES Global	Luxembourg	Luxembourg	Media
Maltacom	Malta	Valletta	Fixed Line Telecoms
Middlesea	Malta	Valletta	Nonlife insurance
ABN Amro	Netherlands	Euronext Amsterdam	Banks
Batenburg Beheer	Netherlands	Euronext Amsterdam	Construction & Materials
Heineken	Netherlands	Euronext Amsterdam	Beverages
Imtech	Netherlands	Euronext Amsterdam	Support Services
ING	Netherlands	Euronext Amsterdam	Life Insurance
KPN	Netherlands	Euronext Amsterdam	Fixed Line Telecoms
Philips	Netherlands	Euronext Amsterdam	Leisure Goods
Royal Dutch Shell	Netherlands	Euronext Amsterdam	Oil & Gas Producers
Stork	Netherlands	Euronext Amsterdam	Industrial Engineering
Unilever	Netherlands	Euronext Amsterdam	Food Producers
Vedior	Netherlands	Euronext Amsterdam	Support Services
Wolters Kluwer	Netherlands	Euronext Amsterdam	Media
Bank BPH	Poland	Warsaw	Banks
Duda	Poland	Warsaw	Food producers
KGHM	Poland	Warsaw	Industrial Metals
PKN Orlen	Poland	Warsaw	Oil & Gas Producers
TVN	Poland	Warsaw	Media
Banco Comercial Portugues	Portugal	Euronext Lisbon	Banks
Brisa	Portugal	Euronext Lisbon	Industrial Transportation
EDP	Portugal	Euronext Lisbon	Electricity
SAG	Portugal	Euronext Lisbon	General Retailers
Slovnaft	Slovakia	Bratislava	Oil & Gas Producers
Tatra banka	Slovakia	Bratislava	Banks

Company	Country of origin	Primary listing	Industry
KRKA	Slovenia	Ljubljana	Pharmaceuticals & Biotechnology
Sava	Slovenia	Ljubljana	Chemicals
Abertis	Spain	Madrid	Industrial Transportation
Amper	Spain	Madrid	Technology, Hardware & Equipment
Banco Pastor	Spain	Madrid	Banks
Ence	Spain	Madrid	Forestry & Paper
Endesa	Spain	Madrid	Electricity
Ercros	Spain	Madrid	Chemicals
Gas Natural	Spain	Madrid	Gas, Water & Multiutilities
Iberia	Spain	Madrid	Travel & Leisure
Inditex	Spain	Madrid	General Retailers
Indra Sistemas	Spain	Madrid	Software & Computer Services
Jazztel	Spain	Madrid	Software & Computer Services
Mapfre	Spain	Madrid	Nonlife Insurance
OHL	Spain	Madrid	Construction & Materials
Repsol	Spain	Madrid	Oil & Gas Producers
Santander	Spain	Madrid	Banks
Sol Meliá	Spain	Madrid	Travel & Leisure
Telefónica	Spain	Madrid	Fixed Line Telecoms
Zeltia	Spain	Madrid	Pharmaceuticals & Biotechnology
Alfa Laval	Sweden	Stockholm	Industrial Engineering
Bergman & Beving	Sweden	Stockholm	Industrial Engineering
Ericsson	Sweden	Stockholm	Technology, Hardware & Equipment
Medivir	Sweden	Stockholm	Pharmaceuticals and Biotechnology
Nordea Bank	Sweden	Stockholm	Banks
Telia Sonera	Sweden	Stockholm	Mobile Telecoms
3i	UK	London	General Financial

Company	Country of origin	Primary listing	Industry
Anglo American	UK	London	Mining
ARM Holdings	UK	London	Technology, Hardware & Equipment
BG	UK	London	Oil & Gas Producers
BHP Billiton	UK	London	Mining
BP	UK	London	Oil & Gas Producers
British American Tobacco	UK	London	Tobacco
British Land	UK	London	Real Estate
BT	UK	London	Fixed Line Telecoms
Burren Energy	UK	London	Oil & Gas Producers
Cadbury Schweppes	UK	London	Food Producers
Cobham	UK	London	Aerospace and Defence
Dairy Crest	UK	London	Food Producers
Diageo	UK	London	Beverages
EMI	UK	London	Media
First Choice	UK	London	Travel & Leisure
FKI	UK	London	Industrial Engineering
Fuller, Smith & Turner	UK	London	Travel & Leisure
GlaxoSmithKline	UK	London	Pharmaceuticals & Biotechnology
Headlam	UK	London	Household Goods
Inchcape	UK	London	General Retailers
Jardine Lloyd Thompson	UK	London	Nonlife Insurance
Kazakhmys	UK	London	Mining
Lloyds TSB	UK	London	Banks
McBride	UK	London	Household Goods
Northern Rock	UK	London	Banks
Provident Financial	UK	London	General Financial
Prudential	UK	London	Life Insurance

Company	Country of origin	Primary listing	Industry
PZ Cussons	UK	London	Personal Goods
Redrow	UK	London	Household Goods
Rentokil	UK	London	Support Services
Royal & SunAlliance	UK	London	Nonlife Insurance
Royal Bank of Scotland	UK	London	Banks
RoyalBlue	UK	London	Software & Computer Services
SAB Miller	UK	London	Beverages
Tesco	UK	London	Food & Drug Retailers
Tomkins	UK	London	General Industrials
Tribal	UK	London	Support Services
Vodafone	UK	London	Mobile Telecoms
WSP	UK	London	Support Services

Appendix 2: Sample 2 companies

Company	Country of origin	Industry
Unibind	Cyprus	Industrial Engineering
Bertelsmann	Germany	Media
Braun	Germany	Healthcare Equipment & Services
Deutsche Bahn	Germany	Industrial Transportation
Patrizia	Germany	Real Estate
Banco Antonovera	Italy	Banks
Banco Popolare di Vicenza	Italy	Banks
ITAS Mutua	Italy	Banks
Rabobank	Netherlands	Banks
ANA	Portugal	Airport
Caixa Geral de Depositos	Portugal	Banks
EFACEC	Portugal	Electronics & Electrical Materials
La Caixa	Spain	Banks
WAM Acquisition	Spain	IT Services
SJ	Sweden	Travel & Leisure
Vattenfall	Sweden	Electricity
KPMG	UK	Professional services
Nationwide Building Society	UK	Banks

Appendix 3: Sample 3 companies

Part 1: Publicly traded companies included in Sample 1

Company	Country of origin	Industry
CEZ	Czech Republic	Electricity
Komerční Banka	Czech Republic	Banks
H+H	Denmark	Construction & Materials
Blue Star Ferries	Greece	Travel & Leisure
Info-Quest	Greece	Software & Computer Services
OTE	Greece	Fixed Line Telecoms
Gedeon Richter	Hungary	Pharmaceuticals & Biotechnology
OTP Bank	Hungary	Banks
Allied Irish Bank	Ireland	Banks
Irish Life & Permanent	Ireland	Life insurance
Kerry	Ireland	Food Producers
L'Espresso	Italy	Media
Maltacom	Malta	Fixed Line Telecoms
Middlesea	Malta	Nonlife Insurance
Royal Dutch Shell	Netherlands	Oil & Gas Producers
PKN Orlen	Poland	Oil & Gas Producers
Jazztel	Spain	Software & Computer Services
3i	UK	General Financial
BG	UK	Oil & Gas Producers
Burren Energy	UK	Oil & Gas Producers
Dairy Crest	UK	Food Producers
Fuller, Smith & Turner	UK	Travel & Leisure
Headlam	UK	Household Goods
Kazakhmys	UK	Mining

Company	Country of origin	Industry
Lloyds TSB	UK	Banks
Northern Rock	UK	Banks
Provident Financial	UK	General Financial
Redrow	UK	Household Goods
Royal & SunAlliance	UK	Nonlife Insurance
Royal Bank of Scotland	UK	Banks
RoyalBlue	UK	Software & Computer Services
WSP	UK	Support Services

Part 2: Other companies

Company	Country of origin	Industry
Charalambides Dairy	Cyprus	Food Producers
Raindale	Cyprus	Investment
Tetra Pak (Cyprus)	Cyprus	General Industrials
Finlombarda	Italy	Banks
Sanpaolo IMI Internazionale	Italy	Banks
Heathorns International	Malta	Travel & Leisure
Nautilus (Europe)	Malta	Nonlife insurance
Oiltanking Malta	Malta	Oil Services
Game Theory	Malta	Travel & Leisure
Sparkasse Bank	Malta	Banks
CIRES	Portugal	Construction & Materials
EFACEC Capital	Portugal	Electronics & Electrical Materials
JMR	Portugal	General Retailers
Recheio	Portugal	General Retailers
Exco International	UK	Investment

Company	Country of origin	Industry
Forum Energy	UK	Mining
Intercapital	UK	Investment
Pan Pacific Aggregates	UK	Mining

Appendix 4: Academic research paper

Value Relevance of the International Financial Reporting Standards (IFRS): Investigations of the Transitional Documents for UK, Spanish, French and Italian companies

Joanne Horton* and George Serafeim∫

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* **London School of Economics**, *Department of Accounting & Finance*, j.horton@lse.ac.uk, London WC2A 2AE, UK.

∫ **Harvard Business School**, *Unit of Accounting & Management*, gserafeim@hbs.edu, Boston 02163 MA.

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APPENDIX 4: Return Model: Test of the Relative Value Relevance of the Reconciliation Adjustments

APPENDIX 5: Measures Related to Strength of Laws, Investor Protection & Enforcement Mechanisms

Introduction

This study investigates whether the information contained in transitional documents required by IFRS 1 *First Time Adoption of International Financial Reporting Standards* is value relevant. Our focus is on the explanatory power of accounting information for measures of market value. More specifically, we investigate both the ability of earnings and book values to explain the variation in stock prices and the ability of earnings to explain the variation in stock returns. The value relevance of IFRS is of great importance given the primary application of accounting numbers is equity valuation and facilitation of investment decisions.

IFRS 1 *First Time Adoption of International Financial Reporting Standards* generally requires that the accounting policies adopted are compliant with IFRS and that these policies are applied retrospectively to all periods presented. Hence, every entity must present a number of reconciliations in order to explain the transition to IFRS. These include a reconciliation of the balance sheet and income statement from domestic GAAP to IFRS for the date of transition. The transitional documents therefore enable the authors to address and investigate several important questions. Firstly, on a country by country basis, are the differences between domestic GAAP and IFRS, as summarized in the aggregate reconciliations of earnings and shareholders' equity, value-relevant? That is, does the reconciliation of accounting data to IFRS increase the association between accounting measures and market value? Investigating this enables inferences to be drawn regarding whether the reconciliation adjustments are used implicitly by investors in valuing firms. Secondly, is the level of value relevance for IFRS compliance significantly different between countries given the difference in their domestic GAAP? For example, are the reconciliation adjustments for UK firms more or less value relevant than for French firms. This provides us with evidence on the relative explanatory power of IFRS between countries, *conditional* on the amount of information which was available before in each country. In other words, we will be able to test whether the value added by IFRS, in terms of explanatory power, differs between countries after taking into account the information available already by domestic GAAP. Therefore by comparing differences in value relevance we can draw possible conclusions on whether the same accounting regime—IFRS—has different properties in different countries and in which countries firms provide investors with more useful information than before. These findings may also have implications in relation to achieving accounting harmonization internationally.

The preliminary results suggest that for those firms previously reporting under UK, French or Italian GAAP the earnings reconciliation adjustment, necessary to achieve compliance with IFRS, appears to be incrementally value relevant over and above their domestic GAAP numbers. Contrary to this however, we find for those firms previously reporting under Spanish GAAP, that although there appears to be no value relevance of the earnings reconciliation adjustment, the shareholders' equity reconciliation adjustment does appear to be value relevant and have incremental price relevance over and above Spanish GAAP. Indeed given the negative sign of the respective coefficient it would appear that the market reverses the IFRS adjustment.

Consistent with these results we also find that for the French and UK firms the earnings reconciliation adjustments are also highly significant in explaining the stock returns, after controlling for the firm's earnings under their domestic GAAP. Also consistent is the lack of association for Spanish firms between the firm's returns and their earnings reconciliation adjustment. Interestingly however, for the Italian firms we find no significant level of association with the earnings reconciliation despite the value relevance results reported above.

Cross-country Setting

One of the main stated objectives for countries adopting IFRS is to provide users of accounting information with high quality, comparable and decision useful information. However, in recent years concerns have been raised about the possibility of achieving true harmonization of financial reporting among countries. Ball, Robin & Wu (2003) find that similar standards are applied differently in different countries. Studies also document non-compliance across a large number of firms claiming to report under IAS in their audited financial statements (Cairns 2001). A more optimistic view is offered by Bradshaw & Miller (2007) who study non-US firms adopting US GAAP. They find that most firms are adjusting their accounting methods to those required by US GAAP and that the properties of the accounting numbers change significantly after adopting US GAAP. They condition appropriate adoption of US GAAP on effective regulatory oversight. Such findings have led academics to conclude that global comparability will be conditional on other factors unrelated to the specific accounting standards.

Concepts relating to the level of enforcement of financial information in each country, investor protection mechanisms and the origin of securities laws have recently been elevated as a necessary condition for the successful implementation of IFRS. Academics argue that the extent to which standards are enforced and violations are punished is as important as the standards themselves (Sunder 1997). With the absence of proper enforcement and judicial mechanisms even mandatory principles become voluntary. Without laws to protect investors from expropriation by managers and majority shareholders, countries adopting IFRS should not expect to develop their stock markets (La Porta *et al* 2000). More particularly, it has been suggested that laws mandating disclosure and facilitating private enforcement through liability rules, as opposed to public enforcement, seem to benefit stock markets (La Porta, Lopez-de-Silanes & Shleifer 2006). For a brief review of the level of measures relating to strengths of laws, investor protection and enforcement mechanisms suggested by some academics and independent bodies see Appendix 5.

Recognizing the important role of enforcement of financial information, the Commission of European Securities Regulators (CESR) published 21 principles which focus on – the definition of enforcement of standards on financial information; its scope; the selection techniques applicable by the enforcers; and the responsibility of the different parties involved. The CESR (2003) note that the harmonization of enforcement systems in Europe is an effective tool in which to create an efficient capital market, improve investors' confidence in financial markets and enhance comparability between financial information published by listed issuers in Europe.

This study examines for which countries IFRS reconciliations are incrementally value relevant over and above the previous domestic GAAP and whether this value relevance differs between countries. As we discuss, legal and economic factors may be able to explain such differences.

Our research design provides us with an ideal opportunity in which to examine the relative power of two different accounting regimes by holding constant the firms, the financial period and the institutional setting. Thus it overcomes some of the limitations of the previous literature in this area, which tends to vary not only the accounting standards but some of the other factors simultaneously (Holthausen & Watts 2001). After identifying the value relevance of IFRS numbers *within* countries we then turn our attention to *across* country comparisons by holding constant the accounting standards i.e. IFRS.

Previous Research

Previous research into the effects of IFRS adoption has been limited. Harris and Muller (1999) have investigated the market valuation of earnings and book value amounts prepared under International Accounting Standards ('IAS') and US GAAP. Their sample consisted of foreign firms listed in the US that prepared their home country financial statements using IASC standards and reconciled from IAS to US GAAP in their Form 20-F filings. They found evidence that the US GAAP earnings reconciliation adjustment is value relevant for the market value and returns models. Ashbaugh and Pincus (1998) tested whether the adoption of IAS improved the usefulness of accounting information for predicting future earnings. They found, after controlling for analysts' following and firm size, that for their non-US firm sample who adopted IAS between 1990 and 1993, there was a significant increase in the accuracy of analysts' forecasts in the year after adoption. While these studies provided valuable early results on the properties of IAS numbers, their results may not be generalizable today since IASs have changed radically in the last decade. As a result a re-examination of the value relevance of IFRS numbers is necessary in order to assess whether the new accounting system produces numbers which are more closely related to stock prices.

More recently, Armstrong *et al.* (2006) investigated the general market reaction to events surrounding the probable adoption of IFRS in Europe. They found that investors generally responded positively to events that increased the likelihood of adoption to IFRS, and negatively to events that decreased this likelihood, thus suggesting that investors perceived the expected benefits of more comparable financial reports and the prospect of increased capital flows to outweigh the expected costs of implementation. On the other hand De Jong *et al.* (2006) explored the possible economic implications for Dutch firms arising from compliance with IAS 32. One of IAS 32's requirements imposes a change in the accounting treatment of preference shares, from an equity classification to a liability classification. They found that IAS 32 changed the capital structure of firms, and caused a shift towards a more equity-based capital structure in the Netherlands. Horton and Serafeim (2007) investigated the market reaction to and value relevance of the transitional documents for UK firms. Using an event study they found that firms decreasing their earnings in the reconciliation document experience a negative abnormal return at the date of the announcement and an abnormal increase in trading activity. In addition they observed that the IFRS earnings reconciliation adjustment (but not the reconciliation adjustment to shareholders' equity) was incrementally value relevant after controlling for the UK GAAP figures and specifically the adjustments in relation to goodwill impairment, share based payments, employee benefits, financial instruments and deferred taxes were associated with stock prices. They conclude that IFRS communicated value relevant and timely information for a sub-sample of firms which changed their equilibrium price.

Methodology and Research Design

In a similar vein to both Amir *et al.* (1993) and Harris *et al.* (1999), we investigate the value-relevance, incremental, and relative association of IFRS measures of earnings and owners' equity, versus domestic GAAP measures. Thus we adopt the following market value model which relates a firm's earnings and shareholders' equity measured under domestic GAAP together with the respective IFRS reconciliation adjustments, to its market value:

$$MV_{it+3} = \alpha_0 + \beta_1 BV_{it}^{DM} + \beta_2 ERN_{it}^{DM} + \beta_3 BV_{it}^{IFRS-DM} + \beta_4 ERN_{it}^{IFRS-DM} + \beta_5 NOSH_{it} + \varepsilon_{it} \quad (1)$$

Where:

MV_{it+3} = market value of shareholders' equity for the firm three months after the publication of their interim report which contained the restatement at time *t*;

BV_{it}^{DM} = book value of shareholders' equity under domestic GAAP for firm *i* included in the transitional report at time *t*;

ERN_{it}^{DM} = earnings under domestic GAAP for firm *i* included in the transitional report at time *t*;

$BV_{it}^{IFRS-DM}$ = difference between domestic GAAP and IFRS book value of shareholders' equity for firm *i* included in the transitional report at time *t;*

$ERN_{it}^{IFRS-DM}$ = difference between domestic GAAP and IFRS earnings for firm *i* included in the transitional report at time *t*;

$NOSH_{it}$ = number of shares outstanding at time *t* for firm *i.*

The model is run for each individual country. Also consistent with the suggestions of Barth and Kallapur (1996), equation (1) is estimated undeflated with White's (1980) correction for heteroscedasticity and a separate variable to proxy for scale is included – the number of common shares outstanding ($NOSH_{it}$). However, in order to examine the robustness of our results to alternative specifications, we also estimate equation (1) using the number of shares outstanding as a deflator (i.e., a price-per-share specification). In addition consistent with other value relevant studies and given the potential effect of implementing IFRS may be industry specific we also modified equation (1) to include industry fixed effects. (In every model we controlled for industry but it didn't change qualitatively any of our results. Here we report the results without including dummy variables for industries).

We predict positive coefficients for each variable. If the IFRS adjustments are value relevant then β_3 and/or β_4 should be positively signed and significantly different from zero. This would indicate that the reconciliation to IFRS is associated with market values after controlling for owners' equity and earnings reported under domestic GAAP. Following previous studies we define value relevance as the association between accounting information and equity market values (Francis and Schipper*,* 1999 and Barth *et al.* 2001).

In order to examine whether the reconciliation adjustments are valued differently in different countries, i.e. the relative level of association of the IFRS adjustments between countries is significantly different, we construct a model similar to Davis-Friday *et al* (1999). Equation (1) is modified to allow for different coefficients in relation to the firms previous GAAP regime to give the following model:

$$MV_{it+3} = \alpha_0 + \alpha_1 IT + \alpha_2 SP + \alpha_3 UK + \beta_1 BV_{it}^{DM} + \beta_2 ERN_{it}^{DM} + \beta_3 BV_{it}^{IFRS-DM} + \beta_4 ERN_{it}^{IFRS-DM} +$$
$$\beta_5 NOSH_{it} + \beta_6 IT * BV_{it}^{DM} + \beta_7 IT * ERN_{it}^{DM} + \beta_8 IT * BV_{it}^{IFRS-DM} + \beta_9 IT * ERN_{it}^{IFRS-DM}$$
$$+ \beta_{10} IT * NOSH_{it} + \beta_{11} SP * BV_{it}^{DM} + \beta_{12} SP * ERN_{it}^{DM} + \beta_{13} SP * BV_{it}^{IFRS-DM}$$
$$+ \beta_{14} SP * ERN_{it}^{IFRS-DM} + \beta_{15} SP * NOSH_{it} + \beta_{16} UK * BV_{it}^{DM} + \beta_{17} UK * ERN_{it}^{DM} + \beta_{18} UK * BV_{it}^{IFRS-DM}$$
$$+ \beta_{19} UK * ERN_{it}^{IFRS-DM} + \beta_{20} UK * NOSH_{it} + \varepsilon_{it}$$

(2)

The variables are as described above (for equation 1) with country fixed effects *IT*, *UK*, *SP*, which represent, Italy, UK and Spain respectively. These dummy variables capture any unobserved variation between countries and thereby eliminate any bias which could arise due to different levels of sophistication of the four stock markets. The dummy variable *IT* for example takes on the value of unity if the firm is Italian, and zero otherwise. Initially the base case used is France and therefore the coefficients in equation

2 corresponding to French firms are α_0 (intercept) and β_1 through β_5. The differences in intercept and slope between French firms and Italian firms are represented by β_6 through β_{10}, between French and Spanish are represented by β_{11} through β_{15} and between French and UK are represented by β_{16} through β_{20}. The coefficient for say the Italian firms equals the coefficient for the French firms plus the corresponding *IT* coefficient. Thus the Italian firms coefficient for $ERN^{IFRS-DM}$ is (β_4+ β_9) in equation 2.

We also employ a return specification in order to provide more credible inferences (Kothari & Zimmerman 1995). Using both price and returns models allow the authors to check the robustness of the results and thus make stronger statements since a combination of methodologies reduces the probability that the results are driven by econometric issues. We therefore estimate the following models:

$$R_i = \alpha_0 + \beta_1 ERN_{it}^{DM} + \beta_2 ERN^{DMt-DMt-1} + \beta_3 ERN_{it}^{IFRS-DM} + \varepsilon_{it}$$

(3)

and

$$R_i = \alpha_0 + \alpha_1 IT + \alpha_2 SP + \alpha_3 UK + \beta_1 ERN_{it}^{DM} + \beta_2 ERN^{DMt-DMt-1} + \beta_3 ERN_{it}^{IFRS-DM} + \beta_4 IT * ERN_{it}^{DM}$$
$$+ \beta_5 IT * ERN^{DMt-DMt-1} + \beta_6 IT * ERN_{it}^{IFRS-DM} + \beta_7 SP * ERN_{it}^{DM} + \beta_8 SP * ERN^{DMt-DMt-1}$$
$$+ \beta_9 SP * ERN_{it}^{IFRS-DM} + \beta_{10} UK * ERN_{it}^{DM} + \beta_{11} UK * ERN^{DMt-DMt-1} + \beta_{12} UK * ERN_{it}^{IFRS-DM} + \varepsilon_{it}$$

(4)

Where:

R_i =	daily log returns accumulated 9 months before 31/12/2005 and 3 months after for firm *i*;
ERN_{it}^{DM} =	earnings under domestic GAAP for firm *i* included in the transitional report at time *t*;
$ERN_{it}^{DMt-DMt-1}$ =	difference between domestic GAAP earnings between years t and t-1 for firm *i;*
$ERN_{it}^{IFRS-DM}$ =	difference between domestic GAAP and IFRS earnings for firm *i* included in the transitional report at time *t*;

Limitations and Caveats

There are a number of limitations and caveats in investigating value relevance of IFRS restatements. A major caveat when considering any market reactions is that 'efficiency' assumes that the market will understand the implications and effects of IFRS compliance and act accordingly. But even if the new information communicated to the market is value-relevant, it may not react if investors are unable to process this information. In addition the preliminary results reported below cannot make any inferences about the usefulness of the IFRS requirements. For example, if the reconciliation adjustments are found to be highly associated with market value one cannot state whether the adjustments themselves created/reduced value or whether the adjustments reflect previously known information. It seems plausible that a sophisticated investor may have been able to reconstruct the value relevant data in respect of some adjustments from the previous domestic GAAP reports where relevant information was disclosed in the notes.

Sample Description

Our initial sample consists of firms included in the Datastream EU Index. From this sample we extracted the French, Italian, Spanish and UK firms totalling 880 firms (250 French, 160 Italian, 120 Spanish and 350 UK). From this base of firms 276 firms were excluded due to lack of data either because there were no English translation available, firms had previously not reported under their domestic GAAP but alternative ones such as US GAAP or IFRS, and/or market data was not available for the specific dates or time periods. After excluding these firms, our total sample consists of 605 firms: 159 French, 99 Italian, 67 Spanish and 280 UK firms. Appendix 1 details the industrial classification of the firms by country and for the total sample. For the total sample, the predominate industry is 'Industrial Goods and Services' with 17% of the firms within this classification. This is also the most dominate industry for UK and France. In Italy and Spain, Banks and Construction dominate respectively. The least dominate industry overall is Chemicals representing only 1.32% of the sample. It may be noted that the Spanish sample does not contain any Automobiles firms.

Appendix 2 (Panels A to E) details the market capitalization, shareholders' equity, earnings under domestic GAAP and the reconciliation adjustments, necessary to bring domestic GAAP inline with IFRS. Panel A reports that the average market capitalisation for the whole sample is €9,960m (standard deviation of €17,400m), with a maximum of €207,000m and a minimum of €22m. The French sample has the highest average market capitalisation of €7,530m (standard deviation of €16,500), with a maximum of €140,000m and a minimum of €22m. The Italian sample on average has the lowest market capitalisation of €4,990m (standard deviation €12,100m), with a maximum of €99,000m and a minimum of €81m.

Panel B reports the mean shareholders' equity under both domestic GAAP and IFRS. For the full sample the shareholders' equity under domestic GAAP (BV^{DM}) is approx €3,130m (with a standard deviation of €10,600m), whilst under IFRS this is approx €3,230m (with a standard deviation of €11,200m). Thus the difference between reported domestic GAAP and IFRS shareholders' equity on average is approx €101m (see Panel D) which is small relative to the total shareholders' equity under domestic GAAP (i.e. approx 0.04% of shareholders' equity) indicating that IFRS book values are very close to domestic GAAP book values for our sample of firms. However, it may be noted that for Italian firms the adjustment necessary to their shareholders equity to achieve IFRS compliance is on average higher than for the other countries, with an average adjustment of approx. €96m which represents approximately 5% of their shareholders' equity under domestic GAAP. Interestingly for Spanish firms the adjustment to shareholders' equity tends on average to be negative, indicating that IFRS compliance tends to reduce their shareholders' equity, although the adjustment represents on average only about 1.4% of their shareholders' equity under domestic GAAP.

Panel C reports the mean earnings under both domestic GAAP and IFRS. The mean earnings under domestic GAAP (ERN^{DM}) for the full sample is approximately €376m (with a standard deviation of €1,540m), whilst under IFRS is approximately €489m (with a standard deviation of €1,610m). For all countries the necessary adjustment to achieve IFRS compliance is positive, and interestingly both the mean and median earnings reconciliation adjustments ($ERN^{IFRS\text{-}DM}$) for the full sample are very high relative to domestic GAAP earnings: 95% and 6% respectively (see Panel E). Those firms whose earnings are most affected by IFRS compliance are the UK firms with an average adjustment of €160m (with a standard deviation of 1,280m), this represents approximately 174% relative to their domestic GAAP earnings, whilst the least affected are firms from Spain with an median adjustment of approximately 2% relative to their domestic GAAP earnings (although the mean for this sample is approximately 4%).

Results for Level Model

The country by country results for equation 1 deflated are reported in Appendix 3: Level Model. The results under both the level and per-share basis are consistent and thus only the per-share models are reported. Following Belsley *et al.* (1980) *DFBETAS* were estimated to ascertain whether there were outliers driving the results for each country– a number of outliers were identified and deleted from the sample, however the results of the variables of interest post-deletion were qualitatively unchanged. Note, the comparison of R-squares between countries to infer relative value relevance is not appropriate given that the scale effects can bias r-squares in level regressions and this bias increases in the scale factor's coefficient of variation. For an excellent illustration see Brown, Lo & Lys (1999).

The results for UK firms indicate that the earnings reconciliation adjustment appears to be value relevant and have incremental price relevance over and above UK GAAP numbers. The coefficient of $ERN_{it}^{IFRS-DM}$ is positive and significant at the 0.1% level. The coefficient for the balance sheet reconciliation $BV_{it}^{IFRS-DM}$ is negative but not statistically significant under any model specifications. These initial results may reflect the earlier observation that the IFRS and UK GAAP earnings are very different (certainly in terms of magnitude) and are highly variable, whereas the IFRS and UK GAAP shareholders' equity appear to be very similar, suggesting that one would not be surprised that the balance sheet reconciliation is negligible and therefore irrelevant, as opposed to the earnings adjustment. It may be noted that coefficients on BV_{it}^{DM} and ERN_{it}^{DM} are positive under both specifications (deflated and un-deflated), and significant at the 0.1% level. Thus, it appears that the market places a high value on the earnings reconciliation adjustment between IFRS and UK GAAP. Although the earnings differences have value-relevance this does not appear to be the case for the differences in shareholders' equity between IFRS and UK GAAP. These results are consistent with Horton & Serafeim (2007).

Interestingly for Spanish firms the results indicate that the shareholders' equity reconciliation adjustment appears to be value relevant and have incremental price relevance over and above Spanish GAAP. This is not the case for any of the other countries investigated or for the pooled sample. The coefficient of $BV_{it}^{IFRS-DM}$ is negative (not as predicted) and significant at the 2% level. This however is not the case for the profit and loss reconciliation $ERN_{it}^{IFRS-DM}$ coefficient, although positive, it is not statistically significant. Thus it appears that $ERN_{it}^{IFRS-DM}$ is not value relevant, nor does it appear to have incremental price relevance over and above Spanish GAAP numbers. Again these results may reflect the earlier observation that Spanish firms appear to be the only country in the sample, whose effect of IFRS compliance reduces the shareholders' equity previously reported under Spanish GAAP. Therefore it would seem that the market partly reverses this decrease. Similarly the lack of significance for the earnings reconciliation may also be partially explained by the earlier observation that Spanish firms' earnings were the least affected by IFRS compliance and therefore suggesting that one would not be surprised that the earnings reconciliation is negligible and therefore irrelevant[1]. It may be noted that coefficients on BV_{it}^{DM} and ERN_{it}^{DM} are positive under both specifications (deflated and un-deflated), and significant at the 2% and 0.1% level respectively.

The results for French firms indicate that the earnings reconciliation adjustment appears to be value relevant and have incremental price relevance over and above the French

[1] Appendix 2 reports that the median reconciliation adjustment for earnings relative to Spanish GAAP earnings was approximately 2% this is compared to the other countries whose median range between 6% and 10%.

GAAP numbers. The coefficient of $ERN_{it}^{IFRS-DM}$ is positive (as predicted) and significant at the 0.1% level. This is not the case for the balance sheet reconciliation, the $BV_{it}^{IFRS-DM}$ coefficient is positive, although it is not statistically significant under any model specifications (deflated and un-deflated). It may be noted that coefficients on BV_{it}^{DM} and ERN_{it}^{DM} are positive under both specifications (deflated and un-deflated), and significant at the 0.1% level. The results for the French sample are very similar to the UK sample, since it also appears that the market places a high value on the earnings reconciliation adjustment between IFRS and French GAAP.

The results for Italian firms are similar to the French and UK results in relation to the reconciliation items. The earnings reconciliation adjustment is value relevant and has incremental price relevance over and above the Italian GAAP numbers. The coefficient of $ERN_{it}^{IFRS-DM}$ is positive (as predicted) and significant at the 5% level, although its significance is not as strong as that for the UK and French samples. The coefficient on balance sheet reconciliation $BV_{it}^{IFRS-DM}$ is positive, although it is not statistically significant under any model specifications (deflated and un-deflated). Interestingly there does however appear to be an anomaly with respect to Italian GAAP earnings. Unlike the rest of the results Italian earnings do not appear to have any value relevance over and above Italian GAAP shareholders' equity, which is highly significant.

The results for the pooled sample are consistent with the findings for UK and French firms. The earnings reconciliation adjustments, unlike the balance sheet adjustment, are incrementally value relevant after controlling for domestic GAAP figures. Appendix 4: Level Model reports the preliminary results of Equation 2. We do find that some information is weighted differently by the market depending on the firms' country characteristics. Consistent with the results above we find that the Spanish shareholders' equity reconciliation adjustment relative to the French adjustment is statistically significant at the 2% level (both for the deflated and un-deflated models) suggesting that the market weights the value relevance of the Spanish firms' shareholders' equity adjustments differently from that for French firms. Similarly, we find that the UK earnings reconciliation adjustment relative to the French adjustment is statistically significant at the 2% level. Again this suggests that the market weights the value relevance of UK firms earning adjustments differently from that for French firms. Interestingly both UK GAAP earnings and book values relative to the French firm's earnings and book values are statistically significant, which may provide some evidence to suggest that UK GAAP earnings are more value relevant than French GAAP earnings. In addition the intercepts α_1, α_2 and α_3 were also found to be negative and statistically significant at the 0.1% level. This indicates that share price for French firms tends to be on average higher compared to those of the other countries.

Results for Return Model

The earnings reconciliation adjustment is highly significant in explaining returns. Appendix 3: Return Model, reports the results for the return model in equation 3. The results obtained from the level model confirm our previous conclusions that investors use the reconciliation adjustment to earnings in valuing a firm. Therefore IFRS earnings include a value relevant component which was not recognized previously in the financial statements.

At the country level we find that this result is true only for UK and French companies. The coefficients are both positive and very significant (at 0.8% and 0.01% significance levels correspondingly). Whereas for Italy and Spain the earnings adjustment is highly insignificant. The component included in IFRS earnings and not included in earnings

under Italian GAAP and Spanish GAAP appears not to be considered useful by investors in the valuation process. Interestingly returns for Spanish firms seem to be associated with the level of earnings under domestic GAAP, something which is not true for any other country.

For equation 4, reported in Appendix 4: Returns Model we find both the difference in earnings from the previous year under domestic GAAP and the IFRS earnings reconciliation adjustment to be value relevant. Interestingly we find that for UK firms the reconciliation is even more significant compared to that for French firms. IFRS reconciliations seem to be of the greatest importance for the valuation of UK firms followed by French firms and irrelevant for the valuation for Italian and Spanish firms.

Initial Conclusions

The research uses the IFRS reconciliation disclosure provided by firms to evaluate the value relevance of IFRS accounting regime relative to a firm's previous domestic UK GAAP regime. These reconciliation documents capture the pure accounting change of moving from one accounting regime to another and therefore provide an ideal opportunity to investigate the value relevance of IFRS compliance relative to the firm's previous accounting regime.

The preliminary results suggest that for those firms previously reporting under UK, French or Italian GAAP the earnings reconciliation adjustment, necessary to achieve compliance with IFRS, appear to be incrementally value relevant over and above their domestic GAAP numbers. Contrary to this however, we find for those firms previously reporting under Spanish GAAP, that although there appears to be no value relevance of the earnings reconciliation adjustment, the shareholders' equity reconciliation adjustment does appear to be value relevant and have incremental price relevance over and above Spanish GAAP. Indeed given the negative sign of the respective coefficient it would appear that the market reverses the IFRS adjustment.

Consistent with these results we also find that for the French and UK firms the earnings reconciliation adjustments are also highly significant in explaining the stock returns, after controlling for the firm's earnings under their domestic GAAP. Also consistent is the lack of association for Spanish firms between the firms' returns and their earnings reconciliation adjustment. Interestingly however, for the Italian firms we find no significant level of association with the earnings reconciliation despite the value relevance results reported above.

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APPENDIX 1

Distribution of total sample of firms by industry classification and country sample by industry classification

Industry	Code	Total Sample	UK	SPAIN	FRANCE	ITALY
Automobiles & Parts	AUTMB	12 (1.98%)	1 (0.36%)	0 (0.00%)	6 (3.77%)	5 (5.05%)
Banks	BANKS	39 (6.45%)	9 (3.21%)	8 (11.94%)	6 (3.77%)	16 (16.16%)
Basic Resources	BRESR	14 (2.31%)	7 (2.50%)	4 (5.97%)	2 (1.26%)	1 (1.01%)
Chemicals	CHMCL	8 (1.32%)	4 (1.43%)	1 (1.49%)	2 (1.26%)	1 (1.01%)
Construction & Material	CNSTM	30 (4.96%)	5 (1.79%)	9 (13.43%)	8 (5.03%)	8 (8.08%)
Financial Services	FINSV	69 (11.40%)	45 (16.07%)	4 (5.97%)	15 (9.43%)	5 (5.05%)
Food & Beverage	FDBEV	30 (4.96%)	10 (3.57%)	6 (8.96%)	11 (6.92%)	3 (3.03%)
Healthcare	HLTHC	18 (2.98%)	7 (2.50%)	1 (1.49%)	7 (4.40%)	3 (3.03%)
Industrial Goods & Services	INDGS	103 (17.02%)	60 (21.43%)	7 (10.45%)	26 (16.35%)	10 (10.10%)
Insurance	INSUR	28 (4.63%)	13 (4.64%)	2 (2.99%)	6 (3.77%)	7 (7.07%)
Media	MEDIA	43 (7.11%)	16 (5.71%)	4 (5.97%)	15 (9.43%)	8 (8.08%)
Oil & Gas	OILGS	21 (3.47%)	11 (3.93%)	2 (2.99%)	5 (3.14%)	3 (3.03%)
Personal & Household Goods	PERHH	45 (7.44%)	20 (7.14%)	4 (5.97%)	13 (8.18%)	8 (8.08%)
Retail	RTAIL	35 (5.79%)	23 (8.21%)	1 (1.49%)	10 (6.29%)	1 (1.01%)
Technology	TECNO	31 (5.12%)	10 (3.57%)	2 (2.99%)	16 (10.06%)	3 (3.03%)
Telecommunications	TELCM	9 (1.49%)	4 (1.43%)	1 (1.49%)	1 (0.63%)	3 (3.03%)
Travel & Leisure	TRLES	39 (6.45%)	25 (8.93%)	4 (5.97%)	6 (3.77%)	4 (4.04%)
Utilities	UTILS	31 (5.12%)	10 (3.57%)	7 (10.45%)	4 (2.52%)	10 (10.10%)
	TOTAL	605	280	67	159	99

APPENDIX 2

Descriptive Statistics of Market Value, Earnings and Book Values under both domestic GAAP and IFRS for the full sample and samples per country

PANEL A: Market Capitalisation

	TOTAL (n=605)	UK (n=280)	SPAIN (n=67)	FRANCE (n=159)	ITALY (n=99)
	€'000	€'000	€'000	€'000	€'000
Mean	6,960,000	7,300,000	7,100,000	7,530,000	4,990,000
Median	1,860,000	1,780,000	2,480,000	1,620,000	1,960,000
Maximum	207,000,000	207,000,000	68,400,000	140,000,000	99,000,000
Minimum	22,390	378,000	120,000	22,390	80,600
Std. Dev.	17,400,000	20,100,000	13,400,000	16,500,000	12,100,000

PANEL B: Shareholders' equity under both Domestic GAAP (BV^{DM}) and under IFRS (BV^{IFRS})

	TOTAL (n=605)		UK (n=280)		SPAIN (n=67)		FRANCE (n=159)		ITALY (n=99)	
	BV^{DM}	BV^{IFRS}	BV^{DM}	BV^{IFRS}	BV^{DM}	BV^{IFRS}	BV^{DM}	BV^{IFRS}	BV^{DM}	BV^{IFRS}
	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000
Mean	3,130,000	3,230,000	3,640,000	3,820,000	2,490,000	2,250,000	3,080,000	3,170,000	2,190,000	2,280,000
Median	665,000	637,000	655,000	602,000	736,000	735,000	684,000	574,000	656,000	679,000
Maximum	158,000,000	158,000,000	158,000,000	158,000,000	39,300,000	32,600,000	35,600,000	41,100,000	32,500,000	35,500,000
Minimum	-1,160,000	- 1,590,000	- 1,160,000	-1,590,000	37,141	37,528	22,255	-546,000	53,777	53,972
Std. Dev.	10,600,000	11,200,000	14,300,000	15,300,000	5,720,000	4,810,000	6,060,000	6,430,000	4,630,000	4,870,000

PANEL C: Earnings under both Domestic GAAP (ERN^{DM}) and under IFRS (ERN^{IFRS})

	TOTAL (n=605)		UK (N=280)		SPAIN (N=67)		FRANCE (N =159)		ITALY (N=99)	
	ERN^{DM}	ERN^{IFRS}	ERN^{DM}	ERN^{IFRS}	ERN^{DM}	ERN^{IFRS}	ERN^{DM}	ERN^{IFRS}	ERN^{DM}	ERN^{IFRS}
	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000	€'000
Mean	376,000	489,000	431,000	591,000	354,000	367,000	368,000	495,000	248,000	271,000
Median	77,087	94,357	79,642	99,039	116,000	113,000	53,728	80,739	77,400	86,000
Maximum	22,200,000	24,100,000	22,200,000	24,100,000	3,140,000	3,610,000	9,610,000	10,900,000	7,270,000	7,060,000
Minimum	-12,700,000	-1,580,000	-12,700,000	-281,000	-156,000	-153,000	-3,610,000	-641,000	-1,550,000	-1,580,000
Std. Dev.	1,540,000	1,610,000	2,020,000	2,090,000	673,000	741,000	1,100,000	1,230,000	868,000	877,000

APPENDIX 2 Cont'd

PANEL D: IFRS Reconciliation Adjustments ($BV^{IFRS\text{-}DM}$) necessary to Shareholders' Equity under Domestic GAAP (BV^{DM})

	TOTAL (n=605)		UK (n=280)		SPAIN (n=67)		FRANCE (n =159)		ITALY (n=99)	
	$BV^{IFRS\text{-}DM}$	$\frac{BV^{IAS-DM}}{BV^{DM}}$	$BV^{IFRS\text{-}DM}$	$\frac{BV^{IAS-DM}}{BV^{DM}}$	$BV^{IFRS\text{-}DM}$	$\frac{BV^{IAS-DM}}{BV^{DM}}$	$BV^{IFRS\text{-}DM}$	$\frac{BV^{IAS-DM}}{BV^{DM}}$	$BV^{IFRS\text{-}DM}$	$\frac{BV^{IAS-DM}}{BV^{DM}}$
	€'000		€'000		€'000		€'000		€'000	
Mean	101,000	-0.0004	190,000	-0.0334	-242,000	-0.0143	93,678	0.0343	96,088	0.0468
Median	-424	-0.0012	- 10,593	-0.0137	-3,988	-0.0119	1,600	0.0058	11,507	0.0251
Maximum	82,200,000	4.6694	82,200,000	4.6694	2,890,000	0.6866	5,470,000	1.1742	3,070,000	1.0365
Minimum	-6,610,000	-6.5000	-5,920,000	-6.5000	-6,610,000	-0.6606	-1,230,000	-0.8800	-1,890,000	-0.2474
Std. Dev.	3,420,000	0.4776	4,960,000	0.6706	1,200,000	0.1852	632,000	0.2145	510,000	0.1431

PANEL E: IFRS Reconciliation Adjustments ($ERN^{IFRS\text{-}DM}$) necessary to Earnings under Domestic GAAP (ERN^{DM})

	TOTAL (n =605)		UK (n=280)		SPAIN (n=67)		FRANCE (n=159)		ITALY (n=99)	
	$ERN^{IFRS\text{-}DM}$	$\frac{ERN^{IAS-DM}}{ERN^{DM}}$	$ERN^{IFRS\text{-}DM}$	$\frac{ERN^{IAS-DM}}{ERN^{DM}}$	$ERN^{IFRS\text{-}DM}$	$\frac{ERN^{IAS-DM}}{ERN^{DM}}$	$ERN^{IFRS\text{-}DM}$	$\frac{ERN^{IAS-DM}}{ERN^{DM}}$	$ERN^{IFRS\text{-}DM}$	$\frac{ERN^{IAS-DM}}{ERN^{DM}}$
	€'000		€'000		€'000	€'000	€'000		€'000	
Mean	113,000	0.9451	160,000	1.7472	13,829	0.3972	127,000	0.3563	22,850	-0.0069
Median	6,404	0.0615	8,593	0.0583	603	0.0164	7,300	0.1009	4,670	0.0615
Maximum	21,000,000	258.7937	21,000,000	258.7937	470,000	42.1482	5,600,000	15.0845	932,000	1.3533
Minimum	- 557,000	-32.3184	- 557,000	-32.3184	-167,000	-15.9766	- 283,000	-8.9492	-215,000	-4.2500
Std. Dev.	918,000	13.4186	1,280,000	19.4654	92,591	5.5388	531,000	2.0044	115,000	0.6139

APPENDIX 3

Level Model
Test of Value Relevance of Reconciliation adjustments from Domestic GAAP to IFRS
Coefficients Values and t-statistics for the regression (White's Heteroscedasticity consistent t-statistics in parentheses)

$$SP_{it+3} = \alpha_0 + \beta_1 BVps_{it}^{DM} + \beta_2 ERNps_{it}^{DM} + \beta_3 BVps_{it}^{IFRS-DM} + \beta_4 ERNps_{it}^{IFRS-DM} + \varepsilon_{it}$$ (1) – per share basis

Dependent Variable	Predicted Sign	Price-per-share UK	SPAIN	FRANCE	ITALY	POOLED
Sample *n*		(n=276)[a]	(n=66)[a]	(n=157)[a]	(n=97)[a]	(n=601)[a]
Intercept	+/-	**2.816**	**3.79**	**19.97**	**2.01**	**6.19**
		(5.61)* **	**(2.489)** **	**(8.57)*** **	**(2.97)** **	**(9.99)*** **
$BVps^{DM}$	+	**0.446**	**0.001**	**0.865**	**1.52**	**1.09**
		(3.27)* **	**(3.45)** **	**(6.01)*** **	**(5.38)*** **	**(9.32)*** **
$ERNps^{DM}$	+	**7.675**	**0.01**	**3.29**	0.667	**4.07**
		(6.60)* **	**(5.46)*** **	**(3.64)*** **	(0.410)	**(4.32)*** **
$BVps^{IFRS-DM}$	+	-(0.01)	**-0.003**	0.628	1.75	0.02
		(-0.24)	**(-3.02)** **	(1.19)	(1.37)	(0.91)
$ERNps^{IFRS-DM}$	+	**3.671**	0.003	**1.566**	**12.84**	**1.69**
		(3.66)* **	(0.45)	**(5.41)*** **	**(2.26)* **	**(3.77)*** **
R^2 Adj		67.92%	78.24%	68.21%	66.68%	76.49%
F-statistic		146.58***	59.43***	81.53***	49.04***	489.21***

[a] = excluded outlier(s) following the calculation of *DFBETAS*. *, **, *** indicate significance at 5, 2 and 0.1 percent levels respectively.
SP = share price of equity 3 months after the interim results which contained the IFRS reconciliation document;
BV^{DM} = the accounting book value of shareholders' equity per share calculated under domestic GAAP;
ERN^{DM} = the earnings per share calculated under domestic GAAP;
$BV^{IFRS-DM}$ = the difference between domestic GAAP and IFRS book value of shareholders' equity per share;
$ERN^{IFRS-DM}$ = the difference between domestic GAAP and IFRS earnings per share.

Appendix 3: Return Model

Test of Value Relevance of Reconciliation adjustments from Domestic GAAP to IFRS
Coefficients Values and t-statistics for the regression
(White's Heteroscedasticity consistent t-statistics in parentheses)

$$R_i = \alpha_0 + \beta_1 ERN_{it}^{DM} + \beta_2 ERN^{DMt - DMt - 1} + \beta_3 ERN_{it}^{IFRS - DM} + \varepsilon_{it} \quad (2)$$

Dependent Variable		***Return-per-share***				
	Predicted Sign	**UK**	**SPAIN**	**FRANCE**	**ITALY**	**POOLED**
Sample *n*		(n=277)[a]	(n=63)[a]	(n=157)[a]	(n=97)[a]	(n=602)[a]
Intercept	+/-	**0.0382**	0.0013	0.0062	0.0278	**0.0489**
		(2.10)*	(0.03)	(0.20)	(0.91)	(3.73)***
ERN^{DM}	+	0.0224	**0.0694**	-0.0035	0.0235	0.0041
		(1.74)	(2.66)**	(-0.52)	(1.51)	(0.07)
$ERN^{DMt-DMt-1}$	+	**0.0466**	-0.0043	**0.0249**	0.0586	0.0126
		(2.48)**	(-1.40)	(2.31)*	(0.84)	(1.33)
$ERN^{IFRS-DM}$	+	**0.0801**	-0.2193	**0.0087**	-0.0857	**0.0059**
		(2.66)**	(-1.46)	(3.96)***	(-1.08)	(2.23)*
R^2 Adj		1.00%	6.39%	6.35%	0.20%	0.63%
F-statistic		2.36*	2.41*	4.52***	1.06	2.27***

[a] = excluded outlier(s) following the calculation of *DFBETAS*. *, **, *** indicate significance at 5, 2 and 0.1 percent levels respectively. R_i = daily log returns accumulated 9 months before 31/12/2005 and 3 months after; $BVps^{DM}$ = the accounting book value of shareholders' equity per share calculated under domestic GAAP; $ERNps^{DM}$ = the earnings per share calculated under domestic GAAP; $BVps^{IFRS-DM}$ = the difference between domestic GAAP and IFRS book value of shareholders' equity per share; $ERNps^{IFRS-DM}$ = the difference between domestic GAAP and IFRS earnings per share.

Appendix 4: Level Model
Test of the Relative Value Relevance of the Reconciliation Adjustments
Coefficients Values (White's Heteroscedasticity consistent t-statistics)

$$SP_{it+3} = \alpha_0 + \alpha_1 IT + \alpha_2 SP + \alpha_3 UK + \beta_1 BV_{it}^{DM} + \beta_2 ERN_{it}^{DM} + \beta_3 BV_{it}^{IFRS-DM} + \beta_4 ERN_{it}^{IFRS-DM} + \beta_5 NOSH_{it} + \beta_6 IT * BV_{it}^{DM} + \beta_7 IT * ERN_{it}^{DM} + \beta_8 IT * BV_{it}^{IFRS-DM} + \beta_9 IT * ERN_{it}^{IFRS-DM} + \beta_{10} IT * NOSH_{it} + \beta_{11} SP * BV_{it}^{DM} + \beta_{12} SP * ERN_{it}^{DM} + \beta_{13} SP * BV_{it}^{IFRS-DM} + \beta_{14} SP * ERN_{it}^{IFRS-DM} + \beta_{15} SP * NOSH_{it} + \beta_{16} UK * BV_{it}^{DM} + \beta_{17} UK * ERN_{it}^{DM} + \beta_{18} UK * BV_{it}^{IFRS-DM} + \beta_{19} UK * ERN_{it}^{IFRS-DM} + \beta_{20} UK * NOSH_{it} + \varepsilon_{it} \quad (3)$$

Dependent Variable		**Price per share** (n=601)[a]	
	Predicted Sign	**Coefficient**	**t-statistics**
Intercept	+/-	19.97	8.56***
IT	**+/-**	**-17.99**	**-7.37*****
SP	**+/-**	**-15.74**	**-7.05*****
UK	**+/-**	**-16.76**	**-5.59*****
BV^{DM}	**+**	**0.86**	**6.00*****
ERN^{DM}	**+**	**3.29**	**3.63*****
$BV^{IFRS-DM}$	+	0.63	1.19
$ERN^{IFRS-DM}$	**+**	**1.57**	**5.41*****
$IT*BV^{DM}$	+/-	**0.64**	**1.79^**
$IT*ERN^{DM}$	+/-	-1.08	-0.45
$IT*BV^{IFRS-DM}$	+/-	0.21	0.13
$IT*ERN^{IFRS-DM}$	+/-	9.58	1.45
$SP*BV^{DM}$	+/-	0.21	0.45
$SP*ERN^{DM}$	+/-	5.87	1.61
$SP*BV^{IFRS-DM}$	**+/-**	**-3.09**	**-2.34****
$SP*ERN^{IFRS-DM}$	**+/-**	-3.47	-0.46
$UK*BV^{DM}$	**+/-**	**-0.58**	**-2.89****
$UK*ERN^{DM}$	**+/-**	**4.44**	**3.00****
$UK*BV^{IFRS-DM}$	+/-	-0.61	-1.15
$UK*ERN^{IFRS-DM}$	**+/-**	**2.83**	**2.79****
R^2 Adj		82.36%	
F-statistic		144.24***	

[a] = initial sample was 605 firms, outlier(s) were excluded following the calculation of *DFBETAS;*
^, *, **, *** = significance at 10, 5, 2 and 0.1 percent levels respectively on two-tailed tests;
SP = share price of equity 3 months after the interim results which contained the IFRS reconciliation document;
BV^{DM} = the accounting book value of shareholders' equity per share calculated under domestic GAAP;
ERN^{DM} = the earnings per share calculated under domestic GAAP;
$BV^{IFRS-DM}$ = the difference between domestic GAAP and IFRS book value of shareholders' equity per share;
$ERN^{IFRS-DM}$ = the difference between domestic GAAP and IFRS earnings per share;
Dummy variables *IT* = Italian firms, *SP* = Spanish firms, *UK* = UK firms.

APPENDIX 4

Return Model
Test of the Relative Value Relevance of the Reconciliation Adjustments
Coefficients Values (White's Heteroscedasticity consistent t-statistics)

$$R_i = \alpha_0 + \alpha_1 IT + \alpha_2 SP + \alpha_3 UK + \beta_1 ERN_{it}^{DM} + \beta_2 ERN^{DMt\text{-}DMt\text{-}1} + \beta_3 ERN_{it}^{IFRS-DM} + \beta_4 IT * ERN_{it}^{DM} + \beta_5 IT * ERN^{DMt\text{-}DMt\text{-}1} + \beta_6 IT * ERN_{it}^{IFRS-DM} + \beta_7 SP * ERN_{it}^{DM} + \beta_8 SP * ERN^{DMt\text{-}DMt\text{-}1} + \beta_9 SP * ERN_{it}^{IFRS-DM} + \beta_{10} UK * ERN_{it}^{DM} + \beta_{11} UK * ERN^{DMt\text{-}DMt\text{-}1} + \beta_{12} UK * ERN_{it}^{IFRS-DM} + \varepsilon_{it} \quad (4)$$

Dependent Variable		Return per-share (n=603)	
	Predicted Sign	Coefficient	t-statistics
Intercept	+/-	-0.0065	-0.20
IT	**+/-**	0.0538	1.15
SP	**+/-**	0.0454	0.76
UK	**+/-**	0.0568	1.47
ERN^{DM}	**+**	-0.0022	-0.33
$ERN^{DMt\text{-}DMt\text{-}1}$	+	**0.0248**	**2.30****
$ERN^{IFRS\text{-}DM}$	**+**	**0.0094**	**4.18*****
$IT^* ERN^{DM}$	+/-	0.0258	1.53
$IT^* ERN^{DMt\text{-}DMt\text{-}1}$	+/-	0.0189	0.26
$IT^* ERN^{IFRS\text{-}DM}$	+/-	-0.1023	-1.31
$SP^* ERN^{DM}$	+/-	**0.0497**	**1.69^**
$SP^* ERN^{DMt\text{-}DMt\text{-}1}$	+/-	**-0.0299**	**-2.65****
$SP^* ERN^{IFRS\text{-}DM}$	**+/-**	-0.1854	-1.21
$UK^* ERN^{DM}$	**+/-**	0.0211	1.41
$UK^* ERN^{DMt\text{-}DMt\text{-}1}$	**+/-**	0.0190	0.86
$UK^* ERN^{IFRS\text{-}DM}$	+/-	**0.0595**	**2.03***
R^2 Adj		2.40%	
F-statistic		1.98**	

Sample consists of 603 firms ^,*, **, *** = significance at 10, 5, 2 and 0.1 percent levels respectively on two-tailed tests.
R_i = daily log returns accumulated 9 months before 31/12/2005 and 3 months after;
ERN^{DM} = the earnings per share calculated under domestic GAAP for year t;
$ERN^{DMt\text{-}DMt\text{-}1}$ = the difference between domestic GAAP earnings per share for years t and t-1;
$ERN^{IFRS\text{-}DM}$ = the difference between domestic GAAP and IFRS earnings per share,
Dummy variables *IT* = Italian firms, *SP* = Spanish firms, *UK* = UK firms.

APPENDIX 5

Measures Related to Strength of Laws, Investor Protection & Enforcement Mechanisms

Measures	UK	France	Spain	Italy
Disclosure Requirements	0.83	0.75	0.50	0.67
Public Enforcement	0.68	0.77	0.33	0.48
Liability Standard	0.66	0.22	0.66	0.22
Supervisor Characteristics	0.00	1.00	0.67	0.67
Rule-Making Power	1.00	0.50	0.00	1.00
Investigative Powers	1.00	1.00	0.50	0.25
Orders	1.00	1.00	0.00	0.00
Criminal Sanctions	0.42	0.33	0.50	0.50
Enforcement-CESR	1.00	1.00	0.75	1.00
Enforcement-Hope 2003	1.16	-0.99	-3.65	-3.55
SECREQ-Hail&Leuz 2006	0.73	0.58	0.50	0.46

The disclosure requirement index is taken from La Porta, Lopez-de-Silanes & Shleifer 2006 and includes laws about disclosures related to prospectus, compensation, equity ownership structure, inside ownership, irregular contracts and related parties transactions;
The public enforcement index is taken from La Porta, Lopez-de-Silanes & Shleifer 2006 and includes indexes related to supervisor characteristics, rule making power, investigative power, orders and criminal sanctions;
The liability standard index is taken from La Porta, Lopez-de-Silanes & Shleifer 2006 and includes liability standards for the issuer, directors, distributors and accountants;

Appendix 5: On-line survey questionnaire

The Institute of Chartered Accountants in England and Wales (ICAEW) is conducting research among preparers, auditors and users of financial statements across the EU to ascertain how the implementation of IFRS has affected them, especially in the first year of its implementation.

The questionnaire should take approximately 15 minutes to complete.

We would like to assure you that your answers will remain completely anonymous and the interviews will be conducted in accordance with the UK Data Protection Act and the UK Market Research Society Code of Conduct. No one will try to sell you anything during or after this project.

ALL RESPONDENTS

QA Please indicate country of residence

Austria
Belgium
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hungary
Ireland
Italy
Latvia
Lithuania
Luxembourg
Malta
Poland
Portugal
Slovakia
Slovenia
Spain
Sweden
The Netherlands
United Kingdom

QB How familiar would you say you are with International Financial Reporting Standards (IFRS)?

Very familiar
Quite familiar
Not very familiar
Not worked with IFRS

QC Do you work (in whatever capacity) in a practising firm of accountants/auditors, or in a business?

Please select one

In business
In practice
Other

PREPARERS OF FINANCIAL STATEMENTS

QD Do you have a role in the preparation of IFRS financial statements?

Yes
No

QDa Has your company published IFRS legal entity financial statements?

Yes
No
Don't know

QE Did your company adopt IFRS in its consolidated financial statements for the first time for 2005/2006 reporting?

Yes
No

QF For which reporting period did your company first adopt IFRS in its consolidated financial statements?
Please write in the year in space provided

AUDITORS OF FINANCIAL STATEMENTS

QG And have you audited IFRS consolidated financial statements?

Yes
No

PREPARERS OF FINANCIAL STATEMENTS

Q1 Which of the following best describes the organisation you work for?
Please select one

A listed company
A subsidiary of a listed company
An unlisted company
A subsidiary of an unlisted company
Other (write in_______________)
Don't know

Q2 What would you say has been the impact of IFRS on your company's consolidated reported profits?

Please select one

Much higher profit
Slightly higher profit
No change
Slightly lower profit
Much lower profit
Don't know

Q3 Please indicate which areas of your company's consolidated financial statements have been restated under IFRS?

Please select all that apply

Associates
Business combinations
Consolidation
Debt / equity
Deferred tax
Derivatives
Employee pensions
Employee share options
Financial instruments (other than debt/equity and derivatives)
Foreign currency
Goodwill
Impairments
Intangible assets
Joint ventures
Leases
Revenue recognition
Tangible fixed assets
Other area (write in___________)
None of the above

The introduction of IFRS may have had a significant impact on both day to day accounting procedures and year end reporting procedures.

Q4a Thinking about your own company's day to day accounting procedures, please indicate which three areas you consider have been most affected by the adoption of IFRS in the company's consolidated financial statements?

Q4b Thinking about your own company's year end reporting procedures, please indicate which three areas you consider have been most affected by the adoption of IFRS in the company's consolidated financial statements?

	Q4a Day to day accounting	Q4b Year end reporting
Associates		
Business combinations		
Consolidation		
Debt / equity		
Deferred tax		
Derivatives		
Employee pensions		
Employee share options		
Financial instruments (other than debt/equity and derivatives)		
Foreign currency		
Goodwill		
Impairments		
Intangible assets		
Joint ventures		
Leases		
Revenue recognition		
Tangible fixed assets		
Other area (write in___________)		

Q4c Are there any other areas not already mentioned in which the introduction of IFRS has had a significant impact on your company's consolidated financial statements?

Q5a For each accounting policy which was changed on the transition to IFRS in your company's consolidated financial statements, please indicate the effect of this change on the amount of work required by your accounting and finance team to prepare the consolidated financial statements.

Please select one answer for each accounting policy

	A lot less work	Slightly less work	No change	Slightly more work	A lot more work	Don't know / did not affect our company
Associates	1	2	3	4	5	6
Business combinations	1	2	3	4	5	6
Consolidation	1	2	3	4	5	6
Debt / equity	1	2	3	4	5	6
Deferred tax	1	2	3	4	5	6
Derivatives	1	2	3	4	5	6
Employee pensions	1	2	3	4	5	6
Employee share options	1	2	3	4	5	6
Financial instruments (other than debt/equity and derivatives)	1	2	3	4	5	6
Foreign currency	1	2	3	4	5	6
Goodwill	1	2	3	4	5	6
Impairments	1	2	3	4	5	6
Intangible assets	1	2	3	4	5	6
Joint ventures	1	2	3	4	5	6
Leases	1	2	3	4	5	6
Revenue recognition	1	2	3	4	5	6
Tangible fixed assets	1	2	3	4	5	6
OTHER item (if written in at Q4)	1	2	3	4	5	6

Q5b For each accounting policy which was changed on the transition to IFRS in your company's consolidated financial statements, how do you feel the change has affected the usefulness of the information to the external users of your consolidated financial statements?

Please select one answer for each accounting policy

	It has had a significant negative effect on the usefulness of the financial information	It has had a slightly negative effect	It has had no effect	It has made a slight improvement	It has made a significant improvement to the usefulness of the financial information	Don't know
Associates	1	2	3	4	5	6
Business combinations	1	2	3	4	5	6
Consolidation	1	2	3	4	5	6
Debt / equity	1	2	3	4	5	6
Deferred tax	1	2	3	4	5	6
Derivatives	1	2	3	4	5	6
Employee pensions	1	2	3	4	5	6
Employee share options	1	2	3	4	5	6
Financial instruments (other than debt/equity and derivatives)	1	2	3	4	5	6
Foreign currency	1	2	3	4	5	6
Goodwill	1	2	3	4	5	6
Impairments	1	2	3	4	5	6
Intangible assets	1	2	3	4	5	6
Joint ventures	1	2	3	4	5	6
Leases	1	2	3	4	5	6
Revenue recognition	1	2	3	4	5	6
Tangible fixed assets	1	2	3	4	5	6
OTHER item (if written in at Q4 and Q5a)	1	2	3	4	5	6

Q6a In its consolidated financial statements, has your company elected to use the fair value option in IAS 39 to designate some of your financial instruments at fair value through profit and loss rather than at cost or amortised cost?

Yes
No
Unsure

Q6b What has your company used the fair value option for and why has it used it?

Q6c In any legal entity financial statements prepared in accordance with national law, as amended by EU Fair Value Directive, has your company elected to use fair value accounting?

Yes
No
Unsure
Not applicable

Q6d What has your company used fair value accounting for in any legal entity financial statements and why has it used it?

Q7a Please provide an estimate of the additional costs of preparing your first set of IFRS consolidated financial statements under the following cost headings:

(Please include the costs of preparing the transition balance sheet, first IFRS six monthly accounts and restating any prior periods as well as the costs associated with the first full IFRS period).

The IFRS Project Team
Other staff (such as IT staff, Internal Audit and Management)
Training of staff
External technical advice
Tax advice
Software and systems changes
Communications with third parties
Additional external audit costs
Costs arising from changes such as renegotiating debt covenants
Other additional external data requirements (such as actuarial valuations)
Other costs (Please specify)

0 to 50,000 Euros
50,000 to 100,000 Euros
100,000 to 250,000 Euros
250,000 to 1M Euros
1M to 2M Euros
2M to 5M Euros
Over 5M Euros
Don't know

Q7b Very broadly what percentage of the above total additional cost is recurring cost i.e. are ongoing costs which will be repeated each year and would not have been incurred if IFRS had not been adopted?
Please base responses on the current IFRS standards and ignore any new or revised IFRS which have not yet been issued.

% recurring costs ____ _____

Q7c Where material, please provide estimated percentage of the total cost to implement the changes arising from IFRS in the following areas of accounting: (Please include the costs of preparing the transition balance sheet, the first IFRS six monthly accounts and restating any prior periods, as well as the costs associated with the first full IFRS period.)

General costs of preparing the financial reports (such as financial statement re-drafting and issues of presentation)
Associates
Business combinations
Consolidation
Debt/ equity
Deferred tax
Derivatives
Employee pensions
Employee share options
Financial instruments (Other than debt/equity and derivatives)
Foreign currency
Goodwill
Impairment
Intangible assets
Joint ventures
Leases
Revenue recognition
Tangible fixed assets
Other

Nothing
Less than 1% of total costs
2% to 5% of total costs
5 to 10% of total costs
10 to 20% of total costs
20 to 50% of total costs
Over 50% of total costs

Q7d Are there ways in which you could have undertaken the IFRS implementation project at significantly lower total cost?

Yes
No

Q7e How could you have undertaken the IFRS implementation project at significantly lower total cost?
Please tick all that apply

Started sooner
Sought expert advice sooner
Made a better initial assessment of the impact
Communicated better with subsidiaries/ business units
Brought in more expert assistance
Trained staff better/ sooner
Communicated impact to non financial staff better
Communicated impact to the board better
Managed the project better
Other (Please specify_________)

Q7f Are there any recommendations you would offer **to regulators and standard setters** to reduce the cost of implementation of future new or revised IFRSs?

Yes
No

Q7g What would you recommend?
Please tick all that apply

Allow more time between the finalisation of an IFRS and its mandatory implementation
Bring in all changes in a year on the same effective date
Ensure that no more than one change is required in one financial year
Greater consultation with companies who will have to apply the standards before introducing new IFRS or making changes to existing ones.
Other (Please specify______________)

Q8a How would you rate the Board of Directors' (Management Board) understanding of the effects of IFRS on…………?

Very poor
Quite poor
Neither good nor poor
Quite good
Very good

Please select one answer for each statement

Reported profits
Earnings per share
Company share price

Q8b Do you use IFRS accounting for your internal reporting?

Yes
No
Don't know

Q8c Has this been beneficial for management purposes?

Yes
No
Don't know

Q9a Did your company make a presentation or hold other meetings with investors to inform them of the implications of transition to IFRS on your company's consolidated financial statements?

Yes
No

Q9b Thinking about your company's first IFRS consolidated financial statements only, what has been the effect of the introduction of IFRS on the amount of dialogue between your company and investors? There has been……

Much less dialogue
Slightly less dialogue
No change
Slightly more dialogue
Much more dialogue

Q9c What do you think will be the effect of the introduction of IFRS in your consolidated financial statements on the level of dialogue between your company and investors in future periods when compared with the level of dialogue prior to your company's adoption of IFRS ? There will be……

Much less dialogue
Slightly less dialogue
No change
Slightly more dialogue
Much more dialogue

Q9d How much easier or difficult is it to explain to investors your company's consolidated results under IFRS compared with your company's results prior to your adoption of IFRS?

A lot more difficult under IFRS
A little more difficult under IFRS
No difference to previous GAAP
A little easier under IFRS
A lot easier under IFRS

Q10 Do you believe that your company's share price has been affected by the introduction of IFRS?

The share price has fallen by a large amount (>10%)
The share price has fallen slightly (>1% and <10%)
No, there has been no effect on share price
The share price has risen slightly (>1% and <10%)
The share price has risen by a large amount (>10%)
Unsure / don't know

Q11 Do you believe that the cost of capital to your company has been affected by the introduction of IFRS?

The cost of capital has fallen by a large amount
The cost of capital has fallen slightly
No, there has been no effect on our company's cost of capital
The cost of capital has risen slightly
The cost of capital has risen by a large amount
Unsure / don't know

12a Please indicate the extent to which you agree or disagree with the statements below:

Please select one answer for each statement

	Disagree strongly	Disagree slightly	Neither agree nor disagree	Agree slightly	Agree strongly	Don't know
IFRS has improved the efficiency of EU capital markets	1	2	3	4	5	6
IFRS has made consolidated financial statements easier for investors to understand	1	2	3	4	5	6
IFRS has made financial statements easier for regulators and supervisors to use	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across countries	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across competitors within the same industry sector	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across industry sectors	1	2	3	4	5	6
IFRS has improved the quality of disclosure in consolidated financial statements	1	2	3	4	5	6
IFRS has changed the way we run our business (see 12b and 12c)	1	2	3	4	5	6

Q12b You say that IFRS has changed the way your company runs its business. To what extent do you agree or disagree that it has improved the way your company runs its business?

Disagree strongly
Disagree slightly
Neither agree nor disagree
Agree slightly
Agree strongly

Q12c In what way(s) has your company changed the way it runs its business?

Q13a How confident are you that fund managers and analysts understand fully the impact of IFRS on your company's consolidated financial statements?
Not at all confident
Not very confident
Fairly confident
Very confident
Don't know

Q13b Thinking now about your current level of knowledge and understanding of IFRS, and your own personal experiences of it, what effect do you think the adoption of IFRS has had on the overall quality of your company's consolidated financial statements?

It has made them significantly worse
It has made them slightly worse
If has had no effect
It has made them slightly better quality
It has made them significantly better quality

Q14a How many employees are there in the group you work for (all offices, all locations)?

Less than 500 employees
501-1,000 employees
1,001-5,000 employees
5,001+ employees
Don't know

Q14b Please indicate your company's consolidated annual turnover (revenue). If you do not know exactly your best estimate is fine. Please answer in EUROs.

<€1mn
€1-50mn
€51-100mn
€101-500mn
€501-1000mn
€1001-5000mn
>€5,001mn
Don't know

Q14c Please indicate your company's industry sector.

Please select one

Oil and Gas
Chemicals
Basic Resources
Construction and Materials
Industrial Goods and Services
Automobiles and Parts
Foods and Beverages
Personal and Household Goods
Health Care
Retail
Media
Travel and Leisure
Telecommunications
Utilities
Banks
Insurance
Financial Services
Technology
Other (write in)____________

Q14d Please indicate your own job title / job function:

Q15 What do you think have been the main benefits of IFRS to your company?

Q16 Can you think of any ways of improving IFRS?

Q17 Are there any other comments you wish to make about the introduction of IFRS?

AUDITORS OF IFRS FINANCIAL STATEMENTS

Q1 Generally speaking how easy or difficult have you found auditing IFRS consolidated financial statements compared with auditing consolidated financial statements prior to the adoption of IFRS?

Very difficult
Quite difficult
Neither easy nor difficult
Quite easy
Very easy

Q2 For each accounting policy which has changed on the transition to IFRS, please indicate for one of your largest clients the effect of the change on the amount of work required to audit the consolidated financial statements?

Please select one answer for each accounting policy

	A lot less work	Slightly less work	No change	Slightly more work	A lot more work	Don't know /have not been required to audit
Associates	1	2	3	4	5	6
Business combinations	1	2	3	4	5	6
Consolidation	1	2	3	4	5	6
Debt / equity	1	2	3	4	5	6
Deferred tax	1	2	3	4	5	6
Derivatives	1	2	3	4	5	6
Employee pensions	1	2	3	4	5	6
Employee share options	1	2	3	4	5	6
Financial instruments (other than debt/equity and derivatives)	1	2	3	4	5	6
Foreign currency	1	2	3	4	5	6
Goodwill	1	2	3	4	5	6
Impairments	1	2	3	4	5	6
Intangible assets	1	2	3	4	5	6
Joint ventures	1	2	3	4	5	6
Leases	1	2	3	4	5	6
Revenue recognition	1	2	3	4	5	6
Tangible fixed assets	1	2	3	4	5	6
Other (write in________)	1	2	3	4	5	6

Q2a Please indicate this client's industry sector.

Oil and Gas
Chemicals
Basic Resources
Construction and Materials
Industrial Goods and Services
Automobiles and Parts
Foods and Beverages
Personal and Household Goods
Health Care
Retail
Media
Travel and Leisure
Telecommunications
Utilities
Banks
Insurance
Financial Services
Technology
Other (write in)________________

Q3a Did you charge an additional audit fee for the audit of the transition balance sheet and the restatement of prior periods?

Yes
No
Don't know

Q3b If yes how much higher was the audit fee?
0 to 50,000 Euros
50,000 to 100,000 Euros
100,000 to 250, 000 Euros
250,000 to 1M Euros
1M to 2M Euros
2M to 5M Euros
Over 5M Euros

Q3c Was your audit fee of the first IFRS consolidated financial statements higher as a direct consequence of the introduction of IFRS?

Yes
No
Don't know

Q3d If yes how much higher was the audit fee?

0 to 50,000 Euros
50,000 to 100,000 Euros
100,000 to 250, 000 Euros
250,000 to 1M Euros
1M to 2M Euros
2M to 5M Euros
Over 5M Euros

Q4a To what extent did you help your clients with the introduction to IFRS?
Please select all that apply

Gave training seminars
Issued publications/ guidance notes
Provided model of IFRS Financial Statements
Gave advice on selection of accounting policies
Gave advice on developing accounting policies
Other (Write in___________)
None of the above

Q4b In total how much did you charge for the work of helping your clients with the introduction to IFRS?

Nothing
0 to 50,000 Euros
50,000 to 100,000 Euros
100,000 to 250, 000 Euros
250,000 to 1M Euros
1M to 2M Euros
2M to 5M Euros
Over 5M Euros

Q5 Please indicate the extent to which you agree or disagree with the statements below:
Please select one answer per statement

	Disagree strongly	Disagree slightly	Neither agree nor disagree	Agree slightly	Agree strongly	Don't know
IFRS has improved the efficiency of EU capital markets	1	2	3	4	5	6
IFRS has made consolidated financial statements easier for investors to understand	1	2	3	4	5	6
IFRS has made consolidated financial statements easier for regulators and supervisors to use	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across countries	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across competitors within the same industry sector	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across industry sectors	1	2	3	4	5	6
IFRS has improved the quality of disclosure in consolidated financial statements	1	2	3	4	5	6
IFRS has helped change the way businesses are run	1	2	3	4	5	6

Q6 Thinking now about your current level of knowledge and understanding of IFRS, and your own personal experiences of it, what effect do you think the move to IFRS has had on the quality of companies' consolidated financial statements?

It has made them significantly worse
It has made them slightly worse
If has had no effect
It has made them slightly better quality
It has made them significantly better quality

Q7 In your opinion, are there any significant issues that have caused you problems while auditing IFRS consolidated financial statements?

Q8 What do you think have been the main benefits of IFRS to the companies that you have audited?

Q9 In your opinion, are there any significant issues which require improvement to or elaborations of IFRS?

Q10 Are there any other comments you wish to make about the introduction of IFRS?

INVESTORS / USERS OF IFRS FINANCIAL STATEMENTS

QA Please indicate country of residence

Austria
Belgium
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hungary
Ireland
Italy
Latvia
Lithuania
Luxembourg
Malta
Poland
Portugal
Slovakia
Slovenia
Spain
Sweden
The Netherlands
United Kingdom

Q1a And how familiar would you say you are with International Financial Reporting Standards (IFRS)?

Very familiar
Quite familiar
Not very familiar
Not at all familiar/ not worked with IFRS

Q1b How confident are you that you have a full understanding of the impact of IFRS on the companies that you are investing in / tracking?

Not at all confident
Not very confident
Fairly confident
Very confident
Don't know

Q2 Which of the following countries do you currently invest in / track?

Please select all that apply

Austria
Belgium
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hungary
Ireland
Italy
Latvia
Lithuania
Luxembourg
Malta
Netherlands
Poland
Portugal
Slovakia
Slovenia
Spain
Sweden
United Kingdom
Other (specify)

Q2a Please indicate which of the following industry sectors you currently invest in or track. *Please select all that apply*

Oil and Gas
Chemicals
Basic Resources
Construction and Materials
Industrial Goods and Services
Automobiles and Parts
Foods and Beverages
Personal and Household Goods
Health Care
Retail
Media
Travel and Leisure
Telecommunications
Utilities
Banks
Insurance
Financial Services
Technology
Other (write in) ___________________

Q3 Generally speaking what would you say has been the impact of IFRS on companies' consolidated reported profits?
Please select one

Much higher profit
Slightly higher profit
No change
Slightly lower profit
Much lower profit
Unsure / Don't know

Q4 Please indicate the extent to which you agree or disagree with the statements below:

Please select one answer per statement

	Disagree strongly	Disagree slightly	Neither agree nor disagree	Agree slightly	Agree strongly	Don't know
IFRS has improved the efficiency of EU capital markets	1	2	3	4	5	6
IFRS has made consolidated financial statements easier for investors to understand	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across countries	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across competitors within the same industry sector	1	2	3	4	5	6
IFRS has made consolidated financial statements easier to compare across industry sectors	1	2	3	4	5	6
IFRS has improved the quality of disclosure in consolidated financial statements	1	2	3	4	5	6

Q5a Has the move to IFRS consolidated financial statements influenced the way you make your investment decisions?

Yes, a great deal
Yes, a fair amount
Yes, just a little
No, not at all
Don't know

Q5b How have your investment decisions been affected?

Please select one

I invest in countries I have not invested in previously
I invest in sectors I have not invested in previously
I have withdrawn funds from countries I invested in previously
I have withdrawn funds from sectors I invested in previously
I rely more on published consolidated financial statements compared to previously
I rely less on published consolidated financial statements compared to previously
I rely more on speaking to company management than previously
Other (specify________________)

Q5c Thinking about all companies that you track, do you believe that their share prices have been affected by the introduction of IFRS?

They have fallen by a large amount (>10%)
They have fallen slightly (>1% and <10%)
No, there has been no effect on share prices
They have risen slightly (>1% and <10%)
They have risen by a large amount (>10%)
Unsure / don't know

Q5d Thinking about all companies that you track, do you believe that the overall cost of capital for these companies has been affected by the introduction of IFRS?

The cost of capital has fallen by a large amount
The cost of capital has fallen slightly
No, there has been no effect on the companies' cost of capital
The cost of capital has risen slightly
The cost of capital has risen by a large amount
Unsure / don't know

Q6a One of the key aims of IFRS is to make consolidated financial statements easier for external users such as investors to understand.

From your knowledge and experience of using IFRS consolidated financial statements please rate each of the accounting areas on whether you believe they are easier or more difficult to understand under IFRS as compared with their understandability prior to the adoption of IFRS?

Please select one answer per statement

	Much more difficult to understand	Slightly more difficult	No change	Slightly easier to understand	Much easier to understand	Don't know
Associates	1	2	3	4	5	6
Business combinations	1	2	3	4	5	6
Consolidation	1	2	3	4	5	6
Debt / equity	1	2	3	4	5	6
Deferred tax	1	2	3	4	5	6
Derivatives	1	2	3	4	5	6
Employee pensions	1	2	3	4	5	6
Employee share options	1	2	3	4	5	6
Financial instruments (other than debt/equity and derivatives)	1	2	3	4	5	6
Foreign currency	1	2	3	4	5	6
Goodwill	1	2	3	4	5	6
Impairments	1	2	3	4	5	6
Intangible assets	1	2	3	4	5	6
Joint ventures	1	2	3	4	5	6
Leases	1	2	3	4	5	6
Revenue recognition	1	2	3	4	5	6
Tangible fixed assets	1	2	3	4	5	6

Q6b Are there any other areas which you consider to be more difficult to understand under IFRS?

Q7 To what extent do you agree or disagree with the statement "IFRS more accurately reflects the economic reality of company performance and its position than previous GAAP"

Disagree strongly
Disagree slightly
Neither agree nor disagree
Agree slightly
Agree strongly

Q8 Generally speaking, what would you say has been the impact on the quality of financial information of the disclosures presented in IFRS consolidated financial statements compared with the disclosure presented prior to the adoption of IFRS? The additional disclosure….

Please select one

Greatly detracts from the overall quality of the financial statements
Slightly detracts from the overall quality of the financial statements
No impact
Slightly enhances the overall quality of the financial statements
Greatly enhances the overall quality of the financial statements
Don’t know

Q9 Thinking now about your current level of knowledge and understanding of IFRS, and your own personal experiences of it, what effect do you think the move to IFRS has had on the quality of companies’ consolidated financial statements?

Please select one
It has made them significantly worse
It has made them slightly worse
If has had no effect
It has made them slightly better quality
It has made them significantly better quality

Q9a Did you attend company presentations or other meetings where companies explained to you the implications of the transition to IFRS on their consolidated financial statements?

Yes
No

Q9b Thinking the introduction of IFRS, what has been the effect of the introduction of IFRS on the amount of dialogue between yourself and companies? There has been……

Please select one

Much less dialogue
Slightly less dialogue
No change
Slightly more dialogue
Much more dialogue

Q9c What do you think will be the effect of the introduction of IFRS on the level of dialogue between yourself and companies in future periods when compared with the level of dialogue prior to the introduction of IFRS? There will be……

Please select one

Much less dialogue
Slightly less dialogue
No change
Slightly more dialogue
Much more dialogue

Q10 What do you think have been the main benefits of IFRS to the companies that you track?

Q11 Can you think of any ways of improving IFRS?

Q12 Are there any other comments you wish to make about the introduction of IFRS?

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ICAEW Financial Reporting Faculty
Chartered Accountants' Hall
PO Box 433 Moorgate Place
London EC2P 2BJ
T +44 (0)20 7920 8487
F +44 (0)20 7638 6009
E nigel.sleigh-johnson@icaew.com
www.icaew.com/ecifrsstudy