

## TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS – NEEDS AND PROBLEMS

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***Abstract:** The efforts for successful conversion to International Financial Reporting standards (IFRS) are characterized by a thorough strategic assessment, creation of a robust step-by-step plan, alignment of resources to the efficient execution of the plan, and smooth integration of the change into normal business operations. In a business-wide conversion, all departments that contribute to the creation of financial information, or that use financial information in their daily activities, should be involved.*

*The existence of a global benchmark enables direct comparison of corporate financial reports between jurisdictions. Such high-quality standards enhance investor's confidence by allowing economic transactions of a similar nature to be treated and reflected in the same manner around the globe.*

**Key words:** conversion, international standards, accounting, problems.

### Introduction

Adopting IFRS will likely impact key performance metrics, requiring thoughtful communications plans for the managers, shareholders and other key stakeholders. Internally, IFRS could have a broad impact on a company's infrastructure, including underlying processes, systems, controls, and even customer contracts and interactions.

The full benefits of such a global benchmark will be realized only when it is implemented around the world in a consistent manner. Many developing countries and countries with economies in transition lack the accounting infrastructure and professional institutions needed for building the technical capacity required to meet the challenges posed by the transition to a common set of global standards – standards that are formulated with developed markets in mind and which have been becoming increasingly sophisticated.

Conversion experience in Europe, as well as in other parts of the world, shows that conversion projects often take more time and resources than anticipated. Historically, that has led some companies to rush and risk mistakes or outsource more work than necessary, driving up costs and hindering the embedding of IFRS knowledge within the company.

### The evolution and opportunities of International financial reporting standards

In an increasingly interconnected global economy, many market participants are considering the question of whether it is possible or desirable to move toward a more uniform global “language” for financial reporting. The proponents of this idea argue that a uniform set of global accounting standards, supported by strong governance, independent standard-setting and a sound regulatory framework, could benefit investors and businesses

alike. Others suggest that trying to establish a uniform set of global standards would run the risk of overlooking the unique economic, political, cultural, legal and regulatory realities that exist in different nations and regions.

Over the past decade, this global discussion has intensified. In 2001, the International Accounting Standards Board (IASB) adopted the first iteration of International Financial Reporting Standards, to serve as a possible pathway for establishing uniform global accounting standards. Since then, IFRS has been adopted or become accepted in over 100 countries.

Accounting standards around the world have evolved over centuries of business and capital market development. In this process, accounting standards historically were designed to meet the needs of each nation's capital markets. Those standards that were found to work well in the legal, cultural, political and economic context of each nation became the "generally accepted accounting principles," or GAAP, for that particular jurisdiction. Naturally, different norms in each nation led to different GAAPs in each nation.

The growing dynamic of globalization presented a challenge to these "legacy systems." Global protocols for the internet, electronic payments, software systems and cargo shipping demonstrated the potential value of uniform global systems. A discussion began among market participants over whether the global capital markets would similarly benefit by having a single set of high-quality accounting standards that could be applied around the world.

In order to create a uniform global system for financial reporting, the IASB was formed to serve as the global accounting standard-setting body.

The evidence shows that there are number of factors that support the idea of adoption or acceptance of IFRS in all countries:<sup>1</sup>[1]

- **Facilitation of more efficient capital allocations**

A single set of high-quality global accounting standards would increase the ability of companies to raise capital in multiple jurisdictions around the world, while at the same time allowing investors to more efficiently compare global investment opportunities.

- **Align each nations with the rest of the world**

Already, more than 100 nations have adopted or accepted IFRS, including most of the world's developed economies. At this point, it is fair to say that IFRS is becoming the global norm. If all countries were to adopt IFRS, it would be joining much of the rest of the world, which would provide a powerful push toward worldwide acceptance of a single set of global accounting standards.

- **Protect long-term competitiveness of capital markets**

Cross-border investment and the integration of capital markets may be easier among those nations that adopt IFRS.

- **Promote increased transparency**

IFRS is a more "principles-based" set of accounting standards than national accounting standards. As such, it may allow companies and auditors to focus less on strict adherence to detailed requirements and "bright lines," and instead concentrate on providing a clear statement of an entity's assessment of the economic realities of its business activities. Some studies have suggested that this principles-based approach allows for, and in fact,

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<sup>1</sup> "Guide to International Financial Reporting Standards", Center for audit quality, September, 2009

incentivizes companies to provide financial reports that offer a more transparent picture of the firm's economic condition.

• **Reduce complexity in financial reporting**

Over the last several decades, the national standards of each country and associated guidance have grown to many thousands of pages. By contrast, IFRS is substantially shorter in length. The principles-based nature of IFRS standards may facilitate an enhanced focus on the economic purpose of a company's business activities in its financial reports. This may make it possible for businesses to produce financial reports that are less complex for investors and other users of financial information. It is worth noting that while IFRS is less mature than national accepted accounting standards, it does provide a level of interpretive guidance to assist companies in applying the principles.

• **Increase efficiency for companies**

Adoption of IFRS in countries offers potential cost savings for companies operating in multiple countries around the world, by making it less costly to find local accountants, as the acceptance of IFRS worldwide may reduce the number of accountants with knowledge of national standards. In addition, it may help reduce the costs associated with maintaining multiple sets of books, as well as reduce the chance of errors associated with translating financial information from IFRS to national standards. Moreover, the transition to IFRS could lessen costs for investors by eliminating many of the adjustments that analysts and other users currently must make in order to compare financial results and financial conditions in different countries.

Users of financial statements – first and foremost investors, but equally analysts, credit rating agencies as well as the whole range of consultants and advisors who assist investors in optimising their choices – are logically the first rank of “clients” of the accounting standardsetting process. Indeed, the IASB's conceptual framework states explicitly that the information needs of investors should be at the forefront of the standard-setter's preoccupations. Yet financial statement users are often conspicuously absent from the debate over accounting issues albeit that debate has become significantly more vigorous since the European Union's decision, in 2002, to adopt IFRS as the framework for the publication of the consolidated financial statements of quoted companies.

After several years of European implementation, the first lessons from experience of the new standards are emerging. At the same time, numerous decisions remain to be taken before implementation will have been stabilised and it would be a mistake to imagine that the market has already reached cruising speed as far as IFRS application is concerned.

There are some remarks like conclusions from the process of beginning implementation of IFRS, from the perspective of investors and market participants from different countries, and most important are the following:<sup>2</sup> [2]

1. The assessment of the **quality of the standards** and in this respect, have provide several conclusions:

- The introduction of IFRS has provided increased **transparency** in several areas: derivative instruments, off-balance sheet items more generally, securitisation, pension obligations, stock options, segment reporting. In all these respects, the richness of the information provided under IFRS is generally very positively appreciated, even if certain users deplore the sometimes cumbersome nature of the resulting financial statement developments.

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<sup>2</sup> “Investor perspectives on IFRS implementation”, Collection of essays, Paris, 2007

- The **relevance** of the information provided is, on the other hand, disputed and also gives rise to conflicting perceptions. Many users remain attached to the analysis of operating flows, an approach that is not necessarily facilitated under IFRS in comparison with the standards previously applicable. The financial instrument categories defined by IAS 39 are criticised for their rigidity. Several interviewees remain sceptical as to the prescribed bases for testing goodwill for impairment. The rules applying to capitalisation of research and development expenditure are also criticised. Several observers feel that the IASB's approach is too often one of abstract formalism far removed from economic reality. Others express misgivings in respect of the temptation of certain entities to focus their communication on pro forma data, not subject to the requirements of IFRS, as a means of countering the perceived deficiencies in terms of relevance of the IFRS framework.

- The **reliability** of IFRS financial statements is more or less unanimously recognised as superior to that of the prior configuration and the potential for “earnings management”, particularly in the area of financial services, has been considerably reduced. On the other hand, users remain extremely prudent on the subject of impairment testing of goodwill which is considered to be very dependent on market conditions.

- The **understandability** of financial data is sometimes considered to have suffered since the adoption of IFRS. Certain users consider that this is the necessary corollary of transparency, but others feel that the standards have been made unnecessarily complex. Insurance companies are perceived as a special case in the absence of a final standard governing their liabilities.

- Finally, certain recent standards raise specific misgivings which may often be attributed to the process of convergence with US GAAP. This is particularly the case of IFRS 8 dealing with operating segment.

2. The second major category of conclusions relates to IFRS **implementation** during following adoption are:

- The **preparation of the transition** by major French and foreign issuers is generally recognised to have been of high quality. The complexity of the exercise was properly anticipated and significant resources were committed both internally, to preparing the new financial statements, and externally in terms of alerting and “educating” the market to the impacts of the new rules, even though certain observers remain of the opinion that the transitional information provided has been insufficient.

- The **quality of audit** generally gives rise to a prudent assessment as the users interviewed do not always feel qualified to express an informed opinion. However most believe that the audit mechanism alone is not sufficient to ensure coherent application of IFRS and that financial reporting of quality also implies the active participation of users and regulators. Certain observers go so far as to underscore the challenge faced by the audit networks in training and adapting their staff skills in this area.

- The key issue in assessing IFRS implementation remains that of the **comparability** of financial statements, in particular between different European Union countries for a given business segment. The universal adoption of the international standards clearly does improve comparability, but application of the standards remains subject to significant disparities which are sometimes described as “local flavour” and even as “nostalgic accounting”. All the observers recognise that comparability was not achievable as early as first-time adoption (given in particular the facilitating options provided for by IFRS 1), but there are diverging views as to the capacity of the existing mechanisms – pressure from the market, auditors and regulators as well as peer benchmarking by issuers of financial statements – gradually to eliminate the differences observed so as to achieve satisfactory comparability ultimately.

- A question that follows on from this is that of the capacity of IFRS to remain principlesbased, with as its corollary that of the need to introduce more detailed **implementation guidance**. It is striking to note the convergence of opinion as to the fact that more precise guidance or rules will gradually be required if consistency of application is to be ensured, a user consensus which appears to contradict the position of other participants in the public debate over IFRS who remain, on the contrary, firm believers in the principles-based approach.

3. **Governance** of the standard-setting process, and control over related matters of implementation, are also commented on.

- The **governance process of the IASB**, and more generally of the overall structure of international standard setting including the IASC Foundation and IFRIC, is often criticised for the scant attention paid to the viewpoints of users of financial statements.

- The **European dimension** raises a certain number of interrogations. Several observers stress the political responsibility assumed by the European Union in imposing IFRS on its corporate entities, and the resulting political necessity of ensuring a successful outcome for implementation. The interaction with the American authorities, and in particular with the SEC, is generally scored positively if it is mentioned albeit some reservations are also expressed as to the cultural differences which subsist on both sides of the Atlantic.

4. The global **impact** of the adoption of IFRS is the final issue and no doubt the most important one.

- The **overall cost/benefit effect** is judged severely by certain users but more favourably by others. Several interviewees insist on the fact that no definitive assessment will be possible before several years have elapsed and IFRS implementation has left the transitional phase behind and entered a more permanent regime.

- The **volatility** in accounting balances induced by the adoption of IFRS is not judged to have had any serious harmful consequences, but certain observers regret that due weight is not given to the long economic cycles existing in particular in the area of insurance and reinsurance. Further, as the market had been well prepared for this issue the anticipated accounting volatility did not translate into stock market volatility – on the contrary, the period of first-time adoption of IFRS was one of greatly reduced volatility when compared with the peak.

- The impact of IFRS on companies' **management decisions** is generally considered to have been limited. The users interviewed are rarely convinced by the idea that the new standards encourage entities to have a more short-term approach to their management and certain observers even believe that the opposite impact has been the case.

- Finally, many users noted the importance the **economic climate** has had during the adoption phase. The favourable market conditions in force since 2003-4 have facilitated the transition to IFRS and the robustness of this framework – which is much more responsive to market changes than the standards it replaces, cannot be properly assessed until a complete market cycle has taken place.

### Which approach will work for conversion to IFRS?

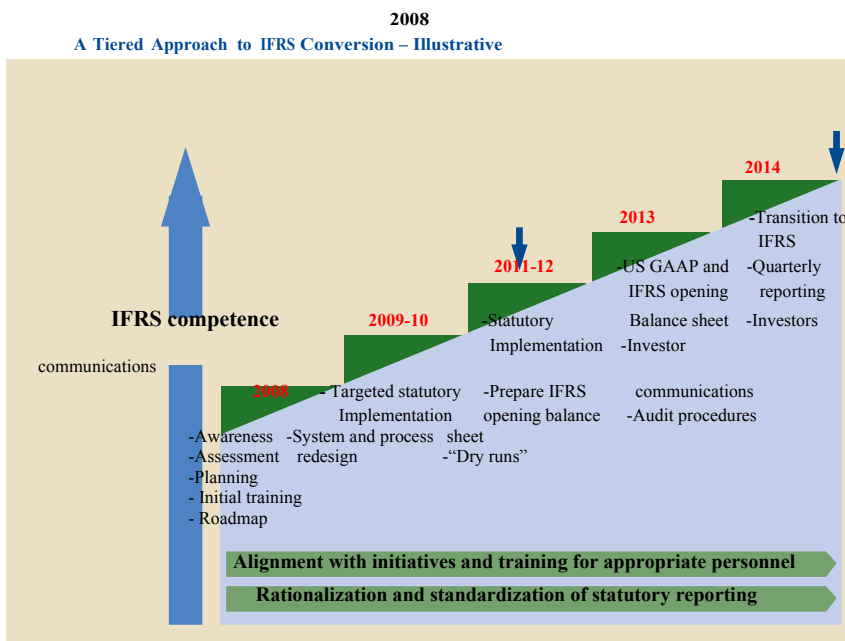
Generally speaking, two approaches to IFRS conversion predominate: all-in and tiered.<sup>3</sup>[3] The former is characterized by a relatively short time frame; simultaneous conversion of all reporting entities, dedicated project teams and devotion of significant resources. The latter is conducted over a more extended period, with phased conversion of

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<sup>3</sup> “The Path to IFRS Conversion: Consideration for the Banking and Capital Markets Industry”, Deloitte, 2008

reporting entities, with at least some personnel retaining their “day job” duties and with a spreading out of project costs. When the European Union converted to IFRS in 2005, it was, for most companies, an all-in effort driven by the tight timelines imposed by the European regulators. Without the luxury of time to convert on a staggered basis, most companies were forced to rush through the process, leading to inevitable inefficiencies and ineffectiveness.

A tiered-approach – staged, rational, and measured – to IFRS conversion will likely provide better results. This advice comes with a seemingly self-contradictory caveat: you’ll have to act fast if you want to go slow. That is, if you want to reap the benefits of phasing in your conversion, you’ll need to start planning soon. Companies that choose a tiered strategy should consider staggering their conversions on a country-by-country or region-by-region basis. As each group moves through the stages (see graphic, “A Tiered Approach to IFRS Conversion”), the processes developed and lessons learned are applied to the next group.



### Conclusion

Transition to International Financial Reporting Standards may result in both positive and negative consequences for companies. Among the positive aspects - increasing transparency, improving comparability and, consequently, increase opportunities for the analysis of their activities and facilitate access to international capital markets. However, by itself does not guarantee accountability inflows. In addition, for example, the value of the net profit according to international standards can be significantly lower than those of the national accounting. In addition, the transition to IFRS will require the company of additional human and financial costs, and estimate the positive economic effects of improvements in the initial stage would be very difficult.

IFRS can be divided into three groups: 1. Working with foreign partners. If the company is actively cooperating with foreign partners, the statements have been prepared in a language they understand, would be a big plus. 2. In need of credit resources. One of the main obstacles to the growth of companies today is the shortage of capital. So now the most attractive western capital markets with a relatively low interest rates and the availability of long-term loans. This category includes primarily capital-intensive businesses that belong to the fastest growing sector (leasing, commercial and industrial companies). 3. Having developed a system of corporate culture. The effect is to provide managers with information that increases the effectiveness of controls, allows to intelligently communicate with the market and shareholders, strengthens the system of corporate governance, and hence the credibility of management. The most beneficial effect of adoption of IFRS will be in companies where the owner has no representatives in the management of the company and had to be satisfied with information received from the financial statements.

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