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The Move to International Financial Reporting Standards

A whistle-stop tour for the business recovery professional ...

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The position at September 2005

As part of the drive to develop a single capital market across Europe, and to ensure as far as possible a common 'language' for financial information, publicly listed companies across Europe now have to report their results in accordance with International Financial Reporting Standards (IFRSs). At the time of writing (September 2005), IFRSs only apply to those companies that are active and direct participants in the capital markets: in other words, those that have shares or bonds that are publicly traded on recognized exchanges. There are approximately 7000 such companies (of whom approximately 2500 are in the UK), and, for these companies, IFRSs have been mandatory for all consolidated financial statements for accounting periods starting on or after 1 January 2005. This has been one of the most important and wide-ranging accounting changes the financial world has seen, but it represents the start, rather than the end, of a process of harmonization that will eventually affect all European businesses.

The international conformity of financial reporting standards had been, until 2000, the responsibility of the International Accounting Standards Committee. This was restructured under the EU's financial harmonization plan as the International Accounting Standards Board. Its brief: to produce a single set of high quality accounting standards for use by participants in the global capital markets.

The IASB has, to date, produced 6 new IFRSs, and adopted all the 41 International Accounting Standards (IASs), which had been written under the auspices of its predecessor. Both sets of rules now have the same legal effect, and the term IFRS is now used to include both the new IFRSs and the 'old' IASs.

The US is not (yet?) part of the group of countries that have begun to adopt IFRSs, although since 2002 the US Financial Reporting Standards Board and the IASBs have undertaken several initiatives to reduce differences between new accounting standards. The SEC, however, has stated that it has no plans to accept financial reports prepared under IFRS without reconciliation to US standards, although in Canada, foreign companies *can* now use IFRS without amendment.

AIM and private companies to follow

The process of harmonization does not stop with listed companies and their consolidated accounts. As it currently stands, companies quoted on the Alternative Investment Market will be compelled to report under IFRSs for financial years commencing on or after 1 January 2007, and they are being encouraged to do so earlier if possible. As share analysts become more familiar with IFRSs, it makes commercial sense for AIM companies to prepare for early adoption.

It is also inevitable that subsidiaries and associates of listed companies will need to supply consolidation information based on IFRSs, and this will inevitably lead to unlisted companies wanting to report under IFRSs. Initially, these companies will have the option to choose whether to use FRSs or IFRSs. But having made a decision, they cannot switch between the two in case they gain advantages from such a policy. I expect to see hundreds of thousands of these unquoted SMEs deciding voluntarily to adopt IFRS in the next 3–4 years.

At the small and medium-sized company level, there are 2 things taking place.

- The IASB is slowly developing rules specifically for this sector. This is still in the discussion stages, however indications are that there will be a single cut-down IFRS for SMEs (rather like the one-stop-shop Financial Reporting Standard for Smaller Entities that the UK now has). But the decision over which countries' SMEs apply IFRSs will lie with each national government. The IASB does not have a policing or enforcement role.

- The UK's Accounting Standards Board is writing and revising its standards to converge more and more with IFRS rules. In December 2004 the ASB issued 6 new accounting standards that are all in line with IFRSs. Five of the standards superceded existing requirements, but FRS 26 introduces, for the first time, requirements for the measurement of financial instruments in the UK, which controversially implements in full the measurement and hedge accounting provisions of IAS39.

There is a substantial legal framework surrounding the move to IFRS, which is enacted by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004.

IFRSs – an overview

Many turnaround and insolvency practitioners not directly involved with accounting within fully listed vehicles are adopting an 'ostrich' mentality; burying their heads in the sand hoping that IFRSs are materially the same as existing standards. In reality however, there are significant and important differences. For one thing, there is much more emphasis on disclosure and transparency. It has been reported that one large UK listed organization currently has 3500 lines of information in its accounts. With IFRS, they have found they are going to need 6000 lines to capture all of the additional information they are going to need to disclose. The other main change is towards fair value accounting. The IASB believes that assets and liabilities should be stated at fair or market value on balance sheets (rather than at cost less depreciation/amortization which we in the UK are used to), and that annual losses or gains should be shown on profit or loss accounts.

The major changes that companies will face under the new accounting rules, in overview (and by no means a comprehensive list) are as follows:

Takeover and mergers

Mergers of equal businesses will no longer occur. Instead, all business amalgamations must be accounted for as acquisitions. Goodwill, being the difference between the amount paid and the fair value of the assets acquired, is no longer amortized over a set period, but is tested for impairment and adjusted or retained as appropriate. (IFRS3)

In an attempt to make it more difficult for companies to carry out off-balance-sheet activities, there are new rules for recognizing subsidiaries, including those created for special purposes, where the substance of the relationship indicates that the vehicle is controlled by the company concerned.

Intangible assets

All assets, both tangible and intangible, must be valued, and remain on the balance sheet. Specifically, IAS38 requires a company to recognize an intangible asset, whether purchased or self-created (at cost) if, but only if:

– it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
– the cost of the asset can be measured reliably.

All assets should be recognized and amortized over their useful lives. The life may be indefinite, in which case there must be at least annual impairment reviews. (IFRS3 and IAS38)

Pensions

IAS19 deals with accounting for all types of employee remuneration, including pension liabilities. The principle now is that a company must recognize employee costs in the period they are earned by the employees, rather than when they become payable. Liabilities (present and future) to occupational pension schemes must be shown at full market value on the balance sheet.

Share-based payments

Under IFRS2, transactions such as the granting of share options must be expensed against profits, at full fair value in the period in which they were granted. They are measured by their value to the employee, not the money to be expended by the company (which, if the company is just issuing its own shares, may be negligible). Previously, these costs were effectively kept out of the profit and loss account.

Financial instruments

These are covered by IAS32 and IAS39, which also deal with the treatment of derivatives and hedges. The overall effect of the standard is to reflect financial assets and liabilities in the balance sheet at fair value or, in other words, marked up or down to market values at the balance sheet date. In certain situations (such as where the asset is held for trading), the resulting profit or loss is reflected in the profit and loss account; in others, the periodic change in value is taken to reserves.

Tax liabilities

IAS12 covers the accounting treatment of income taxes. It requires companies to make full provision for deferred tax, which is the liability resulting from income that has already been earned for accounting purposes but not for tax purposes.

The business effect

To date, very few companies have produced full accounts under IFRSs, and although companies with December 2005 year-ends have recently produced interim financial information under the new standards, it is too early to judge the market's reaction and the likely effects on business. Many smaller listed companies seem to be holding back and waiting for the largest companies to make announcements to the

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markets first. What then do we expect to be the business effects?

On the one hand, there is a school of thought that maintains that nothing will change. The theory goes that accounting standards – be they FRSs or IFRSs – are just reporting rules and a change should not alter at all the cash generating ability (hence the value or standing) of a company.

However, in my view, the position is more complex than this. In general, people won't buy what they don't understand. If bankers, investors, brokers and analysts don't understand IFRSs and how they impact specific entities, then they will shy away and investments will go elsewhere. Much though will depend on each company's particular circumstances, and some standards will affect certain industries more than others. Financial institutions will inevitably be more affected by IAS32 and IAS39 and the requirement to keep revaluing assets and liabilities. Acquisitive companies, with a heavy investment in acquired goodwill in its balance sheet and a large amortization charge through the profit and loss account, may see increased profits as the amortization becomes no longer mandatory under IFRSs. Indeed, after an acquisition drive between 1999 to 2002, Vodafone plc had built up GBP 100 billion of goodwill on its balance sheet. As UK GAAP requires goodwill to be written off against the profit and loss account, it had reported large losses since then. The move to IFRSs should now show Vodaphone reporting healthy profits, largely as a result of the requirement not to have to amortize goodwill.

The move to IFRSs is also likely to have the following effects:

- Whereas FRSs have previously promoted smoothing of results, earnings under IFRSs will become more volatile and there will be more 'spikes' in the new accounts. Both valuation and amortization are subjective processes, and having to carry out regular impairment reviews could be an additional cause of volatility in accounts.
- There will be an increase in discretion and thus a decrease in comparability. Companies could end up reflecting the same numbers on a different basis.
- There will be a lack of historic comparables. Although one previous year's results have to be restated to comply with IFRSs, companies will no longer have a readily-comparable 5- or 10-year financial history. They will have to ensure they properly communicate with the market if they want to be understood and remain visible.
- There has been concern that as issuing share options will depress profits, some companies will scale back their employee share option plans.
- The structure of many company's balance sheets will be altered. Quasi-equity or hybrid securities currently used in the market will have to now be reclassified as debt rather than equity, as before. Certain structures will be brought onto the balance sheet. For example, where a company has sold debts into a special purpose vehicle, that vehicle will generally be brought onto the balance sheet of the company, thereby increasing total assets and total liabilities. In these situations there will be an effect on debt/equity and other ratios, as well as on banking covenants.
- Companies will be attracted towards derivative and hedging products which meet the narrow definitions in the IFRSs and will not have to be reported at fair value. These may not always be the best products for risk management purposes.
- It seems that the inevitable consequence of the new standards, which bring forward the recognition of income, will be to accelerate the payment of tax.

Although the immediate focus in most companies has been to put in place the mechanisms to report under IFRSs, many must now start to look carefully at any contractual and statutory provisions which reply on reported financial performance and key performance indicators. Chief among these for most companies will be banking covenants and the ability to pay dividends. Unfortunately a minority might have to concern themselves with solvency.

Banking covenants

Companies will have agreed financial performance indicators, or covenants, with their lenders. A breach of financial covenant is usually an event of default under the loan, which can have dire financial consequences. These covenants will invariably have been drawn up under FRSs.

As reported profits will be changed under IFRSs, companies may inadvertently now breach financial covenants, even though their underlying trading and cash position is unaltered. Although most lenders will, in time, agree amended covenants with their customers, at the moment this has not yet been widely done, and most will still be looking at the covenants as they would be under existing FRSs. Going forward, it is unrealistic to expect companies to have to restate their results under old FRSs, and lenders will want to see covenants that agree to audited figures. Increased volatility of reported results will mean that corporates may need increased flexibility of covenants under IFRSs to avoid repeated breaches. In the meantime, companies experiencing financial problems may need to properly communicate to lenders what are apparent breaches of covenants when they start to report under IFRSs.

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Dividends and realisable profits

UK law relating to distributable profits is based on the premise that only profits that are shown in the financial statements as 'realized' can be distributed to shareholders as dividends. A large write-off of goodwill following a routine impairment review will reduce distributable reserves. This will affect the ability to pay dividends.

There is much disquiet about this rule, and many finance directors are calling for the link between 'realized' profits and dividends to be done away with. Instead, there would be a focus on maintaining solvency and protecting creditors, whilst still allowing a company to be flexible when it comes to making distributions to its shareholders.

With the move to IFRSs, financial statements are becoming less and less driven by the concept of 'realization'. The fair value concept does imply 'readily convertible to cash' and therefore realizable, however this is not strictly the same as being 'realized' for dividend purposes. The determination of which accounting profits are distributable is becoming increasingly complex and a trap for the unprepared.

Solvency

The move to IFRSs will alter the key measures used by analysts and insolvency specialists to appraise value and solvency.

Many commentators will still simply look at a company's net asset position (i.e. total assets less total liabilities) as shown on its balance sheet and conclude that a company is, or is not, balance sheet solvent. It is perfectly possible though to have net liabilities in the balance sheet when reporting under FRSs, and have net assets when using IFRSs, and of course *vice versa.* For something as critical as a company's solvency, it makes little sense for balance sheet solvency to depend on which accounting rules are used. Although accounting rules must be borne in mind when looking at assets and liabilities, it is necessary for appraising solvency to go deeper and look at the *value* of assets and liabilities.

When looking at balance sheet solvency, IFRSs will help rather than hinder this process. This is because they rely on: (a) increased reporting of fair values, and (b) increased detail and disclosure. Companies transferring major assets or undergoing restructuring should be encouraged to undertake a review of solvency which goes beyond a cursory look at the bottom of the balance sheet, if they are to avoid transactions being overturned in the event of a subsequent formal insolvency.

Summary

We are currently experiencing the very first stages of a dramatically changed financial reporting system. IFRSs are principle-based, rather than fully prescriptive, and coupled with the judgements that finance directors will increasingly have to make over issues such as the impairment of intangible assets, it will take 2 or 3 years to see companies reporting on a reasonably consistent basis across the market.

IFRSs have several vital differences to UK FRSs. The most radical of these is the requirement to reflect the fair or market value for assets and liabilities. This will lead to intangibles and goodwill becoming more prevalent on balance sheets, and instead of mandatory amortization through the profit and loss account, there will be periodic impairment reviews. If market conditions have got worse, and the intangibles carried in the accounts are not worth as much they were at the previous year end, companies will have to make significant write-offs and profits will suffer. If things are going well, however, then profits will be increased as amortization will not be needed and balance sheet values will be enhanced. It might be a roller-coaster ride ahead for many acquisitive companies.

These changes are not just of academic accounting interest – they will have knock on effects into wider corporate life, including the key questions of banking covenants, dividend payouts, and solvency.

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