



IFRS – THE EUROPEAN EXPERIENCE Factors for a Successful Implementation

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Recently, the Accounting Standard Board (AcSB) provided a timeline and transitioning guidance for adoption of International Financial Reporting Standards (IFRS) by as early as 2009, and mandatory use of IFRS starting in 2011. The transition from Canadian generally accepted accounting principles (GAAP) to IFRS is underway.

Because of their success in implementing IFRS and their similarities to Canadian companies, European companies provide Canadian companies with clear examples of how to make this transition.

BACKGROUND

In 2002, the European Commission voted to require publicly traded European companies to prepare consolidated financial statements using IFRS as adopted by the European Union for each financial year starting on or after January 1, 2005. Certain Member States allowed publicly traded companies with only debt securities to defer compliance until 2007. In addition, each European Member State had the option to require or permit non-publicly traded companies to use IFRS-EU instead of national GAAP.

Some European jurisdictions permitted early adoption of IFRS in their markets. Interestingly, 29 percent of respondents to a survey conducted by the Institute of Chartered Accountants in England and Wales (ICAEW) adopted IFRS early. Most notably, starting in 1998, Germany permitted listed parent companies to prepare their consolidated accounts

according to internationally accepted accounting standards. Several major German corporations adopted international accounting standards before the rest of the European Union.

A related ICAEW study concluded that the “IFRS implementation had been challenging, but successful” for European companies. Effective implementers of IFRS often started early, paid close attention to significant accounting issues, and focused on good project and change management.

EVALUATING ACCOUNTING ISSUES

Implementing a single new accounting standard can have a major impact on a business. The transition to IFRS can involve the simultaneous implementation of multiple standards with corresponding effects on policies, processes, technologies and controls. Specific accounting treatments appear to be the most challenging for organizations transitioning to IFRS. For example, according to the ICAEW survey, 43 percent of participants found derivative accounting to be slightly more difficult or much more difficult to understand, with 40 percent responding likewise for financial instruments. Deferred tax, business combinations and foreign currency rounded out the top five most challenging accounting issues. The top five areas in terms of cost produce a similar list, including: derivatives, general costs, employee pensions, revenue recognition and financial instruments.

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The Financial Reporting Review Panel (UK) discussion of consolidated financial statements of publicly traded companies drawn from the FTSE 350 and smaller companies “complained about the tendency for companies to include ‘boilerplate’ descriptions of accounting policies.” The regulators expected companies to describe their accounting policies in greater detail to allow investors to better understand “company-specific application.”

As Canadian companies prepare a set of pro forma IFRS-based financial statements at least one year prior to adoption, it will facilitate better communication to external stakeholders by the Board and management of the impact of changes in accounting policies. It will be important for companies to include sufficient time in their project plans to concurrently report under Canadian GAAP and IFRS to confirm that processes and applications are functioning properly.

IFRS 1: FIRST-TIME ADOPTION OF IFRS

IFRS 1— First-time Adoption of IFRS provides a set of optional exemptions that may be applied to the opening IFRS statement of financial position. These exemptions were provided to mitigate confusion related to first-time adopters’ need to apply transition provisions of existing IFRS and International Accounting Standards. According to the ICAEW study:

- All companies used the exemption for business combinations, avoiding a restatement of pre-transition acquisitions
- No first-time adopters used fair value or revaluations as the deemed cost of intangible assets
- All companies that opted to use the corridor approach, recording income and expense for retirement plan valuation changes only if it exceeds defined boundaries, recognized all gains and losses at transition
- All companies used the exemption for cumulative foreign currency translation differences, zeroing existing balances and moving the offset to equity
- All companies used the exemption for compound financial instruments, eliminating the need to separate liability and equity components of compound instruments when the liability component is no longer outstanding at transition

According to the ICAEW report, “Larger companies especially had prepared early, and had devoted considerable resources to educating and training their boards, staff and investors.” This practice for one company was extended to include the parallel use of GAAP and IFRS accounting systems for a period of six months to assist its Board in understanding the changes.

As noted by these examples, companies should carefully evaluate changes to accounting policies and the use of first-time adoption exemptions, taking the time to understand how these changes will affect their financial statements’ opening balance sheets, financial metrics and ongoing profit and loss reporting.

MANAGING THE TRANSITION

Global companies managing the transition to IFRS will have to gauge the extent to which they use IFRS for management reporting and other internal uses such as planning and forecasting. According to the ICAEW study, 69 percent of organizations use IFRS for internal reporting with 48 percent believing it has been beneficial for those purposes.

An additional consideration is the effect IFRS will have on the company’s internal policies. Adopting IFRS for internal reporting can improve the consistency and comparability of business unit reporting across decentralized operations, improving overall management decision-making. Further, IFRS has actually affected companies’ business practices. Differing approaches to financial instruments; leases; property, plant and equipment; and other contracts such as franchises and debt covenants affect the financial analysis underlying many decisions. Companies may want to review or renegotiate contractual commitments made during or prior to IFRS adoption. It should be noted that the AcSB has successfully pushed for changes to the proposed amendments to IFRS 1, which would mean that Canadian companies are exempt from retrospective application of IFRS for oil and gas assets using the full cost method under its previously applied GAAP, and it may elect to measure exploration and evaluation assets at the amount determined under the entity’s previous GAAP, and to measure oil and gas assets in the development or production phases by allocating the amount determined under the entity’s previous GAAP for those assets to the underlying assets pro rata using reserving volumes or reserve values as of that date. As for operations subject to rate regulation in Canada, an entity could elect to use the carrying amount of the items of property, plant and equipment held, or previously held, for use in such

operations as their deemed cost at the date of transition to IFRS if both retrospective restatement and using fair value as deemed cost are impracticable. These both only relate to the initial conversion balance sheets and not subsequent balance sheets where fair value and impairment testing would have to take place. IFRS 1 proposed amendments are still at a project level with final comments currently anticipated in mid-2009.

Secondly, the AcSB confirmed again with the IASB under the proposed amendments to IFRS 1 that Canadian companies could exempt themselves from applying IFRIC 4 for the evaluation of existing leasing contracts, again under IFRS on conversion only if the first-time adopter made the same determination under the previously applied GAAP. This with the exception of grandfathering provisions/relief for contracts issued or acquired prior to a certain date as required by IFRIC 4 under the equivalent Canadian standard, Emerging Issues Committee Abstract Number 150, where any previously grandfathered contracts may not be eligible for this proposed IFRS 1 exemption.

Similarly, companies will need to consider how a change in internal policies might affect compensation plans and other operating metrics to ensure appropriate business decisions continue to be made, regardless of the method of accounting. Transitioning accounting policies and altering internal reporting, compensation plans and operating metrics will directly affect non-financial staff. According to research by the CFO

Executive Board, two of the top five most difficult challenges include training and educating non-controller staff and communicating the significance of transition to key external stakeholders.

In addition, according to the ICAEW survey, a subset of companies identified procedures that, if implemented effectively, might have significantly lowered their IFRS implementation costs. These include:

- Improved staff training
- Started sooner
- Made a better initial assessment of the impact
- Managed the project better
- Communicated better with subsidiaries

A transition to IFRS is more than an accounting exercise; it requires a significant amount of training and communication as well. For example, one CFO Executive Board-member company developed customized training and communication approaches for specific stakeholders, including finance staff, non-finance staff, senior management and external audiences.

It is clear that managing the people side of this effort is critical to a cost-effective implementation. As expected with an undertaking of this magnitude, allowing plenty of time and focusing on planning and project management are keys to success. In addition, companies looking to implement IFRS need to manage the change processes through targeted training and communication.

IFRS TRANSITION COSTS BY ORGANIZATION SIZE AND COST TYPE (OOOs EUR)

Cost Type	<500 mm EUR	500 mm to 5,000 mm EUR	> 5,000 mm EUR
IFRS project team	64	261	768
Software and systems changes	56	43	566
External auditing costs	85	109	541
External technical advice	129	125	376
Staff training	35	58	299
Other staff	33	75	271
Communications with third parties	36	30	296
Tax advice	55	57	157
Additional external data costs	32	75	95
Renegotiating debt covenants	29	34	61

COSTS AND BENEFITS

European companies had three years to switch their financial reporting systems from their GAAP to IFRS. Canadian companies will need to begin to transition at least two to three years before the mandatory filing date. In addition, companies should complete an impact assessment before beginning the transition period to scope and time the effort appropriately. The assessment will also identify current improvements that will streamline the implementation of IFRS.

According to research performed by the Corporate Executive Board, European companies with revenue in excess of \$5 billion spent on average \$3.3 million dollars to implement IFRS. More than half of the companies took one to two years to make the transition with 40 percent exceeding two years. The ICAEW estimates that European companies with revenue between 500 million euros and 5 billion euros spent .05 percent of their revenue switching from their local GAAP to IFRS in year one. The table on Page 4 from the ICAEW report summarizes the costs by organization size and cost type.

The ICAEW survey also profiled companies most likely to benefit from a conversion to IFRS, noting that, “larger companies that rely more on equity financing and have more foreign exposure perceive the benefits of IFRS as greater than other companies.”

Companies with operations outside North America found they were often able to leverage existing IFRS experience, since many organizations had worked with these standards within their subsidiaries. In addition, they were better able to streamline operations across locations. Larger companies generally had lower implementation costs as a percentage of revenue since they have a larger base over which to spread the fixed project costs. This makes an IFRS implementation similar to the C SOX (Bill 198) experience, where larger companies had a lower cost to implement as a percentage of revenue compared to smaller reporting companies. Finally, the transition to IFRS also provided companies the opportunity to improve communication with investor groups, which made raising capital easier.

There appears to be consensus regarding the effort and cost to implement IFRS. The obvious question is whether changes to financial results and efficiencies gained outweigh those costs. The key is to make an initial assessment early in the process and begin planning for the ultimate mandatory transition. Staying ahead of this major initiative provides companies with the opportunity to reap the

transition benefits while mitigating downsides.

ESTABLISHING AN IFRS TIMELINE

Based on European companies’ experiences, the transition to IFRS should take approximately two-and-one-half to three years. Working backward, companies will run parallel accounting systems for the last six to 12 months to ensure processes and controls are operating effectively, and communicate internally how IFRS affects key financial statements and metrics such as the non-GAAP KPI of the debt-to-equity ratio. Prior to that, companies will spend 12 to 18 months implementing system, process and control changes related to the adoption of IFRS. In the six to 12 months prior to the actual implementation, the company will have to assess the impact of the transition, align resources and design the changes.

IFRS requires companies to present comparable balance sheets for two years. *IFRS 1 First-Time Adoption of IFRS* also requires companies to prepare an opening statement of financial position at the beginning of the first period presented – the date of transition.

ARE YOU READY FOR IFRS?

The transition to IFRS is a broad and pervasive effort requiring a diverse skill set to implement. The seven pivotal considerations below will help companies assess their readiness to implement IFRS:

- 1. Tone at the top set by senior management.**
Is senior management committed to taking advantage of the benefits of a truly global finance function, or is the implementation of IFRS viewed as just another compliance activity that will divert resources and attention away from the business? Helping top executives understand the operational and decision-making value of implementing IFRS will ensure that appropriate resources are available for the transition effort.
- 2. Well-documented policies and procedures.**
Are policies and procedures documented, current and able to withstand third-party scrutiny? Just as with C SOX, if companies have sound policies and procedures in place, the amount of streamlining and consolidation work to implement IFRS will be significantly reduced. Good policies and procedures are the foundation for assessing the impact of IFRS on the organization and gaining efficiencies from the globalization of the finance function.

3. **Existence of skilled IFRS resources.**

Are your employees experienced in working with IFRS? Many multinational companies will have these skill sets in their non-Canadian entities. Putting programs in place to leverage that experience – for example, rotating those employees to roles inside Canada for a period of time could benefit both the individual and the company while reducing the overall implementation cost by reducing dependence on outside resources. This experience will be important in completing an initial IFRS impact assessment.

4. **Existence of IFRS knowledge in key line and operational positions outside of finance.**

One risk is that companies focus on training finance personnel on IFRS while business managers are untrained and unable to understand their internal reporting results. Companies should identify how widely financial information is distributed and articulate a strategy for preparing key stakeholders to use the financial information.

5. **Existence of other key skilled resources.**

Do you have personnel with the right skills? An IFRS implementation will require a broad range of skills – technical accounting, financial analysis, project management, process management, information technology, tax, internal controls, etc. It is wise to pull teams together during the assessment phase to cover the breadth of issues faced. This includes regulatory and risk reporting requirements.

6. **Organizational capacity for making accounting judgments.**

Principles-based IFRS allows for more accounting judgment by preparers of financial statements. Under C SOX, issuers are limited in the advice they can receive from their audit firms. Companies must either hire staff or partner with a professional services firm that can bring the depth of experience to make and support critical accounting decisions and execute the overall initiative. Locking in those relationships early may prevent resource shortages, audit issues, material weaknesses and long, costly disagreements with external auditors. In addition, senior management and the Audit Committee should be prepared to establish an appropriate ethical tone across the company.

7. **Centralization of operations and complexity of organization.**

Companies with centralized finance and control

functions that have begun implementing common accounting systems and processes will be substantially ahead of the curve. They will be able to implement IFRS more quickly and leverage standard systems and processes to drive consistency into their organizations. Centralized finance and control functions also enable companies to select and implement specific IFRS approaches more rapidly.

A sense of urgency around IFRS is even more critical for complex, decentralized companies that need to assess the implementation effort and establish an underpinning for a common accounting platform, including a standard chart of accounts. Those steps often provide immediate benefits in terms of streamlined processes and simplified controls, positioning the companies to move to IFRS when mandated.

Decentralized companies may have hidden advantages – since it's likely IFRS skills are available in their foreign subsidiaries. Leveraging those skills, experiences, and existing policies and procedures can bring global companies quickly up to speed on IFRS.

To prepare for IFRS implementation, companies need a comprehensive plan that addresses critical technical accounting, training, communication and project management issues. The implementation plan should be based on a multi-faceted assessment covering technical accounting issues, financial processes, business performance reporting, internal controls and policy and procedure issues.

CONCLUSION

The experience of European companies provides a clear set of factors for a successful IFRS implementation: 1) start early, 2) implement using a solid project plan, 3) communicate effectively to internal and external stakeholders, and 4) don't forget training for internal stakeholders.

Any evaluation of the impact of transitioning to IFRS should encompass the effect of IFRS on both the financial statements and companies' overall operations. A major benefit of this transition is the opportunity to establish a global finance function with streamlined operations, policies, processes, and controls; consolidated technology; optimized resources; and improved decision support capabilities.

ABOUT JEFFERSON WELLS

Jefferson Wells provides comprehensive solutions

and services in financial reporting and technical accounting, including research, documentation, ongoing reporting compliance and knowledge transfer. Because we do not attest to financial statements, we can support issuers in making the transition to IFRS without independence or other conflict-of-interest issues.

Clients benefit from the full breadth of our skills required to assess and implement IFRS – including:

- technical accounting
- project management
- policy and procedure review and development
- tax strategy and implementation
- risk management
- internal control assessment and implementation
- continuous controls monitoring
- business performance management
- shared service center optimization and
- financial process improvement

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