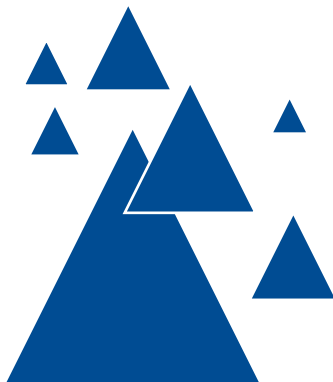




The Implementation of IFRS in the UK, Italy and Ireland

Executive Summary



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EXECUTIVE SUMMARY

Introduction

In 2005 many companies in the EU were required to issue their financial statements based on International Financial Reporting Standards (IFRS) for the first time. A number of concerns had been raised about IFRS, some real and some serious. An independent assessment was, therefore, necessary to examine the implementation of IFRS and to assist future adopters of IFRS.

This study examines the implementation of IFRS in three countries: the UK, Italy and Ireland. The study focuses on these three countries because it was expected that companies in countries with a similar national accounting environment, such as the UK and Ireland, would experience similar reporting changes following the adoption of IFRS, and that companies in countries with a very different reporting environment, legal system and culture, such as Italy, would be affected differently by the adoption of IFRS. For example, the UK and Ireland are common law countries with accounting standards that focus primarily on the needs of shareholders, while Italy has a legal system based on civil law where traditionally creditors are viewed as being the most important users of financial statements. Thus, it was expected that the implementation of IFRS, with its shareholder focus, would require more of a cultural change in Italy than in the UK or Ireland.

The following research objectives are addressed in this study:

- To quantify the nature and extent of the changes in financial reporting that have been experienced as a result of IFRS adoption. In particular, the study examines the increase in disclosure relating to these new accounting standards as well as the changes to net profit and equity

when comparing national Generally Accepted Accounting Practice (GAAP) to IFRS GAAP.

- To assess the costs associated with the production and publication of the new information.
- To identify the standards which have caused the greatest challenges for preparers and users to implement, reflecting education and training needs, changes to valuation models and the need for a general understanding of the accounting requirements and concepts.
- To examine the usefulness of IFRS information from the perspective of preparers and users of financial statements, both from the usefulness of the contents being mandated as well as the formats in which the additional information must be disclosed.
- To review whether the information required under IFRS is decision-useful for stakeholders.

The above research objectives are considered within the framework of decision-usefulness to assess whether IFRS is more useful to users than national GAAP for making investment decisions, after consideration of the costs involved for both preparers and users.

Three different methods of analysis were used to examine the introduction of IFRS when addressing the above research aims:

- a content analysis of financial statements;
- an analysis of the reconciliation statement between IFRS and national GAAP; and
- interviews with multiple-stakeholders on the adoption of IFRS, including interviews with preparers, auditors, analysts and regulators.

Each of these three methods provides an international comparison on the adoption of IFRS between the UK, Italy and Ireland. While the results of each part of the project are reported separately, there emerges a comprehensive evaluation of whether the adoption of IFRS has been useful in each of the three countries. This approach contrasts with much of the extant literature which deals with specific issues or standards.

A content analysis of financial statements

The contents of 175 companies' financial statements were analysed: 138 UK companies; 27 Italian companies; and 10 Irish companies - reflecting the number of companies listed on each market. The findings from the content analysis comparison of company annual reports pre-IFRS and post-IFRS suggests that companies in Italy were more affected by the adoption of IFRS; the size of Italian annual reports grew far more significantly than those published in the UK or Ireland, although even in the latter two countries the annual reports increased substantially in length post-IFRS.

In Italy, on average, 73 pages of the post IFRS annual reports related to new information required by IFRS; this compared with just 13 pages in the UK documents and 19 pages in Ireland. This differential impact reflected the fact that the IFRS standards were a greater departure from Italian GAAP. Thus, many more pages of explanation were typically included regarding the transition to the new reporting regime. For example, 67 of the 73 pages of Italian annual report disclosure related to the implementation and impact of individual standards; this compared with 12 pages in the UK and 17 pages in Ireland where less explanation was typically required regarding the impact of individual accounting treatments.

IAS 32 Financial Instruments: Presentation, IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures accounted for a large proportion of the extra disclosure. Overall, roughly one third of the extra disclosure related to financial instruments. In the UK and Ireland an extra four and six pages respectively were devoted to disclosures related to these three standards. In Italy the effect was even

more pronounced with disclosure relating to the derivatives standards running to 32 pages. In the UK and Ireland the next most frequently discussed topic related to *IAS 19 Employee Benefits*, with about one page devoted to pension disclosure. In Italy this standard ranked third but the associated disclosure was still larger than that typically provided in the other two countries, covering three pages. The second biggest disclosure topic in Italy related to *IAS 14 Segment Reporting*. The area of segmental reporting was not covered by a specific accounting standard in Italy prior to the introduction of IFRS; thus, on average six additional pages of a typical Italian company's annual reports were used to comply with IAS 14 requirements.

For the UK and Ireland, most of the extra disclosure was narrative rather than numerical in form; in the UK and Ireland respectively, 80% and 85% of the disclosures were narrative. This contrasts sharply with the situation in Italy, where most of the extra disclosure was numerical in nature; 55% of the annual reports were devoted to numerical summaries in Italy, much of this concentrating on the provision of information relating to derivatives and other financial instruments.

A breakdown by market listing and industry sector was analysed for the UK companies. This disaggregation revealed that FTSE 100 companies accounted for most of the disclosure, typically providing 16 pages of information; compared to other FTSE companies that typically presented half this level of disclosure. The sectoral analysis indicated that oil and gas as well as utility companies supplied more IFRS-related disclosure than other industrial groupings in the UK. A similar exercise could not be undertaken for the Italian and Irish Companies due to the composition and size of the samples.

Impact of IFRS on profit and equity

IFRS 1 First-time Adoption of International Financial Reporting Standards requires companies to produce a reconciliation of their IFRS equity and profit/loss to their equity and profit/loss reported under national GAAP. The sample was based on the financial statements used in the content analysis, although some companies were excluded because

it was not possible to analyse their reconciliation statements. Using these reconciliation statements an index of conservatism was calculated to assess the differences in profits and equity reported under IFRS as compared to that under national GAAP: what would national GAAP figures have been as a percentage of IFRS GAAP? The impact of IFRS on the reported profit and net equity of the sample companies is summarised in Tables 1 and 2 where the national GAAP profit or net equity figure is shown as a percentage of the IFRS net profit or net equity figure. As can be seen from Table 1, the implementation of IFRS increased the reported profit of companies in the UK, Italy and Ireland such that national GAAP profit was only 66%, 85% and 89% of the IFRS profit respectively.

Table 1 Net profit under national GAAP as a percentage of IFRS net profit - selected standards

	UK	Italy	Ireland
	%	%	%
Net profit	66	85	89
<i>IFRS 2</i>	100	101	101
<i>IFRS 3</i>	79	82	90
<i>IAS 10</i>	95	100	100
<i>IAS 12</i>	102	101	98
<i>IAS 38</i>	97	98	100
<i>IAS 39</i>	101	104	100
<i>IAS 40</i>	96	100	100

Notes:

The table is based on Table 4.4 in chapter four. Only those standards which have a sizeable impact on profit are included in the above summary table.

A percentage above 100% indicates that profit under national GAAP is higher than the profit under IFRS, ie profit has decreased due to the introduction of IFRS.

A percentage below 100% indicates that profit under national GAAP is lower than the profit under IFRS, ie profit has increased due to the introduction of IFRS.

It is also apparent from Table 1 that the standard that has the greatest positive impact on IFRS profit is *IFRS 3 Business Combinations* with the magnitude of this item as a percentage of the profit figure in national GAAP income statement being: 79% of its counterpart in the IFRS income statement for UK companies; 82% of its counterpart in the IFRS income statement for Italian companies; and 90% of its counterpart in the IFRS income statement for Irish companies. *IAS 10 Events after the Balance Sheet Date* (UK only), *IAS 38 Intangible Assets* (except Ireland) and *IAS 40 Investment Property* (UK only) also increased IFRS profit. Three standards had a negative impact on IFRS profit; *IAS 12 Income Taxes* (except Ireland), *IFRS 2 Share-based Payment* (except UK) and *IAS 39 Financial Instruments*, such that profit under national GAAP was higher, because of the impact of these standards. However, the effect on profit varied greatly across the sample companies; for example, the impact of IAS 40 on national GAAP profit ranged from an increase of over 2,500% (a company in the UK) to a less than 1% decrease (a company in Italy).

By contrast, the net equity of the average company was less under IFRS, such that national GAAP net equity was higher by as much as 153% in the UK and 106% in Ireland but was slightly lower in Italy where national GAAP net equity was only 97% of IFRS equity (Table 2).

Table 2 *Net equity under national GAAP as a percentage of IFRS net equity - selected standards*

	UK	Italy	Ireland
	%	%	%
Net equity	153	97	106
<i>IFRS 2</i>	99	100	100
<i>IFRS 3</i>	96	97	98
<i>IAS 10</i>	87	100	96
<i>IAS 12</i>	104	99	107
<i>IAS 16</i>	99	99	100
<i>IAS 19</i>	167	102	104
<i>IAS 32</i>	100	101	100
<i>IAS 38</i>	99	99	100

Notes:

The table is based on Table 4.6 in chapter four. Only those standards which have a sizeable impact on equity are included in the above summary table.

A percentage above 100% indicates that equity under national GAAP is higher than equity under IFRS ie. equity has decreased due to the introduction of IFRS.

A percentage below 100% indicates that equity under national GAAP is lower than equity under IFRS, ie equity has increased due to the introduction of IFRS.

This reduction in IFRS net equity in the UK was mainly attributable to the effects of *IAS 19 Employee Benefits* where the national GAAP equity was 167% of the IFRS net equity, thus net equity under IFRS has reduced substantially as a result of the implementation of IAS 19. This standard also reduced net equity in Ireland. *IAS 12 Income Taxes* (except Italy) and *IAS 32 Financial Instruments: Presentation* (in Italy) also reduced the IFRS net equity. *IFRS 2 Share-based Payment*, *IFRS 3 Business Combinations*, *IAS 10 Events after the Balance Sheet Date*, *IAS 16 Property, Plant and Equipment*, and *IAS 38 Intangible Assets* impacted net equity favourably under IFRS; all five standards on average increased the IFRS reported

net equity. However, the range of the impact of some of these standards was enormous; for example, the implementation of *IFRS 3* resulted in a decrease of almost 1,500% in net equity for one company in the UK while another company, in Italy, experienced an increase in net equity of 30% as a result of this standard.

Eleven accounting standards had no impact on the income statement or the balance sheet. These were:

- IAS 7 *Cash Flow Statements;*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors;*
- IAS 11 *Construction Contracts;*
- IAS 14 *Segment Reporting;*
- IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance;*
- IAS 24 *Related Party Disclosures;*
- IAS 26 *Accounting and Reporting by Retirement Benefit Plans;*
- IAS 29 *Financial Reporting in Hyperinflationary Economies;*
- IAS 30 *Disclosure in the Financial Statements of Banks and Similar Financial Institutions;*
- IAS 33 *Earnings Per Share;* and
- IAS 34 *Interim Financial Reporting.*

These standards are all predominantly orientated to disclosure or focused on statements other than the balance sheet or income statement. Thus, most companies planning for the implementation of IFRS for the first time, could plan to focus their initial efforts on the other standards; it is unlikely that most companies will need to urgently embed any changes into their accounting systems regarding these standards as they do not affect the numbers reported to any significant extent. However, systems will be needed to collect any necessary information for disclosure purposes once the other standards have been dealt with.

Implementation costs and problems

From the 32 interviews that were conducted with various stakeholders, the biggest problem in all three countries when implementing IFRS related to the time commitment in getting up to speed on reading and understanding all the standards and assessing which ones would require the most work. A lot of time and money was spent on training staff and assimilating the new accounting requirements. This was particularly the case in Italy where a cultural change was required in order to shift from a creditor to a shareholder focus. Companies with multinational operations often held internal conferences where staff could get together for training sessions and receive feedback on implementation problems. Some standards were considered to be very technical in nature and required the assimilation of new and specific skills. This was especially the case for *IAS 39*, *IAS 19* and the impairment testing requirements of *IAS 36*. Often external consultants were engaged to provide the requisite skills that were not always available internally within companies. The interviewees identified that rules-based technical standards proved difficult to implement and monitor in practice. *IAS 39 Financial Instruments* is a key example as it adopts a more rules-based approach and as a consequence has resulted in many operational problems. However, the evidence from the interviews and reconciliation statement analysis shows that the implementation is more problematic than the impact on net profit or net equity.

In some companies, major changes were required to information systems, and different processes and operating modes were introduced to collect, process and disclose the extra information required under the new standards. This impact was particularly pronounced in banks and financial institutions. Overall, information systems had to be changed and planning was required in advance to adapt systems to cope with the new standards.

The language barrier created particular problems in Italy as all of the standards had to be translated from English into Italian and these translations were not always made available on a timely basis by the IASB. The availability of standards in all languages on a timely basis is essential

requirement and an increase in the funding of the IASB may be necessary to produce these translations and to make them freely available on the IASB website. Indeed, the interpretation of standards across the many diverse cultures and languages that can exist within multinational organisations was a problem; internal conferences were often used by group companies to ensure that all their national offices possessed the same understanding of the key issues. There were also cultural differences evident in the accounting treatment choices that companies made in different countries. For example, in Italy, companies were more likely to choose the corridor approach available under *IAS 19* than their UK or Irish counterparts, partly because the latter countries were already familiar with a similar standard with no corridor approach *FRS 17 Retirement Benefits*.

Most companies relied heavily on their auditors to advise them on their IFRS implementation, especially in Italy, and in some industries the relevant trade bodies organised joint sessions for its members to debate the interpretation of certain standards. There was also a 'second mover' advantage in that companies with later year ends could review the financial statements of their peers or of best practice leaders to decide how to treat and disclose items that were a particular problem. Similarly, companies that have yet to implement IFRS can review the IFRS financial statements of companies that have already adopted IFRS and then decide how to deal with the requirements of certain standards.

The standards that caused the biggest problems in implementation were: *IAS 39*, *IAS 19*, *IAS 36*, *IAS 38*, *IAS 12*, *IAS 14/IFRS 8*, *IFRS 2* and *IFRS 3*. Most of this was because the accounting requirements were new and different and often required fair values, external data or key assumptions to be made to implement these standards. The planning process was also often hindered by the fact that the Big 4 audit firms did not always agree on the treatment of certain items. Some of the interviewees were annoyed that their auditor had taken a stricter view on the interpretation of some of the standards than the other Big 4 firms and that they had to spend a lot of time and money in numerous discussions with their auditors to get agreement on the treatment of these items. Further, some companies,

especially the banks, thought that they were ahead of the Big 4 in their knowledge of certain standards, in particular *IAS 39*.

Interviewees thought that companies that do not need to produce IFRS statements are at a competitive advantage in some countries, such as Italy, because of the wider disclosure required by IFRS. With the increasing prevalence of private equity buyouts, many companies may be able to avoid more onerous reporting requirements.

Usefulness to users

The intention of the IASB has been to produce financial statements that are useful for decision-making. Rather than taking a narrower shareholder focus this study sought to examine their usefulness to a wider group of stakeholders. The study found that the impact on users in Italy was far greater than in the UK and Ireland. In Italy, analysts were more enthusiastic about the impact of IFRS and suggested that a common set of standards would facilitate comparability between companies and countries. In Italy, the users were very positive that IFRS now required financial statements to be aimed at investors and not creditors. For example, Italian GAAP does not require an earnings per share figure to be shown in the financial statements and the provision of this extra information via *IAS 33* was greeted favourably by the users. In Italy, the increase in disclosure was seen to be a positive feature of IFRS and there was better, clearer, classification of information under the new standards that enabled value-creation to be more clearly assessed. Further, fair values were considered to be more useful as forward-looking information that allowed the 'hidden value to emerge'. The reduced choice of accounting options from Italian GAAP also helped users compare financial statements and the increase in disclosure allowed the results of operations to be better evaluated because of *IAS 14*. The cultural shift in Italy was also helpful as, previously, Italian companies had often merely complied with the law and made disclosures in a limited way, but now the law had changed and they had to disclose far more information under IFRS.

UK and Irish interviewees were more cynical about the transition to IFRS and did not consider that the implementation of the new regime would alter or improve their analysis of companies' financial reports. They thought that IFRS-compliant annual reports were too complex and that users had to be financially literate to understand them. More specifically, the financial statements produced under IFRS had not changed any of their investment decisions and they did not consider them to be any more decision-useful than UK/Irish GAAP financial statements. UK and Irish users also complained that too much choice was allowed under IFRS compared to that which had previously existed under their national GAAP. Analysts thought that the mixed model of fair value and historical cost was very confusing and that the cash flow statement was the only meaningful report as it was the only one that had not been, as one interviewee noted: 'corrupted'. Preparers were unclear about whether the cost of implementation that had been incurred had outweighed the benefits as the costs were tangible and immediate but the benefits gained were intangible and longer-term.

Policy implications and recommendations

From the findings of this study, either in the content analysis, analysis of the reconciliation statement or the interviews, a number of policy implications are suggested as follows:

- From the findings of the interviews and content analysis, annual reports have increased in size and now typically include more complex information. It is suggested that shorter, simpler annual reports that highlight management performance and that can be used as a basis for assessing the future prospects of companies may be helpful and could perhaps be considered by regulators and the IASB.
- The interviews indicated that enhanced comparability of financial reports would be beneficial. The choices of accounting treatments, for example in *IAS 19 Employee Benefits*, needs to be limited so that the performance of global companies operating on an international

basis can be assessed by all stakeholders. The IASB should therefore continue to work towards this objective by limiting choices within standards.

- From the analysis of the reconciliation statement data, the large reduction in net equity for UK companies may have implications for companies wishing to raise additional finance if the strength of their balance sheets has been eroded, with higher gearing levels and greater perceptions of risk. This may prove especially so with the recent credit crunch. Maybe companies should communicate openly with external parties and ensure that stakeholders understand that the financial strength of their operations has not been affected by the change in financial reporting standards per se, although the changes may bring to light an issue or a situation that has not previously been disclosed or recognised.
- The interviewees identified that, all users, not just expert users, need to begin to understand IFRS to ensure that they do not apply misleading valuations to company securities. Additional training should be undertaken by institutional investors and analysts.
- From the content analysis and interviews the effect of IFRS was far greater for Italian companies and Italian users than for those based in the UK and Ireland. Language and cultural issues were factors in this difference. Perhaps the IASB and EU should ensure that translations are made available in a timely manner across all jurisdictions and made freely available on the IASB website. Additional funding of the IASB may therefore be required to facilitate this.
- From the interviews, users need to engage more with the financial reporting process in order to understand and thus enhance the usability of financial reports and to ensure that published reports are useful for decision-making purposes. Perhaps more extensive communication and encouragement to engage in the IASB's consultation process would help in this regard.

- The interviewees also suggested that generic guidance should be produced to assist companies that are in the process of adopting IFRS about which standards to start with when planning the implementation of IFRS.
- From the interviews, it is suggested that audit firms and the professional bodies, such as ICAS, should be encouraged to produce joint documents advising on the interpretation and implementation of standards. Inconsistent advice between audit firms and belated advice have been confusing for preparers and users.

Summary

Overall, the implementation of IFRS has not been an easy process. Although the financial impact has often been negligible, the changes within organisations to their systems and processes should not be underestimated. Hopefully these policy recommendations will be considered and progressed and that this will assist companies adopting IFRS in the future, so that they will find the process much easier.



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