

# 1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

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The year 2005 marked the beginning of a new era in global conduct of business, and the fulfillment of a thirty-year effort to create the financial reporting rules for a worldwide capital market. For during that year's financial reporting cycle, as many as 7,000 listed companies in the 27 European Union member states, plus many others in countries such as Australia, New Zealand, Russia, and South Africa were expected (in the EU, required) to produce annual financial statements in compliance with a single set of international rules—International Financial Reporting Standards (IFRS). Many other business entities, while not publicly held and not currently required to comply with IFRS, also planned to do so, either immediately or over time, in order to conform to what is clearly becoming the new worldwide standard. Since there are about 15,000 SEC-registered companies in the USA that prepare financial statements in accordance with US GAAP (plus countless nonpublicly held companies also reporting under GAAP), the vast majority of the world's large businesses are now reporting under one or the other of these two comprehensive systems of accounting and financial reporting rules.

There were once scores of unique sets of financial reporting standards among the more developed nations ("national GAAP"). However, most other national GAAP standards have been reduced in importance or are being phased out as nations all over the world have embraced IFRS. For example, Canada announced that Canadian GAAP (which was modeled on

and very similar to US GAAP) is to be eliminated and replaced by IFRS in 2011. China required that listed companies employ IFRS beginning with their 2007 financial reporting. Many others planned to follow this same path.

2007 and 2008 proved to be watershed years for the growing acceptability of IFRS. In 2007, one of the most important developments was that the SEC dropped the reconciliation (to US GAAP) requirement that had formerly applied to foreign private registrants; thereafter, those reporting in a manner fully compliant with IFRS (i.e., without any exceptions to the complete set of standards imposed by IASB) do not have to reconcile net income and shareholders' equity to that which would have been presented under US GAAP. In effect, the US SEC was acknowledging that IFRS was fully acceptable as a basis for accurate, transparent, meaningful financial reporting.

This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listing their equity or debt securities in the US led, quite naturally, to a call by domestic companies to permit them to also freely choose between financial reporting under US GAAP and IFRS. By late 2008 the SEC had begun the process of acquiescence, first for the largest companies in those industries having (worldwide) the preponderance of IFRS adopters, and later for all publicly held companies. A new SEC chair took office in 2009, expressing a concern that the move to IFRS, if it were to occur, should perhaps move more slowly than had previously been indicated. In the authors' view, however, any revisiting of the earlier decision to move decisively toward mandatory use of IFRS for public company financial reporting in the US will create only a minor delay, if any. Simply put, the worldwide trend to uniform financial reporting standards (for which role the only candidate is IFRS) is inexorable and will benefit all those seeking to raise capital and all those seeking to invest.

It had been highly probable that nonpublicly held US entities would have remained bound to only US GAAP for the foreseeable future, both from habit and because no other set of standards would be viewed as being acceptable. However, the body that oversees the private-sector auditing profession's standards in the US amended its rules in 2008 to fully recognize IASB as an accounting standard-setting body (giving it equal status with the FASB), meaning that auditors and other service providers in the US may now opine (or provide other levels of assurance, as specified under pertinent guidelines) on IFRS-based financial statements. This change, coupled with the promulgation by IASB of a long-sought standard providing simplified financial reporting rules for privately held entities (described later in this chapter), has probably increased the likelihood that a broad-based move to IFRS will occur in the US within the next several years.

The impetus for the convergence of historically disparate financial reporting standards has been, in the main, to facilitate the free flow of capital so that, for example, investors in the United States will become more willing to finance business in, say, China or the Czech Republic. Having access to financial statements that are written in the same "language" would eliminate what has historically been a major impediment to engendering investor confidence, which is sometimes referred to as "accounting risk," which adds to the already existing risks of making such cross-border investments. Additionally, the permission to list a company's equity or debt securities on an exchange has generally been conditioned on making filings with national regulatory authorities, which have historically insisted either on conformity with local GAAP or on a formal reconciliation to local GAAP. Since either of these procedures was tedious and time-consuming, and the human resources and technical knowledge to do so were not always widely available, many otherwise anxious would-be registrants forwent the opportunity to broaden their investor bases and potentially lower their costs of capital.

The authors believe that these difficulties are soon coming to an end, however. The historic 2002 Norwalk Agreement—between the US standard setter, FASB, and the IASB—called for “convergence” of the respective sets of standards, and indeed a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment, with more changes expected in the immediate future. These changes are identified in the following table:

<u>Financial Reporting Topic</u>	<u>US GAAP Converged to IFRS</u>	<u>IFRS Converged to US GAAP</u>
Share-based payments	FAS 123 adopted aspects of IFRS 2	
Business combinations	FAS 141(R) adopted elements of IFRS 3	Revised IFRS 3 adopted aspects of FAS 141(R)
Inventory costs	FAS 151 adopted elements of IAS 2	
Exchanges of nonmonetary assets	FAS 153 adopted approach used by IAS 16	
Accounting changes and corrections of errors	FAS 154 adopted requirements under IAS 8	
Fair value option for reporting financial instruments	FAS 159 adopted option under IAS 39	
Reporting noncontrolling interests in consolidated financial statements	FAS 160 converges with IAS 27	IAS 27 conforms with FAS 160
Subsequent events reporting	FAS 165 brings guidance formerly in the auditing literature into US GAAP requirements	IAS 1 requirements had always included guidance on reporting of subsequent events
Transfers of financial instruments	FAS 166 converges with IFRS guidance	
Special purpose/variable interest entities	FAS 167 converges with IFRS guidance	
Noncurrent assets held for sale and reporting of discontinued operations		IFRS 5 largely conforms with FAS 146 under US GAAP
Reporting segments of the business		IFRS 8 conforms to FAS 131
Income taxes		Proposal currently outstanding largely converges on FAS 109 and other US GAAP literature
Construction period interest		Revised IAS 23 adopts mandatory capitalization per US GAAP
Leases	Joint project will result in convergence	Currently outstanding Exposure Draft will result in convergence

Several other convergence projects are still under joint development by IASB and FASB. The completion date for all these projects has now been set at no later than June 2011. It thus is anticipated that by that date all or virtually all distinctions between US GAAP and IFRS will be eliminated, even if US GAAP remains an independent set of financial reporting rules, notwithstanding that there remain challenging issues to be resolved before full convergence can occur. For one very important example, while IFRS bans the use of LIFO costing for inventories, it remains a popular financial reporting method under US GAAP because of a “conformity rule” that permits entities to use the method for tax reporting only if it is also used for general-purpose external financial reporting. In times of increasing costs, LIFO almost inevitably results in tax deferrals and is thus widely employed. US-based companies will be reluctant to fully embrace IFRS if it means that this tax strategy must be abandoned.

## Origins and Early History of the IASB

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematized form of accounting regulation developed in continental Europe, starting in France in 1673. Here a requirement for an annual fair value statement of financial position was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic actors was copied by other states and later incorporated in the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon's efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This "code law" family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on business profits started to be introduced, mostly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual company and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses that are not financially sound or were run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their (nonmanagement) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialized. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting began to become focused on consolidated accounts and the group, rather than the individual company. For different reasons, neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

The second model of financial reporting, generally regarded as the Anglo-Saxon financial reporting approach, can be characterized as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC's mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed at the investor, not the government.

Neither of the two above-described approaches to financial reporting is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonized by industrialized nations) they have adopted variants of one or the other of these two models.

IFRS are an example of the second, capital market-oriented, systems of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC), was formed in 1973, during a period of considerable change in account-

ing regulation. In the US the Financial Accounting Standards Board (FASB) had just been created, in the UK the first national standard setter had recently been organized, the EU was working on the main plank of its own accounting harmonization plan (the Fourth Directive), and both the UN and the OECD were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (Institute of Chartered Accountants in England and Wales—ICAEW) and the American profession (American Institute of Certified Public Accountants—AICPA).

A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands, and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

The actual reasons for the IASC's creation are unclear. A need for a common language of business was felt, to deal with a growing volume of international business, but other more political motives abounded also. For example, some believe that the major motivation was that the British wanted to create an international standard setter to trump the regional initiatives within the EU, which leaned heavily to the Code model of reporting, in contrast to what was the norm in the UK and almost all English-speaking nations.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to become a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

Both the UN and OECD were active in international rule making in the 1970s but the IASC was successful in persuading them to leave establishment of recognition and measurement rules to the IASC. However, having established itself as the unique international rule maker, IASC encountered difficulty in persuading any jurisdiction or enforcement agency to use its rules. Although member professional bodies were theoretically committed to pushing for the use of IFRS at the national level, in practice few national bodies were influential in standard setting in their respective countries (because standards were set by taxation or other governmental bodies), and others (including the US and UK) preferred their national standards to whatever IASC might propose. In Europe, IFRS were used by some reporting entities in Italy and Switzerland, and national standard setters in some countries such as Malaysia began to use IFRS as an input to their national rules, while not necessarily adopting them as written by the IASC or giving explicit recognition to the fact that IFRS were being adopted in part as national GAAP.

IASC's efforts entered a new phase in 1987, which led directly to its 2001 reorganization, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was interested in identifying a common international "passport" whereby companies could be accepted for secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to endorse IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to a quality and comprehensiveness level that IOSCO stipulated.

Historically, a major criticism of IFRS had been that it essentially endorsed all the accounting methods then in wide use, effectively becoming a “lowest common denominator” set of standards. The trend in national GAAP had been to narrow the range of acceptable alternatives, although uniformity in accounting had not been anticipated as a near-term result. The IOSCO agreement energized IASC to improve the existing standards by removing the many alternative treatments that were then permitted under the standards, thereby improving comparability across reporting entities. The IASC launched its *Comparability and Improvements Project* with the goal of developing a “core set of standards” that would satisfy IOSCO. These were complete by 1993, not without difficulties and spirited disagreements among the members, but then—to the great frustration of the IASC—these were not accepted by IOSCO. Rather than endorsing the standard-setting process of IASC, as was hoped for, IOSCO seemingly wanted to cherry-pick individual standards. Such a process could not realistically result in near-term endorsement of IFRS for cross-border securities registrations.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further period of frenetic activities, where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps in IFRS. This time the set of standards included, among others, IAS 39, on recognition and measurement of financial instruments, which was endorsed, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the same time, the IASC had undertaken an effort to consider its future structure. In part, this was the result of pressure exerted by the US SEC and also by the US private sector standard setter, the FASB, which were seemingly concerned that IFRS were not being developed by “due process.” While the various parties may have had their own agendas, in fact the IFRS were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events. The challenges presented to IASB ultimately would serve to make IFRS stronger.

If IASC was to be the standard setter endorsed by the world’s stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but possibly where national standard setters appointed representatives—or a small, professional body of experienced standard setters which worked independently of national interests.

The end of this phase of the international standard setting, and the resolution of these issues, came about within a short period in 2000. In May of that year, IOSCO members voted to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which itself was quickly exceeded by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the EU eclipsed the lukewarm IOSCO approval, and since then the EU has appeared to be the more influential body insofar as gaining acceptance for IFRS has been concerned. Indeed, the once-important IOSCO endorsement has become of little importance given subsequent developments, including the EU mandate and convergence efforts among several standard-setting bodies.

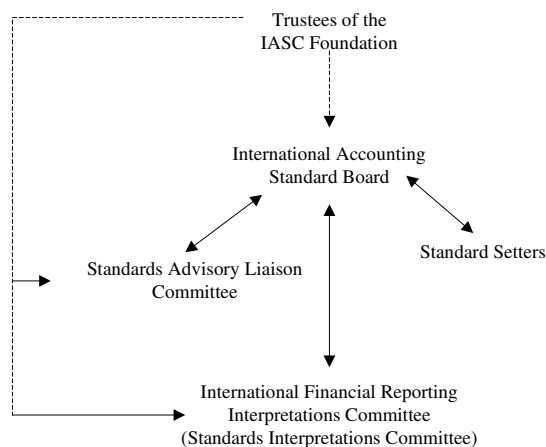
In July 2000, IASC members voted to abandon the organization’s former structure, which was based on professional bodies, and adopt a new structure: beginning in 2001,

standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

### The Current Structure

The formal structure put in place in 2000 has the IASC Foundation, a Delaware corporation, as its keystone. The Trustees of the IASC Foundation have both the responsibility to raise the \$19 million a year currently needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council (SAC).

The Standards Advisory Council (SAC) meets with the IASB three times a year, generally for two days. The SAC consists of about 50 members, nominated in their personal (not organizational) capacity, but are usually supported by organizations that have an interest in international reporting. Members currently include analysts, corporate executives, auditors, standard setters, and stock exchange regulators. The members are supposed to serve as a channel for communication between the IASB and its wider group of constituents, to suggest topics for the IASB's agenda, and to discuss IASB proposals.



The International Financial Reporting Interpretations Committee (IFRIC) is a committee comprised mostly of technical partners in audit firms but also includes preparers and users. It succeeded the Standards Interpretations Committee (SIC), which had been created by the IASC. IFRIC's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different rules. In recent times it has also proposed modifications to standards to the IASB, in response to perceived operational difficulties or need to improve consistency. IFRIC liaises with the US Emerging Issues Task Force and similar bodies liaison as standard setters, to try to preserve convergence at the level of interpretation. It is also establishing relations with stock exchange regulators, who may be involved in making decisions about the acceptability of accounting practices, which will have the effect of interpreting IFRS.

The liaison standard setters are national bodies from Australia, Canada, France, Germany, UK, USA, and Japan. Each of these bodies has a special relationship with a Board member, who normally maintains an office with the national standard setter and is responsible for liaison between the international body and the national body. This, together with the SAC, was the solution arrived at by the old IASC in an attempt to preserve some degree of

geographical representation. However, this has been somewhat overtaken by events: as far as the EU is concerned, its interaction with the IASB is through EFRAG (see below), which has no formal liaison member of the Board. The IASB Deputy Chairman has performed this function, but while France, Germany and the UK individually have liaison, EFRAG and the European Commission are, so far, outside this structure.

Furthermore, there are many national standard setters, particularly from developing countries, that have no seat on the SAC, and therefore have no direct link with the IASB, despite the fact that many of them seek to reflect IASB standards in their national standards. At the 2002 World Congress in Hong Kong, the IASB held an open meeting for national standard setters, which was met with enthusiasm. As a result, IASB began to provide time concurrent with formal liaison standard setters' meetings for any other interested standard setters to attend. While this practice was not enshrined in either the Constitution or the IASB's operating procedures, both remain under active review as of late 2009.

### Process of IFRS Standard Setting

The IASB has a formal due process which is set out in the *Preface to IFRS*, revised in 2001. At a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the SAC, liaison standard setters, the international audit firms and others. These are debated by IASB and tentative conclusions are discussed with the various consultative bodies. The IASB also has a joint agenda committee with the FASB. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

The agenda was largely driven in the years immediately after 2001 by the need to round out the legacy standards, to ensure that there would be a full range of standards for European companies moving to IFRS in 2005. Also, it was recognized that there was an urgent need to effect modifications to many standards in the name of convergence (e.g., acquisition accounting and goodwill) and to make needed improvements to other existing standards. These needs were largely met by mid-2004.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by IASB in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper which is then debated at a subsequent meeting. In theory there is an internal process where the staff proposes solutions, and IASB either accepts or rejects them. In practice the process is more involved: sometimes (especially for projects such as financial instruments) individual Board members are delegated special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one thing or another.

The process usually involves: (1) discussion of a paper outlining the principal issues; (2) preparation of an Exposure Draft that incorporates the tentative decisions taken by the Board—during which process many of these are redebated, sometimes several times; (3) publication of the Exposure Draft; (4) analysis of comments received on the Exposure Draft; (5) debate and issue of the final standard, accompanied by application guidance and a document setting out the *Basis for Conclusions* (the reasons why IASB rejected some solutions

and preferred others). Final ballots on the Exposure Draft and the final standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB Web site and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where IASB takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. If the project is controversial or particularly difficult, IASB may issue a discussion paper before proceeding to Exposure Draft stage. It reissued a discussion paper on stock options before proceeding to IFRS 2, *Share-Based Payment*. It is also following this pattern with its financial statement presentation project and its project on standards for small and medium-sized entities. Such a discussion paper may just set out what the staff considers to be the issues, or it may do that as well as indicate the Board's preliminary views.

IASB may also hold some form of public consultation during the process. For example, when revising IAS 39, *Financial Instruments: Recognition and Measurement*, in 2003, IASB held round table discussions. Respondents to the Exposure Draft were invited to participate in small groups with Board members where they could put forward their views and engage in debate.

Apart from these formal consultative processes, IASB also carries out field trials of some standards (as it recently did on performance reporting and insurance), where volunteer preparers apply proposed new standards. The international audit firms receive IASB papers as a result of their membership on IFRIC and are also invited to comment informally at various stages of standard development.

### Constraints

The debate within IASB demonstrates the existence of certain pervasive constraints that will influence the decisions taken by it. A prime concern has, heretofore, been achieving *convergence*. In October 2002, the IASB signed an agreement with the FASB (the so-called Norwalk Agreement) stating that the two boards would seek to remove differences and converge on high-quality standards. This agreement set in motion short-term adjustments and both standard setters subsequently issued a number of Exposure Drafts and final standards changing their respective standards in order to converge with the other on certain issues. The agreement also involved a commitment to the long-term development of joint projects (business combinations, performance reporting, revenue recognition, etc.).

The desire for convergence was driven to a great extent by the perception that international investment is made riskier by the use of multiple reporting frameworks, and that the global capital market would benefit from the imposition of a single global reporting basis—but also specifically by the knowledge that European companies that wished to be listed in the US needed to provide reconciliations of their equity and earnings to US GAAP when they did this. Foreign companies registered with the SEC are required to prepare an annual filing on Form 20-F that, until late 2007—unless the reporting entity prepared its financial statements under US GAAP—required a reconciliation between the entity's IFRS or national GAAP and US GAAP for earnings and equity. This reconciliation was said to be costly to prepare, and resulted in companies reporting, in effect, two different operating results for the year, which was not always understood or appreciated by the capital markets. As of year-end 2007, this requirement was eliminated, provided that the foreign private issuers (i.e., SEC registrants) complied fully with IFRS. Note that IFRS as adopted by the European Union contains departures from IFRS as promulgated by the IASB, and thus reconciliation has not been (thus far, at least) waived.

A major concern for financial reporting is that of *consistency*, but this is a complex matter, since IASB has something of a hierarchy of consistency. As a paramount consideration, IASB would want a new standard to be consistent with its *Conceptual Framework* (currently under development, and discussed below). Thereafter, there may be conflicts both between being consistent with US GAAP and being consistent with preexisting IFRS. However, there is little or no desire to maintain consistency with standards marked for extinction or in clear need of major revision. For example, IASB believes that a number of extant standards are inconsistent with the *Framework* (e.g., IAS 20 on government grants), and need to be changed, or are ineffective or obsolete (e.g., IAS 17 on leases), so there is little purpose in seeking to make a new standard consistent with them. Equally, since it aims to converge with US GAAP, it seems illogical to adopt a solution that is deliberately at variance with US GAAP, which will then have to be reconsidered as part of the convergence program. (Note that the convergence effort is expected, at least in the near term, to continue, notwithstanding the elimination of the SEC's reconciliation requirement and the prospective replacement of US GAAP for public company financial reporting by IFRS. Both parties continue to work on projects having completion dates no later than mid-2011.)

Those members of IASB who have worked in North America are concerned that standards avoid creating abuse opportunities. Experience has sadly shown that there may well be attempts by preparers to evade the intended result of accounting standards, using so-called "financial engineering," in order to be able to achieve the earnings or presentations in the statement of financial position that are desired, particularly in the short term (e.g., quarterly earnings). This concern is sometimes manifested as a desire to impose uniform and inflexible standards, allowing few or no exceptions. There is a justifiable perception that many standards become very complicated because they contain too many exceptions to a simple and basic rule (for example: eliminate complex lease accounting requirements and simply report the property rights and debt obligations implicit in all lease arrangements).

IASB also manifests some concerns about the practicality of the solutions it mandates. While some preparers might think that it is not sympathetic enough in this regard, it actually has limited the extent to which it requires restatements of previous years' reported results when the rules change, particularly in IFRS 1, *First-Time Adoption*. The *Framework* does include a cost/benefit constraint—that the costs of the financial reporting should not be greater than the benefits to be gained from the information—which is often invoked during debates over proposed standards, although IASB considers that preparers are not the best ones to measure the benefits of disclosure.

There is also a procedural constraint that IASB has to manage, which is the relationship between the Exposure Draft and the final standard. IASB's due process requires that there should be nothing introduced in the final standard that was not exposed at the Exposure Draft stage, as otherwise there must be reexposure of the material. This means that where there are several solutions possible, or where a line can be drawn in several places, IASB may tend towards the most extreme position in the Exposure Draft, so as not to narrow its choices when further deliberating the proposal in the light of constituents' comments.

### **Conceptual Framework for Financial Reporting**

The IASB inherited the IASC's *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*). Like the other current conceptual frameworks among Anglo-Saxon standard setters, this derives from the US conceptual framework, or at least those parts of it completed in the 1970s. The *Framework* states that "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making

economic decisions.” The information needs of investors are deemed to be of paramount concern, but if financial statements meet their needs, other users’ needs would generally also be satisfied.

The *Framework* holds that users need to evaluate the ability of the entity to generate cash and the timing and certainty of its generation. The financial position is affected by the economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

The qualitative characteristics of financial statements are understandability, relevance, reliability and comparability. Reliability comprises representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint and that in practice there will often be a trade-off between characteristics. The *Framework* does not specifically include a “true and fair” requirement, but says that application of the specified qualitative characteristics should result in statements that present fairly or are true and fair. IAS 1, *Presentation of Financial Statements*, as revised in 2007, states that financial statements are “a structured representation of the financial position and financial performance of an entity...(whose) objective...is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.” It further states that “fair presentation requires faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria...set out in the *Framework*....The application of IFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.”

Of great importance are the definitions of assets and liabilities. According to IASB, “an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.” A liability is a “present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying future benefits.” Equity is simply a residual arrived at by deducting the liabilities from assets. Neither an asset nor a liability is recognized in the financial statements unless it has a cost or value that can be measured reliably—which, as the *Framework* acknowledges, means that some assets and liabilities may, of necessity, go unrecognized.

The asset and liability definitions have, in the past, not been central to financial reporting standards, many of which were instead guided by a “performance” view of the financial statements. For example, IAS 20 on government grants has been severely criticized and targeted for either revision or elimination, in part because it allows government grants to be treated as a deferred credit and amortized to earnings, while a deferred credit does not meet the *Framework* definition of a liability. Similarly, IFRS 3 requires that where a bargain purchase is identified in a business combination, a gain on a bargain purchase (commonly referred to as negative goodwill) should be released to profit or loss immediately, in contrast to practice under IAS 22 which treated it as a deferred credit—an account that, however, did not actually meet the defined criteria for recognition as a liability.

Accounting standards are now largely driven by statement of financial position considerations. Both FASB and IASB now intend to analyze solutions to reporting issues in terms of whether they cause any changes in assets or liabilities. The revenue recognition project that both bodies are pursuing is perhaps the ultimate example of this new and rigorous perspective. This project has tentatively embraced the view that where an entity receives an order and has a legally enforceable contract to supply goods or services, the entity has both an asset (the right to receive future revenue) and a liability (the obligation to fulfill the order) and it follows that, depending upon the measurement of the asset and the liability, some earnings could be recognized at that point. This would be a sharp departure from existing GAAP,

under which executory contracts (i.e., contracts upon which neither party has yet performed) are almost never formally recognized, and never create earnings.

The IASB *Framework* is relatively silent on measurement issues. The three paragraphs that address this matter merely mention that several different measurement bases are available and that historical cost is the most common. Revaluation of tangible fixed assets is, for example, perfectly acceptable under IFRS for the moment. In practice IFRS have a mixed attribute model, based mainly in historical cost, but using value in use (the present value of expected future cash flows from the use of the asset within the entity) for impairment and fair value (market value) for some financial instruments, biological assets, business combinations and investment properties.

FASB and IASB have been, since 2005, revisiting their respective conceptual frameworks, the objective of which is to build on them by refining and updating them and developing them into a common framework that both can use in developing accounting standards. With concurrent IASB and FASB deliberations and a single integrated staff team, this is truly an international project. IASB believes that it has made good progress on the first phase of the project. Most of the debate for the first year or so focused on the objectives of financial reporting and the qualitative characteristics of decision-useful financial reporting information, and a joint Discussion Paper on these matters was issued in late 2006. This was followed, in May 2008, by Exposure Drafts of the first two (of eight) chapters for the proposed new conceptual framework. The first two chapters deal with, respectively, the objective of financial reporting and the qualitative characteristics of decision-useful financial reporting information.

Regarding the objective of financial reporting, the Exposure Draft proposes the following definition:

*The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Capital providers are the primary users of financial reporting. To accomplish the objective, financial reports should communicate information about an entity's economic resources, claims on those resources, and the transactions and other events and circumstances that change them. The degree to which that financial information is useful will depend on its qualitative characteristics.*

As with the existing FASB Conceptual Framework, this definition of the objective for financial reporting has a wider scope than financial statements, *per se*. It actually sets forth the objective of financial reporting in general, including a range of possible narrative and other presentations that would accompany and amplify the financial statements.

Financial reporting is aimed primarily at capital providers. That does not mean that others, such as management, will not find financial reports useful, but rather that, in deciding on the principles for recognition, measurement, presentation, and disclosure, the information needs of capital providers are to be given paramount consideration.

The draft holds that *decision usefulness* to capital providers is the overriding purpose of financial reporting. Providing information about *management stewardship* of the assets entrusted to it is an important part of that objective, however. The language of the Exposure Draft cites *present and potential* investors as its means of acknowledging that general purpose financial reports are used both for future investment decisions as well as assessing the stewardship of resources already committed to the entity.

The draft identifies equity investors, lenders and other creditors (including suppliers, employees and customers) as *capital providers*, which are those whose information needs are to be met through general purpose financial reports. Governments, their agencies, regulatory

bodies, and members of the public are identified as groups that may find the information in general purpose financial reports useful, but these are not defined as being primary users.

The Exposure Draft continues with the current philosophy that financial reporting should provide information that enables capital providers to assess the entity's ability to generate net cash inflows, coupled with an ability to assess management's ability to protect and enhance the capital providers' investments.

The *stewardship responsibilities of management* are addressed explicitly by the draft document, which notes that management "is accountable to the entity's capital providers for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use" and that the entity complies with applicable laws, regulations and contractual requirements. The ability of management to discharge these responsibilities effectively has an obvious impact on the entity's ability to generate future net cash inflows, suggesting that potential investors are also assessing management performance as they make their investment decisions.

IASB and FASB both note that users of financial reports should be aware of the limitations of the information included in financial reports—specifically because the information is heavily based on estimates, rather than exact measures, and thus involve the application of judgment. Also, users are cautioned to recognize that financial reports are only one source, of potentially many, of information needed by those making investment, credit and similar resource allocation decisions. Thus, other sources of relevant information must also be consulted, for insights about general economic conditions, political events and industry outlooks, among possibly many other topics.

The draft holds that information about the effects of transactions and other events that change assets and liabilities is also essential. Financial reporting must also include management's explanations (an example being the *management discussion and analysis* required under SEC filings in the US), since management knows more about the entity than could any external users. Such explanations, properly constructed and communicated, should provide insight into significant estimates and assumptions used by management.

Chapter two of the proposed new conceptual framework document, which has also been exposed for comment, addresses the qualitative characteristics and constraints of decision-useful financial reporting information. IASB and FASB have refined the approach first seen in the earlier (2006) Discussion Paper, such that there are now two fundamental qualitative characteristics:

- Relevance, and
- Faithful representation.

In addition, there are certain characteristics that are said to enhance the decision-usefulness of financial information. These are complementary to the fundamental qualitative characteristics and are: comparability (including consistency), verifiability, timeliness and understandability. These are defined as follows by the Exposure Draft:

**Relevant** information is that which has predictive value, confirmatory value or both; in other words it is capable of influencing the decisions of capital providers. The users do not need to use such information, but merely have to be given access to it.

**Faithful representation** implies that decision-useful financial information represents faithfully the economic phenomenon (those affecting financial position and results of operations) that it purports to represent.

The enhancing qualitative characteristics are said to help users to distinguish more useful information from less useful information.

**Timeliness** means that the information is provided when it is still highly useful for decision-making purposes.

**Comparability** refers to the ability to identify similarities in—and differences between—two sets of economic phenomena. It is not to be confused with uniformity, which still does not exist under either US GAAP or IFRS (although the range of alternatives has narrowed over recent decades). *Consistency* (the use of the same accounting policies and procedures within an entity from period to period, or in a single period across entities) aids comparability.

**Verifiability** helps to assure users that information represents faithfully the economic phenomena that it purports to represent. It implies that knowledgeable and independent observers could reach a general consensus (but not necessarily absolute agreement) that the information does represent faithfully the economic phenomena it purports to represent without material error or bias, or that an appropriate recognition or measurement method has been applied without material error or bias. It means that independent observations would yield essentially the same measure or conclusions.

**Understandability** enables users who have a reasonable knowledge of business and economic and financial activities and financial reporting, and who apply reasonable diligence to comprehend the information, to gain insights into the reporting entity's financial position and results of operations, as intended. Understandability is enhanced when the information is classified, characterized and presented clearly and concisely. The draft asserts that relevant information should not be excluded solely because it may be too complex or difficult for some users to understand.

The Basis for Conclusions accompanying the Exposure Draft lists additional candidate attributes that were considered by the Boards, but not included in the proposals. These include *transparency* (which was concluded was subsumed within faithful representation and understandability); *true and fair view* (deemed to be equivalent to faithful representation); *credibility* (which is implied by verifiability); and *high quality* (which generally is achieved by adherence to the objective and qualitative characteristics of financial reporting). One other candidate, *internal consistency*, was rejected because IASB and FASB concluded that this, while desirable and a goal of both bodies, could impede the evolution of financial reporting standards.

Two pervasive constraints may also limit the information provided in useful financial reports:

- Materiality, and
- Cost

Regarding *materiality*, which has long been invoked but often not defined in terms precise enough for users and preparers, information is to be deemed material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information. Materiality is not a matter to be considered by standard-setters but by preparers and their auditors. That is, financial reporting requirements will be promulgated without regard to materiality criteria, but actual adherence to such rules may be omitted when the effect of doing so would not be material to the users.

As concerns the *cost-benefit* criterion, it has been stated that the benefits of providing financial reporting information should justify the costs of providing that information. Presumably this will constrain the imposition of certain new requirements, although this is a relative concept, and as information technology continues to evolve and the cost of preparing and distributing financial and other information declines, this constraint conceivably will be relaxed as well.

Discussion has since moved on to the elements of financial statements, in particular the definitions of an asset, a liability, and equity, and on what constitutes the reporting entity. A discussion paper on this segment of the conceptual framework is now being promised for the latter part of 2010, and the timing of a subsequent issuance of an Exposure Draft is uncertain.

Other components of the conceptual framework project, which will address measurement, the reporting entity, presentation, and disclosure, purpose and status, and application to

not-for-profit entities, will follow, but the timing for most of these is still uncertain, although an Exposure Draft for the reporting entity is hoped for by mid-2010. Elements and presentation and disclosure are the most active projects and may result in Discussion Papers, at a minimum before year-end 2009.

### **Hierarchy of Standards**

The *Framework* is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts will articulate their arguments in terms of the *Framework*. However, the *Framework* is not normally intended to be used directly by preparers and auditors in determining their accounting methods. In its 2003 revision of IAS 8, IASB introduced a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1. IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.
2. In the absence of such a directly applicable standard, judgment is to be used to develop and apply an accounting policy that conforms to the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expense set forth in the *Framework*.
3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop its standards, as well as other accounting literature and industry practices that do not conflict with guidance in the IFRS dealing with the same and similar circumstances or with the definitions set forth in the *Framework*.

In effect, therefore, if existing IFRS do not address an accounting issue, the preparer should consider guidance in analogous national GAAP. In the authors' view, the most obvious choice is US GAAP, partly because that is the most complete set of standards, and partly because in the global capital market, US GAAP is the alternative best understood and most widely applied (after IFRS itself). In any event, given the professed intention of IFRS and US GAAP to converge, it would make little sense to seek guidance in any other set of standards, unless US GAAP was also silent on the matter needing clarification. Users should be cautious in relying on any standards not part of IFRS, however.

### **The IASB and Financial Reporting in the US**

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only then that FASB became interested in IASC, when IASC was beginning to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to consider the international financial reporting area, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO's efforts to create a single passport for secondary listings, and IASC's role as its standard setter, while intended to operate worldwide, would have the greatest practical significance for foreign issuers in terms of the US market. It was understood that if the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US capital markets by foreign registrants would be greatly facilitated. The SEC has therefore been a key factor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987, and also observed that too many options for diverse accounting were available under IAS. SEC suggested that it would be more favorably inclined to consider acceptance of IAS (now IFRS) if some or all of these alternatives were

reduced. Shortly after IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) to the effect that, to be acceptable, IFRS would need to satisfy the following three criteria:

1. It would need to establish a core set of standards that constituted a comprehensive basis of accounting;
2. The standards would need to be of high quality, and would enable investors to analyze performance meaningfully both across time periods and among different companies; and
3. The standards would have to be rigorously interpreted and applied, as otherwise comparability and transparency could not be achieved.

IASC's plan was predicated on its completion of a core set of standards, which would then be handed over to IOSCO, which in turn would ask its members for an evaluation, after which IOSCO would issue its verdict as to acceptability. It was against this backdrop that the SEC issued a "concept release" in 2000, that solicited comments regarding the acceptability of the core set of standards, and whether there appeared to be a sufficiently robust compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, whether auditors would ensure this, and whether stock exchange regulators would verify such compliance.

This last-named element remains beyond the control of IASB, and is within the domain of national compliance bodies or professional organizations in each jurisdiction. The IASC's Standards Interpretations Committee (SIC, which was later succeeded by IFRIC) was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to establish liaison channels with stock exchange regulators and national interpretations bodies—but the predominant responsibilities remain in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies.

The SEC's stance at the time was that it genuinely wanted to see IFRS used by foreign registrants, but that it preferred convergence (so that no reconciliation would be necessary) over the acceptance of IFRS as they were in 2000 without reconciliation. In the years since, the SEC has in many public pronouncements supported convergence and, as promised, waived reconciliations in 2008 for registrants fully complying with IFRS. Thus, for example, the SEC welcomed various proposed changes to US GAAP to converge with IFRS.

Relations between FASB and IASB have grown warmer since IASB was restructured, perhaps influenced by the growing awareness that IASB would assume a commanding position in the financial reporting standard-setting domain. The FASB had joined the IASB for informal meetings as long ago as the early 1990s, culminating in the creation of the G4+1 group of Anglophone standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer), in which FASB was an active participant. Perhaps the most significant event was when IASB and FASB signed the Norwalk Agreement in October 2002, which set out a program for the convergence of their respective sets of financial reporting standards. The organizations' staffs have worked together on a number of vital projects, including business combinations and revenue recognition, since the Agreement was signed and, later, supplemented by the 2006 Memorandum of Understanding between these bodies. The two boards have a joint agenda committee whose aim is to harmonize the timing with which the boards discuss the same subjects. The boards are also committed to meeting twice a year in joint session.

However, certain problems remain, largely of the structural variety. FASB operates within a specific national legal framework, while IASB does not. Equally, both have what they term "inherited" GAAP (i.e., differences in approach that have a long history and are not easily resolved). FASB also has a tradition of issuing very detailed, prescriptive ("rules-

based”) standards that give bright line accounting (and, consequently, audit) guidance, which are intended to make compliance control easier and remove uncertainties. Notwithstanding that detailed rules had been ardently sought by preparers and auditors alike for many decades, in the post-Enron world, after it became clear that some of these highly prescriptive rules had been abused, interest turned toward developing standards that would rely more on the expression of broad financial reporting objectives, with far less detailed instruction on how to achieve them (“principles-based” standards). This was seen as being superior to the US GAAP approach, which mandated an inevitably doomed effort to prescribe responses to every conceivable fact pattern to be confronted by preparers and auditors.

This exaggerated rules-based vs. principles-based dichotomy was invoked particularly following the frauds at US-based companies WorldCom and Enron, but before some of the more prominent European frauds, such as Parmalat (Italy) and Royal Ahold (the Netherlands) came to light, which would suggest that neither the use of US GAAP nor IFRS could protect against the perpetration of financial reporting frauds if auditors were derelict in the performance of their duties or even, on rare occasions, complicit in managements frauds. As an SEC study (which had been mandated by the Sarbanes-Oxley Act of 2002) into principles-based standards later observed, use of principles alone, without detailed guidance, reduces comparability. The litigious environment in the US also makes companies and auditors reluctant to step into areas where judgments have to be taken in uncertain conditions. The SEC’s solution: “objectives-based” standards that are both soundly based on principles and inclusive of practical guidance.

Events in the mid- to late-2000s have served to accelerate the pressure for full convergence between US GAAP and IFRS. In fact, the US SEC’s decision in late 2007 to waive reconciliation requirements for foreign registrants complying with “full IFRS” was a clear indicator that the outright adoption of IFRS in the US is on the horizon, and that the convergence process may be made essentially redundant if not actually irrelevant. The SEC has since granted qualifying US registrants (major players in industry segments, the majority of whose world-wide participants already report under IFRS) the limited right to begin reporting under IFRS in 2009, after which (in 2011) it has indicated it will determine the future path toward the supersession of US GAAP by IFRS.

In late 2008, the SEC proposed its so-called “roadmap” for a phased-in IFRS adoption, setting forth four milestones that, if met, could lead to wide-scale adoption beginning in 2014. Under the new leadership, which assumed office in 2009, the SEC may act with less urgency on this issue, and achievement of the “milestones”—which include a number of subjective measures such as improvement in standards and level of IFRS training and awareness among US accountants and auditors—leaves room for later balking at making the final commitment to IFRS. Notwithstanding these possible impediments to progress, the authors believe that there is an inexorable move toward universal adoption of IFRS, and that the leading academic and public accounting (auditing) organizations must, and will, take the necessary steps to ensure that this can move forward. For example, in the US the principal organization of academicians is actively working on standards for IFRS-based accounting curricula, and the main organization representing independent accountants is producing Web-based materials and live conferences to educate practitioners about IFRS matters.

While the anticipated further actions by the US SEC will only directly promote or require IFRS adoption by multinational and other larger, publicly held business entities, and later by even small, publicly held companies, in the longer run, even medium- and smaller-sized entities will probably opt for IFRS-based financial reporting. There are several reasons to predict this “trickle down” effect. First, because some involvement in international trade is increasingly a characteristic of all business operations, the need to communicate with customers, creditors, and potential partners or investors will serve to motivate “one language”

financial reporting. Second, the notion of reporting under “second-class GAAP” rather than under the standards employed by larger competitors will eventually prove to be unappealing. And thirdly, IASB’s issuance of a one-document comprehensive standard on financial reporting by entities having no public reporting responsibilities (IFRS for SMEs, discussed later in this chapter), coupled with formal recognition under US auditing standards that financial reporting rules established by IASB are a basis for an auditor’s professional opinion may actually find enthusiastic support among smaller US reporting entities and their professional services providers, even absent immediate adoptions among publicly held companies.

### **The IASB and Europe**

Although France, Germany, the Netherlands and the UK were founding members of predecessor organization IASC and have remained heavily involved with IASB, the European Commission as such has generally had a fitful relationship with the international standard setter. The EC did not participate in any way until 1990, when it finally became an observer at Board meetings. It had had its own regional program of harmonization since the 1960s and in effect only officially abandoned this in 1995, when, in a policy paper, it recommended to member states that they seek to align their rules for consolidated financial statements on IFRS. Notwithstanding this, the Commission gave IASB a great boost when it announced in June 2000 that it wanted to require all listed companies throughout the EU to use IFRS beginning in 2005 as part of its initiative to build a single European financial market. This intention was made concrete with the approval of the IFRS Regulation in June 2002 by the European Council of Ministers (the supreme EU decision-making authority).

The EU decision was all the more welcome given that, to be effective in legal terms, IFRS have to be enshrined in EU statute law, creating a situation where the EU is in effect ratifying as laws the set of rules created by a small, self-appointed, private-sector body. This proved to be a delicate situation, which was revealed within a very short time to contain the seeds of unending disagreements, as politicians were being asked in effect to endorse something over which they had no control. They were soon being lobbied by corporate interests that had failed to effectively influence IASB directly, in order to achieve their objectives, which in some cases involved continued lack of transparency regarding certain types of transactions or economic effects, such as fair value changes affecting holding of financial instruments. The process of obtaining EU endorsement of IFRS was at the cost of exposing IASB to political pressures in much the same way that the US FASB has at times been the target of congressional manipulations (e.g., over stock-based compensation accounting rules in the mid-1990s, the derailing of which arguably contributed to the practices that led to various backdating abuse allegations made in more recent years).

The EU created an elaborate machinery to mediate its relations with IASB. It preferred to work with another private-sector body, created for the purpose, the European Financial Reporting Advisory Group (EFRAG), as the formal conduit for EU inputs to IASB. EFRAG was formed in 2001 by a collection of European representative organizations (for details see [www.efrag.org](http://www.efrag.org)), including the European Accounting Federation (FEE) and a European employer organization (UNICE). EFRAG in turn formed the small Technical Expert Group (TEG) that does the detailed work on IASB proposals. EFRAG consults widely within the EU, and particularly with national standard setters and the European Commission to canvass views on IASB proposals, and provides input to IASB. It responds formally to all discussion papers and Exposure Drafts.

At a second stage, when a final standard is issued, EFRAG is asked by the Commission to provide a report on the standard. This report is to state whether the standard has the requi-

site quality and is in conformity with European company law directives. The European Commission then asks another entity, the Accounting Regulation Committee (ARC), whether it wishes to endorse the standard. ARC consists of permanent representatives of the EU member state governments. It should normally only fail to endorse IFRS if it believes they are not in conformity with the overall framework of EU law, and should not take a strategic or policy view. However, the European Parliament also has the right to independently comment, if it so wishes. If ARC fails to endorse a standard, the European Commission may still ask the Council of Ministers to override that decision.

Experience has shown that the system suffers from a number of problems. First, although EFRAG is intended to enhance EU inputs to IASB, it may in fact isolate people from IASB, or at least increase the costs of making representations. For example, when IASB revealed its intention to issue a standard on stock options, it received nearly a hundred comment letters from US companies (who report under US GAAP, not IFRS), but only one from EFRAG, which in the early 2000s effectively represented about 90% of IASB's constituents. It is possible, however, that EFRAG is seen at IASB as being only a single respondent, and if so, that people who have made the effort to work through EFRAG feel underrepresented. In addition, EFRAG inevitably will present a distillation of views, so it is already filtering respondents' views before they even reach IASB. The only recourse is for respondents to make representations not only to EFRAG but also directly to IASB.

However, resistance to the financial instruments standards, IAS 32 and IAS 39, put the system under specific strain. These standards were already in existence when the European Commission announced its decision to adopt IFRS for European listed companies, and they had each been exhaustively debated before enactment. European adoption again exposed these particular standards to strenuous debate.

The first task of EFRAG and ARC was to endorse the existing standards of IASB. They did this—but excluded IAS 32 and 39 on the grounds that they were being extensively revised as part of IASB's then-ongoing *Improvements Project*.

During the exposure period of the improvements proposals—which exceptionally included round table meetings with constituents—the European Banking Federation, under particular pressure from French banks, lobbied IASB to modify the standard to permit special accounting for macrohedging. The IASB agreed to do this, even though that meant the issuance of another Exposure Draft and a further amendment to IAS 39 (which was finally issued in March 2004). The bankers did not like the terms of the amendment, and even as it was still under discussion, they appealed to the French president and persuaded him to intervene. He wrote to the European Commission in July 2003, saying that the financial instruments standards were likely to cause banks' reported earnings to be more volatile and would destabilize the European economy, and thus that the proposed standard should not be approved. He also argued that the Commission did not have sufficient input to the standard-setting process.

This drive to alter the requirements of IAS 39 was intensified when the European Central Bank complained in February 2004 that the "fair value option," introduced to IAS 39 as an improvement in final form in December 2003, could be used by banks to manipulate their *prudential ratios* (the capital to assets ratios used to evaluate bank safety), and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although this meant issuing another Exposure Draft and a further amendment to IAS 39 which was not finalized until mid-2005. When IASB debated the issue, it took a pragmatic line that no compromise of principle was involved, and that it was reasonable that the principal bank regulator of the Board's largest constituent by far should be accommodated. The fact that the European Central Bank had not raised these issues at the original Exposure Draft stage was not discussed, nor was the legitimacy of a constituent deciding unilaterally it wanted to

change a rule that had just been approved. The Accounting Standards Board of Japan lodged a formal protest, and many other constituents were not pleased at this development.

Ultimately, ARC approved IAS 32 and IAS 39, but a “carve out” from IAS 39 was prescribed. Clearly the EU’s involvement with IFRS is proving to be a mixed blessing for IASB, both exposing it to political pressures that are properly an issue for the Commission, not IASB, and putting its due process under stress. Some commentators speculated that the EU might even abandon IFRS, but this is not a realistic possibility, given the worldwide movement toward IFRS and the fact that the EU had already tried and rejected the regional standard-setting route.

A better observation is that this is merely part of a period of adjustment, with regulators and lobbyists both being uncertain as to how exactly the system does and should work, and both testing its limits, but with some *modus vivendi* evolving over time. However, it is severe distraction for IASB that financial instruments, arguably the area of greatest accounting controversy in the 1990s, is one that is still causing concern to the present date, in part exacerbated by the worldwide financial crisis of 2007-2009. Some believe that financial instruments accounting issues should have been fully resolved years ago, so that IASB could give its undivided attention to such crucial topics as revenue recognition, performance reporting and insurance contracts.

The EC decision to impose “carve-outs” has most recently had the result that the US SEC’s historic decision to eliminate reconciliation to US GAAP for foreign private issuers has been restricted to those registrants that file financial statements that comply with “full IFRS” (which implies that those using “Euro-IFRS” and other national modifications of IFRS promulgated by the IASB will not be eligible for this benefit). Registrants using any deviation from pure IFRS, and those using any other national GAAP, will continue to be required to present a reconciliation to US GAAP. Over time, it can be assumed that this will add to the pressure to report under “full IFRS,” and that even the EU may line up behind full and complete adherence to officially promulgated IFRS.

### The Future Agenda for IFRS

**Performance reporting.** The matter of performance reporting (now renamed financial statement presentation) has been a priority project for IASB. The project was bifurcated, and the first part, intended to define which financial statements are to be presented, led to a mid-2006 Exposure Draft and the late 2007 promulgation of revised IAS 1 (discussed in greater detail later in this chapter). The second phase, which addresses the manner of presentation of information on the faces of the financial statements, culminated with the issuance of a joint IASB-FASB Discussion Paper in October 2008. The announced intent is to promulgate revisions to IAS 1 based on this exposure document by 2011, following the issuance of a formal Exposure Draft in 2010.

**Revenue recognition.** IASB is also pursuing a revenue recognition project. The purpose of this undertaking is to revisit revenue recognition through an analysis of assets and liabilities, instead of the existing approach which focuses on completed transactions and realized revenue. Such an approach has major implications for the timing of earnings recognition—it would potentially lead to revenue recognition in stages throughout the transaction cycle. It is unlikely that this project will lead to short-term changes, given the fundamental nature of the issues involved. IASB produced a discussion document in late 2008, comments on which were received until mid-2009. An Exposure Draft has been promised by mid-2010, with a final standard expected in 2011.

**Joint projects with FASB and CASB.** Linked to these projects, which are revisions and extensions of the conceptual framework, is a joint project with the Canadian Accounting

Standards Board on initial measurement and impairment, and a catch-up project with FASB on accounting for, and distinguishing between, liabilities and equity, which has eluded definitive resolution for well over a decade.

**Business combinations and group financial reporting.** The very important topic of accounting for business combinations has been pursued in coordination with FASB over several years. In 2008, both Boards completed Phase II of their respective projects, resulting in the issuance of revised IFRS 3 and IAS 27, and the release of the very similar FAS 141(R) and FAS 160 for application under US GAAP. Among the important changes made to prior practice were the imposition of acquisition accounting, the requirement that minority interests be included as part of group (i.e., consolidated) equity, and the inclusion (optional under IFRS, mandatory under US GAAP) of goodwill calculated with reference to 100% of the shareholders' interests, rather than for just the holdings of the controlling group of owners. Additionally, contingent assets and liabilities acquired in a business combination are now to be recognized at fair value determined at the date of the transaction. Full details of IFRS 3 as revised are set forth in Chapter 13.

**IFRS for SMEs.** Also in 2009, IASB completed its work on an important, stand-alone comprehensive standard for what had been known, during its development, first as SME accounting (tailored standards for small and medium-sized entities), then as IFRS for private entities (PE), and finally, again as IFRS for SMEs (although it is to be employed by entities of any size, provided they have no public accountability).

Broadly, the intention of this project (which was the subject of an IASB Discussion Paper in 2004) was to produce a single accounting standard for subject entities, to consist of simplified versions of the existing IFRS, in a manner modeled on what had been achieved in the UK over a decade ago (where it was known as financial reporting standards for smaller enterprises, or FRSSE, which has been since revised several times). IASB was initially reluctant to involve itself in this area, but was persuaded by a number of institutions, including the UN and the European Commission, to conclude that this would satisfy an urgent need. In essence, it had been widely perceived that the full set of IFRS (as with UK GAAP, before it) was burdensome and difficult to comprehend by less sophisticated preparers, auditors, and users, and that a "single volume" standard capturing the key elements of the other standards, with reduced availability of alternative practices and streamlined disclosure requirements, would improve compliance and raise the quality of financial reporting as practiced by such enterprises.

There have been more than a few efforts in the past to distinguish financial reporting principles applicable to major, publicly held or sophisticated entities from those that would prove suitable for smaller, nonpublic, or less complex enterprises and their owners, creditors, customers and vendors. This "big GAAP vs. small GAAP" debate has raged, intermittently, for many decades, and as financial reporting standards (under national GAAP as well as under IFRS) became more complicated—due mainly to the increasing complexity of business transactions and financial structures—this debate would be revived. Past efforts have usually foundered on the failure to identify specific transactions or events that would warrant differential recognition or measurement standards, since those are best based on the nature of the event rather than on the characteristics of the users of the financial statements.

The crucial issue of what is a SME (i.e., would it be based on revenues, profits, assets, or some gauge of size) was never actually resolved. Instead, IASB resolved that entities having no public accountability (i.e., no publicly traded shares or debt obligations) would qualify for use of the SME standard, regardless of size.

IASB posted a draft standard in early 2006, and issued the final standard in mid-2009. IFRS for SMEs is fully discussed in an appendix to this chapter, and explored in greater detail in *Wiley IFRS for SMEs* (forthcoming in early 2010).

**Insurance contracts.** While IFRS 4, issued in March 2004, provides a first standard on accounting for insurance contracts, this is only an interim standard issued to meet the needs of 2005 adopters, and it permits the retention of many existing national practices. IASB is committed to a full standard, an exposure document for which is now projected to be released in 2010. The project should now enter full development. Analysis thus far, based on an asset and liability approach, would potentially allow recognition of some gain on the signing of a long-term contract. This will undoubtedly cause insurance regulators some concerns. IASB is also using fair value as a working measurement assumption, which has aroused opposition from insurers, many of whom have long used an approach which smoothed earnings over long periods and ignored the current market values of insurance assets and liabilities. They claim that fair value will introduce volatility, which is likely true: IASB members have observed that the volatility is in the marketplace, and that the insurers' accounts just do not reflect economic reality.

**Disclosures about financial instruments.** A project addressing IAS 30 disclosure requirements came to fruition in mid-2005 with the issuance of IFRS 7. This standard eliminated IAS 30, which had set forth disclosures for banks, and merges them with requirements formerly presented in IAS 39. Because of issues arising during the "credit crises" of 2008, IASB quickly considered certain amendments to IFRS 7, and by late 2008 had issued an Exposure Draft, *IFRS 7: Disclosures*. Certain changes were finalized in early 2009, dealing with liquidity risk and fair value, but other disclosure revisions and enhancements proposed in late 2008 were abandoned.

**Fair value measurements.** Many IFRS requirements involve assessments or determinations of fair value, but a number of the discrete approaches to fair value are to be found in the international financial reporting standards, and some of these are inconsistent or non-uniform in application. A similar issue arose under US GAAP and was resolved when FASB issued FAS 157 (later codified as ASC 820), establishing a three-level hierarchy of methodologies but imposing no new fair value application requirements. IASB has determined that the guidance under ASC 820 is suitable and has accordingly prepared a draft standard (exposed in May 2009) that "wraps around" FAS 157. This is discussed extensively in Chapter 6. Finalization of a new statement is promised by mid-2010.

**Contingencies.** In mid-2005 IASB issued an Exposure Draft of an amendment to IAS 37. This evolved as part of the ongoing efforts to converge IFRS with US GAAP. In particular, it is responsive to the differences between IAS 37 (on provisions) and FAS 146, addressing certain disposal and exit activities and the costs properly accrued in connection with them. FAS 146 was promulgated by FASB, in part, to curtail certain abuses commonly called providing "cookie jar reserves" during periods of corporate downsizing, when too-generous estimates were often made of future related costs, which in some instances served to absorb costs that would properly have been chargeable to future periods. In other cases, excess reserves (provisions) were used for later release into income, thereby overstating operating results of one or more later periods. FAS 146 applies strict criteria so that reserves that do not meet the definition of liabilities at the end of the reporting period cannot be recorded, since they do not represent present obligations of the reporting entity. The proposal to revise IAS 37 also hews more closely to US GAAP's approach to guarantees, which distinguish between the unconditional element—the promise to provide a service for some defined duration of time—and the conditional element, which is contingent on the future events, such as terminations, occurring.

If adopted, the amended IAS 37 (discussed in great detail in Chapter 14) would eliminate the terms *contingent liability* and *contingent asset*, and would restrict the meaning of constructive obligations so that these would be recognized as liabilities only if the reporting entity's actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform. Furthermore, the probability criterion would be deleted, so that only if a liability is not subject to reasonable measurement would it be justifiable to not record it. Certain changes are also made to IAS 19 by this draft. As of late 2009, these proposed revisions to IAS 37 remain under discussion by the IASB.

**Government grants.** IASB also has expressed its intent to replace IAS 20, and an Exposure Draft had been promised for late 2005 but did not appear. It is likely that this project will not be addressed for perhaps several more years, since IASB's originally conceptualized approach, using the model set forth in IAS 41, was ultimately judged to be inadequate. (See discussion in Chapter 28.) One change made to IAS 20, as part of the 2007 Annual Improvements project, required explicit recognition (as grant income) of the benefit conferred by below-market interest on loans made to an entity. IASB is considering other issues pertinent to the accounting for government grants as part of the aforementioned revenue recognition project.

**Interest during construction periods.** Yet another short-term convergence project has resulted in the elimination from IAS 23 of the former option of expensing borrowing costs associated with long-term asset construction efforts. IAS 23, as revised in 2007, thus converged to the parallel US GAAP standard (FAS 34), which requires capitalization of interest under defined circumstances. The new requirements are explained in Chapter 10.

**Income taxes.** Accounting for income taxes has received much attention by both IASB and FASB over the decades, due to the divergence between the timing of actual tax payments and the reporting of the effects of taxes in the income statement. The desire was to converge to the US GAAP positions, which were seen as being more fully developed, including explicit guidance concerning uncertain tax positions, which was absent under IFRS. Both IFRS and US GAAP have long embraced comprehensive interperiod allocation using the liability method, but certain exceptions are permitted, and these are expected to be narrowed or eliminated by revisions still under consideration. An Exposure Draft of a replacement for IAS 12, the current international standard, was released in early 2009, with a final standard promised for 2010. This is fully discussed in Chapter 17.

Regarding segment disclosures, IFRS now replicates US GAAP, thanks to the promulgation of IFRS 8. This is expected to ease the current challenge of developing segment data under IFRS.

**Segment reporting.** The adoption of IFRS 8 in 2006 largely converged IFRS to US GAAP practice, and further minor changes were made effective in early 2009, as discussed in Chapter 22.

**Leases.** As detailed in Chapter 16, the long-simmering effort to rationalize accounting for leases, at least from the lessee side, appears likely to be soon resolved, as IASB has developed, as a preliminary views document, a comprehensive new approach that would supersede the lessee accounting requirements of IAS 17. Lessor accounting and a few other specialized concerns arising from contractual rights to use property may require separate attention. An Exposure Draft is expected on lessee accounting in 2010, and a final standard is anticipated for 2011.

**Management commentary.** Financial reports often contain materials beyond the financial statements and associated informative disclosures (footnotes). It is customary, and in some settings required (the US SEC's requirement for management discussion and analysis, referred to as MD&A, is often cited), that management offer narrative discussion materials

regarding interpretations of the events and conditions affecting the business, which complements what is reported in the financial statements themselves, as well as supplementary information that is often crucial to an understanding of results of operations and financial condition, but which has no formal place in the actual financial statements—such as order backlogs, planned capital expenditures, and insights regarding new product pipelines.

IASB released an Exposure Draft, *Management Commentary*, in June 2009. This Exposure Draft was prepared based on the understanding that management commentary lies within the broad boundaries of financial reporting and, therefore, is within the scope of the conceptual framework for financial reporting, currently under development. The intention is that this draft be read together with *An Improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting*, and *Chapter 2: Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*, which were released by IASB in May 2008. IASB has stated that this Exposure Draft will not result in an IFRS, and thus reporting entities would not be required to follow the guidance if they are purporting to present their financial statements in accordance with IFRS. This guidance is meant to be directed towards public companies; however, it is not mandated that public companies publish management commentaries, either.

Management commentary is intended to express management's unique perspective on the entity. It supplements the financial statements by including additional explanations of amounts presented in the financial statements and by explaining the conditions and events that shaped that information. It also complements the financial statements by including financial and nonfinancial information about the entity and its performance that is not, and should not be, presented in the financial statements.

Management commentary should focus on not only the present but also the past and future. Concerning the past, management should discuss the entity's resources and claims to those resources. It should present trends and discuss transactions and events that have affected those resources. Commentary should also contain forward-looking information for the readers of the financial statements when appropriate, including management's objectives and strategies, to improve the financial statements' decision-usefulness. When management is aware of trends, uncertainties or other factors that could affect the entity's liquidity, capital resources, revenues and results of the operations, this type of information should be included in the management commentary. This commentary should also address how any forward-looking information in previous years' financial statements has changed.

Building upon the Conceptual Framework, this Exposure Draft explains that in order to be useful, information must possess the fundamental qualitative characteristics of relevance and faithful representation. Characteristics of comparability, verifiability, timeliness and understandability enhance the usefulness of the information. This draft identifies the key content elements of a decision-useful management commentary as

1. The nature of the business;
2. Management's objectives and strategies for meeting those objectives;
3. The entity's most significant resources, risks and relationships;
4. The results of operations and prospects; and
5. The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

IASB is asking for comments on two main questions related to this Exposure Draft. The first question is about the decision to develop a guidance document for management commentary. The second question is about the usefulness of the content elements previously described, and their necessity for the preparation of decision-useful management commentary. This Exposure Draft is open for comments until March 2010.

**Other convergence projects.** Other convergence projects still under development on discussion include those addressing derecognition criteria (exposure document issued in early 2009), accounting for discontinued operations and noncurrent assets held for sale (Exposure Draft issued late 2008, final standard promised before year-end 2009), revisions to earnings per share computations (an Exposure Draft was issued mid-2008, final standard anticipated in 2010), refinement to IFRS 1 regarding transition to IFRS setting forth two additional exemptions (finalized mid-2009, as detailed in Chapter 29), and amendments to the requirements for related-party disclosures (exposed in revised form in late 2008, with a final standard due in late 2009).

Accounting requirements for joint ventures will likely be changed to delete the currently available option of applying the proportionate consolidation method, thus permitting only the equity method, as is the case under US GAAP. (Note that there are a few instances where US GAAP does permit proportionate consolidation, and IFRS may preserve limited options as well.) An Exposure Draft was published in late 2007, and a final standard is anticipated for late 2009.

### Europe 2009 Update

The IASB's long effort to gain acceptance for IFRS began to bear fruit about a decade ago, when the EU briefly considered and then, significantly, abandoned a quest to develop Euro-GAAP, and when IOSCO endorsed, with some qualifications, the "core set of [IAS] standards" following major revisions to most of the then-extant IFRS. A significant impediment was removed with the late 2007 decision by the US Securities and Exchange Commission to eliminate the longstanding requirement for reconciliation of major items to US GAAP. However, since "Euro-IFRS" contains several "carve-outs" from the standards promulgated by IASB, this waiver will not apply to European publicly held entities. This may serve as an impetus for changes in the EU rules previously adopted.

Beginning January 1, 2005, all European Union (EU)-based companies having securities listed on an EU exchange have been required to prepare consolidated (group) accounts in conformity with IFRS. It is estimated that this requirement has affected approximately 7,000 companies, of which some 3,000 are in the United Kingdom. Companies traded both in the EU and on a regulated market outside the EU that were already in 2005 applying another set of internationally accepted standards (for example US Generally Accepted Accounting Principles [GAAP]), and companies that have issued debt instruments but not equity instruments could be temporarily exempted by the member states and not required to comply with IFRS until January 1, 2007. Consequently, companies that took advantage of this exemption (for example Deutsche Bank) were required to implement IFRS in 2007.

On November 15, 2007, the US Securities and Exchange Commission (SEC) eliminated the requirement for foreign registrants to reconcile their financial statements to US GAAP, if the financial statements fully adhere to IFRS as published by the IASB. This regulation helped EU companies, such as Deutsche Bank, in their financial reporting requirements for listing in the US. SEC thus acknowledged that IFRS has the potential to become the global set of high-quality reporting standards, and that investors, issuers, and markets would benefit from the improved comparability of financial reporting across national borders.

It is thought to be quite possible that, within some reasonable interval of time, all the EU states will at least *permit* IFRS in the consolidated accounts of nonlisted companies, although this permission, in some states, might not extend to certain types of companies such as small entities or charities. Additionally, it is possible that most of the EU states will permit IFRS in the annual (i.e., not consolidated, so-called statutory) accounts of all companies, again

possibly subject to some exceptions. Furthermore, some EU states, such as the UK, have already begun to converge their national accounting rules with IFRS.

Privately held EU companies may, if permitted to do so, choose to utilize IFRS for many sound reasons (e.g., for comparability purposes), in anticipation of eventual convergence of national standards with IFRS, and at the specific request of stakeholders such as the entities' credit and investment constituencies.

The remaining impediment to full IFRS conformity among the affected EU companies pertains to the financial instruments standard, IAS 39 which has proved to be extraordinarily controversial, at least among some reporting entities, particularly financial institutions in some, but not all, European countries. Originally, as noted above, all IAS/IFRS standards were endorsed, *except* IAS 32 and IAS 39, as to which endorsement was postponed, nominally because of expected further amendments coming from IASB, but actually due to the philosophical or political dispute over use of fair value accounting for financial instruments and hedging provisions. The single most important of the concerns pertained to accounting for "core deposits" of banks, which drew objections from five of the six dissenting votes on the EFRAG (European Financial Reporting Advisory Group) Technical Expert Group (TEG). In fact, the dissents were a majority of the eleven-member TEG, but since it takes a two-thirds vote to refuse endorsement, the tepid support would be sufficient.

Notwithstanding that IASB had promised a "stable platform" of rules (i.e., no changes or new standards to be issued during the massive transition to IFRS in Europe, so that preparers could be spared the frustration of a moving target as they attempted to prepare, usually, January 1, 2004 restated statements of financial position and 2004 and 2005 financial statements under IFRS), the controversy over IAS 39 resulted in a number of amendments being made in 2005, mostly in order to mollify EU member states. Thus, IAS 39 was (separately) amended to deal with macrohedging, cash flow hedges of forecast intragroup transactions, the "fair value option," and financial guarantee contracts. (These changes are all addressed in this publication.)

Notwithstanding these efforts to satisfy EU member state concerns about specific aspects of IAS 39, the final EU approval was still qualified, with an additional "carve out" identified. Thus, there is the specter of partial compliance with IFRS, and independent auditors were forced to grapple with this when financial statements prepared in accordance with Euro-IFRS were first prepared for issuance in early 2006. At this point in time, the representation that financial statements are "in accordance with IFRS" can be invoked only when the reporting entity fully complies with IFRS, as the standards have been promulgated (and amended, when relevant), but without any deviations permitted in the EU legislation. Auditor references to IFRS have therefore been tempered by citing IFRS as endorsed by the EU as the basis of accounting.

### **Impact of IFRS Adoption by EU Companies**

The effect of the change to IFRS has varied from country to country and from company to company. National GAAP of many European countries were developed to serve or facilitate tax and other regulatory purposes, so principles differed from state to state. The case study of a Belgian company, included in an appendix to this chapter, reveals the nature of many of the differences between IFRS and national GAAP reporting.

Complexity usually means additional cost. One survey of 1,000 European companies indicated that the average compliance cost across UK companies was expected to be about £360,000. This figure was expected to rise to £446,000 for a top-500 company; to £625,000 for companies with a market capitalization value between £1bn-£2bn; and to an amount in excess of £1m for companies valued at more than £2bn.

Implementation, however, is not the only difficulty, and possibly not even the most significant one. Changes in principles can mean significant changes in statements of comprehensive income or statements of financial position. In a 2002 survey of EU companies, two-thirds of respondents indicated that the adoption of IFRS would have a medium to high impact on their businesses (of course, it is typical that more harmful results often are anticipated than are ultimately realized).

One of the most important effects of the change to IFRS-basis financial reporting will reverberate throughout companies' legal relationships. Obviously, companies must make appropriate disclosure to their stakeholders in order to properly explain the changes and their impact. Additionally, accountants and lawyers will also have to review the significantly expanded footnote disclosures required by IFRS in financial statements.

In addition to appropriate stakeholder disclosure, companies must reexamine legal relationships which are keyed to accounting reports. Changed accounting principles can undermine carefully crafted financial covenants in shareholder agreements, financing contracts and other transactional documents.

Drafters must examine the use of "material adverse change" triggers in the context of businesses whose earnings may be subject to accounting volatility. Debt, equity and lease financing arrangements may require restructuring due to unanticipated changes in reported results arising from the use of IFRS.

For example, IFRS may require a reclassification of certain financial instruments previously shown as equity on a company's statement of financial position into their equity and debt components. Additionally, IFRS permits companies to adjust the carrying values of investment property (real estate) to fair market values with any gains being reflected in profit or loss for the period.

Executives may be concerned about compensation systems tied to earnings increases between measurement dates when earnings can be so volatile, or they may simply be concerned that compensation arrangements are keyed to results that are no longer realistic.

Few companies want to entertain dated or "frozen" GAAP for document purposes because of the costs involved in maintaining two separate systems of accounting or an extensive set of "off-line" adjustments. As a result, companies, their lawyers and accountants will have to reexamine agreements in light of the anticipated effect of IFRS on companies' financial statements.

**APPENDIX A****CURRENT INTERNATIONAL FINANCIAL REPORTING STANDARDS  
(IAS/IFRS) AND INTERPRETATIONS (SIC/IFRIC)**

(Recent revisions noted parenthetically)

IAS 1	Presentation of Financial Statements (revised 2007, effective 2009, with additional amendments and improvements effective 2008, 2009, and 2010)
IAS 2	Inventories (revised 2003, effective 2005)
IAS 7	Statement of Cash Flows (amended effective 2009 and 2010)
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors (revised 2003, effective 2005)
IAS 10	Events After the Reporting Period (revised 2003, effective 2005)
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant, and Equipment (revised 2003, effective 2005, and amendments effective 2009)
IAS 17	Accounting for Leases (revised 2003, effective 2005, and amended effective 2010)
IAS 18	Revenue (minor amendment 2009)
IAS 19	Employee Benefits (revised 2004 and 2008)
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance (amended effective 2009)
IAS 21	The Effects of Changes in Foreign Exchange Rates (revised 2003, effective 2005; minor further amendment 2005, further amended effective 2009)
IAS 23	Borrowing Costs (revised 2007, effective 2009)
IAS 24	Related-Party Disclosures (revised 2003, effective 2005)
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements (revised 2008, effective 2009)
IAS 28	Accounting for Investments in Associates (revised 2003, effective 2005; further revised effective 2009)
IAS 29	Financial Reporting in Hyperinflationary Economies (revised effective 2009)
IAS 31	Financial Reporting of Interests in Joint Ventures (revised 2003, effective 2005; further amended effective 2009)
IAS 32	Financial Instruments: Presentation (revised 2003, effective 2005; disclosure requirements removed to IFRS 7 effective 2007; further amended effective 2009)
IAS 33	Earnings Per Share (revised 2003, effective 2005; minor amendments effective 2009)
IAS 34	Interim Financial Reporting (minor amendments effective 2009)
IAS 36	Impairments of Assets (revised 2004; amended effective 2009 and 2010)
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets

IAS 38	Intangible Assets (revised 2004; amended effective 2009)
IAS 39	Financial Instruments: Recognition and Measurement (amended 2005; further amended effective 2008, 2009, and 2010)
IAS 40	Investment Property (revised 2003, effective 2005; further amended effective 2009)
IAS 41	Agriculture (amended effective 2009)
IFRS 1	First-Time Adoption of IFRS (minor amendment 2005; restructured 2008; further amended effective 2009)
IFRS 2	Share-Based Payment (amended effective 2008, 2009, and 2010)
IFRS 3	Business Combinations (revised 2008, effective 2009)
IFRS 4	Insurance Contracts (amended effective 2005)
IFRS 5	Noncurrent Assets Held for Sale and Discontinued Operations (amended effective 2005, 2009, and 2010)
IFRS 6	Exploration for and Evaluation of Mineral Resources (amended 2005)
IFRS 7	Financial Instruments: Disclosures (amended effective 2008 and 2009)
IFRS 8	Operating Segments (revised effective 2010)
SIC 7	Introduction of the Euro
SIC 10	Government Assistance—No Specific Relation to Operating Activities
SIC 12	Consolidation—Special-Purpose Entities
SIC 13	Jointly Controlled Entities—Nonmonetary Contributions by Venturers
SIC 15	Operating Leases—Incentives
SIC 21	Income Taxes—Recovery of Revalued Nondepreciable Assets
SIC 25	Income Taxes—Changes in the Tax Status of an Enterprise or Its Shareholders
SIC 27	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
SIC 29	Disclosure—Service Concession Arrangements
SIC 31	Revenue—Barter Transactions Involving Advertising Services
SIC 32	Intangible Assets—Web Site Costs
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Cooperative Entities and Similar Instruments
IFRIC 4	Determining Whether an Arrangement Contains a Lease
IFRIC 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, <i>Financial Reporting in Hyperinflationary Economies</i>
IFRIC 8	Scope of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment

- IFRIC 11 IFRS 2: Group and Treasury Share Transactions
- IFRIC 12 Service Concession Arrangements
- IFRIC 13 Customer Loyalty Programs
- IFRIC 14 IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and Their Interaction
- IFRIC 15 Agreements for the Construction of Real Estate
- IFRIC 16 Hedges of a Net Investment in a Foreign Operation

## APPENDIX B

### REVISED IAS 1, *PRESENTATION OF FINANCIAL STATEMENTS*

As noted in the body of the chapter, IASB has been pursuing a multiphase project dealing with financial statement presentation. The issuance of revised IAS 1, *Presentation of Financial Statements*, represented the culmination of the first stage of this undertaking. Later phases will address more fundamental issues for presenting information on the face of the financial statements, including: consistent principles for aggregating information in each financial statement; the totals and subtotals that should be reported in each financial statement; whether components of other recognized income and expense should be reclassified to profit and loss; and whether the direct or the indirect method of presenting operating cash flows provides more useful information. The IASB and FASB have decided that financial statements should present information in a manner that reflects a cohesive financial picture of an entity and which separates an entity's financing activities from its business and other activities as well as from its transactions with owners. Additionally, financing activities should be separated into transactions with owners and all other financing activities. Yet another phase of the project will deal with interim financial reporting.

The revised IAS 1 is largely in line with the corresponding US GAAP standard—FAS 130, *Reporting Comprehensive Income*. The FASB decided that it would not publish a separate Exposure Draft on this phase of the project but will expose issues pertinent to this and the next phase together in the future.

Revised IAS 1 is effective for annual periods beginning on or after January 1, 2009, with early application permitted.

**Objective of revised IAS 1.** IAS 1 prescribes the basis for presentation of general-purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure, and minimum requirements for their content. In revising IAS 1, IASB's main objective was to aggregate information in the financial statements on the basis of shared characteristics. Other sources of guidance on the financial statement presentation can be found in IAS 7, 8, 10, 12, 18, 24, 27, 34, and IFRS 5.

**Scope of IAS 1.** IAS 1 applies to all entities, including profit-oriented and not-for-profit entities. Non-for-profit entities in both the private and public sectors can apply this standard, however they may need to change the descriptions used for particular line items within their financial statements and for the financial statements themselves. This standard applies to those entities that present consolidated financial statements and those that present financial statements as defined in IAS 27, *Consolidated and Separate Financial Statements*. It does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34, *Interim Financial Reporting*.

**Purpose of financial statements.** IAS 1, which previously had been substantially revised in 2003, and which received further amendments in 2005 and 2008, and additionally for annual improvements in 2008 and 2009, refers to financial statements as "a structured representation of the financial position and financial performance of an entity" and elaborates that the objective of financial statements is to provide information about an entity's financial position, its financial performance, and its cash flows, which is then utilized by a wide spectrum of end users in making economic decisions. In addition, financial statements also show the results of the management's stewardship of the resources entrusted to it. All this information is communicated through a complete set of financial statements.

**Presentation of financial statements.** IAS 1 defines a complete set of financial statements to be comprised of the following:

1. A statement of financial position as at the end of the period:
  - a. The previous version of IAS 1 used the title “balance sheet.” The revised standard uses the title “statement of financial position.”
2. A statement of comprehensive income for the period:
  - a. Components of profit or loss may be presented either as part of a single statement of comprehensive income or in a separate income statement.
  - b. When an income statement is presented, it becomes part of a complete set of financial statements.
  - c. The income statement should be displayed immediately before the statement of comprehensive income.
3. A statement of changes in equity for the period;
4. A statement of cash flows for the period;
  - a. The previous version of IAS 1 used the title “cash flow statement.” The revised standard uses the title “statement of cash flows.”
5. Notes, comprising a summary of significant accounting policies and other explanatory information; and
6. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.
  - a. This requirement is part of the revised IAS 1.

Financial statements, except for cash flow information, are to be prepared using accrual basis of accounting.

**Fairness exception under IAS 1.** There is a subtle difference between US GAAP and what was required by many European countries regarding the use of an override to assure a fair presentation of the company’s financial position and results of operations. US auditing standards require a *fair presentation in accordance with GAAP*, while the European Fourth Directive requires that statements offer a *true and fair view* of the company’s financial situation. If following the literal financial reporting requirements does not provide this result, then the entity should first consider the salutary effects of providing supplementary disclosures. However, if that is not seen as being sufficient to achieve a true and fair view, the entity may conclude that it must override (that is, ignore or contravene) the applicable accounting standard. US standards contain a rarely invoked exception that permits departure from GAAP if compliance would not result in financial reporting that was deemed appropriate to communicate financial position and results of operations.

IAS 1 has a similar approach. It states the expectation that the use of IFRS will result, *in virtually all circumstances*, in financial statements that achieve a fair presentation. However, in extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity can depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure, and the entity discloses all of the following:

1. Management has concluded that the financial statements present fairly the entity's financial position, financial performance, and cash flows;
2. The entity has complied with all applicable IFRS, except that it has departed from a particular requirement to achieve a fair presentation;
3. The title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Framework*, and the treatment adopted; and
4. For each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

When an entity has departed from a requirement of an IFRS in a prior period, and that departure affects the amounts recognized in the current period, it shall make the disclosures as in 3. and 4. above.

The standard notes that deliberately departing from IFRS might not be permissible in some jurisdictions, in which case the entity should comply with the standard in question and disclose in the notes that it believes this to be misleading, and show the adjustments that would be necessary to avoid this distorted result. In extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, but the relevant regulatory framework prohibits departure from the requirement, to the maximum extent possible, the entity is required to reduce the perceived misleading aspects of compliance by disclosing all of the following:

1. The title of the IFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the *Framework*, and
2. For each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

When assessing whether complying with a specific requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, management should consider the following:

1. Why the objective of financial statements is not achieved in the particular circumstances; and
2. How the entity's circumstances differ from those of other entities that comply with the requirement.
  - a. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the *Framework*.

**Going concern.** When preparing financial statements, management makes an assessment regarding the entity's ability to continue as a going concern. If the result of the assessment casts significant doubt upon the entity's ability to continue as a going concern, management is required to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

**Accrual basis of accounting.** Financial statements, except for cash flow information, are to be prepared using accrual basis of accounting.

**Materiality and aggregation.** An entity should present separately each material class of similar items as well as present separately material items of dissimilar nature or function. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. It is not necessary for an entity to provide a specific disclosure required by an IFRS if the information is not material.

**Offsetting.** Assets and liabilities, or income and expenses, may not be offset against each other, unless required or permitted by an IFRS. However, the reduction of accounts receivable by the allowance for doubtful accounts, or of property, plant, and equipment by the accumulated depreciation, are acts that reduce these assets by the appropriate valuation accounts and are not considered to be offsetting assets and liabilities.

**Frequency of reporting.** An entity should present a complete set of financial statements (including comparative information) at least annually. If the reporting period changes such that the financial statements are for a period longer or shorter than one year, the entity should disclose the reason for the longer or shorter period and the fact that the amounts presented are not entirely comparable.

**Comparative information.** An entity is required to include a statement of financial position as at the beginning of the earliest comparative period whenever an entity retrospectively applies an accounting policy, or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. In those limited circumstances, an entity is required to present, as a minimum, three statements of financial position and related notes, as at

1. The end of the current period;
2. The end of the previous period (which is the same as the beginning of the current period); and
3. The beginning of the earliest comparative period.

When the entity changes the presentation or classification of items in its financial statements, the entity should reclassify the comparative amounts, unless reclassification is impractical. In reclassifying comparative amounts, the required disclosure includes (1) the nature of the reclassification; (2) the amount of each item or class of items that is reclassified; and (3) the reason for the reclassification. In situations where it is impracticable to reclassify comparative amounts, an entity should disclose (1) the reason for not reclassifying the amounts and (2) the nature of the adjustments that would have been made if the amounts had been reclassified.

**Consistency of presentation.** The presentation and classification of items in the financial statements should be consistent from one period to the next. A change in presentation and classification of items in the financial statements may be required when there is a significant change in the nature of the entity's operations, another presentation or classification is more appropriate (having considered the criteria of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*), or when an IFRS requires a change in presentation. When making such changes in presentation, an entity should reclassify its comparative information and present adequate disclosures (see comparable information above).

The revised IAS 1 is effective for annual periods beginning on or after January 1, 2009, with early application permitted.

## APPENDIX C

### IFRS FOR SMEs

A longstanding debate among professional accountants, users and preparers—between those advocating for some form of simplified financial reporting standards for (variously defined) smaller or nonpublicly responsible entities, and those arguing that all reporting entities purporting to adhere to officially mandated accounting standards do so with absolute faithfulness—has now been resolved. On July 9, 2009, IASB published *International Financial Reporting Standards (IFRS) for Small and Medium-Sized Entities (IFRS for SMEs)*. Notwithstanding the name, it is actually intended as an optional, somewhat simplified and choice-limited comprehensive financial reporting standard for enterprises not having public accountability.

A parallel debate raged in the UK, the US, and in other national GAAP domains for decades. In the US a number of inchoate proposals have been offered over at least the past thirty years, but no serious proposal was forthcoming, largely because the idea of differential recognition or measurement standards for smaller entities was seen as conceptually unappealing, leaving the relatively trivial issue of differential disclosures as the focus of discussion. Apart from a limited number of disclosure topics, such as segment results and earnings per share, and some pension obligation details, this proved to not be a very productive line of inquiry, and no sweeping changes were ever adopted or even proposed.

In the UK, the story was different. A single, comprehensive standard, *Financial Reporting Standards for Smaller Entities (FRSSE)*, was successfully implemented over a decade ago, and then revised several times, employing a periodic updating strategy that IASB now appears likely to emulate. Rather than impose different recognition or measurement concepts on smaller entities, the approach taken, in the main, was to slim down the standards, eliminate much of the background and illustrative materials, and in some cases narrow or eliminate the alternative methods that users of full UK GAAP could elect to apply, with some concomitant simplifications to informative disclosures. Since this was deemed to have been successful in the UK, IASB determined to emulate it, beginning with a discussion paper in 2004, and continuing through an early-2007 Exposure Draft and a final standard in mid-2009.

The enthusiasm and support that was shown for the IFRS for SMEs project from national accounting standard setters throughout the world stemmed mostly from the widely acknowledged complexity of the full body of IFRS, and from the different statutory requirements for financial reporting in many countries, which in many instances demands that audited financial statements, without any qualifications, be submitted to tax or other authorities. For example, in the European Union about 7,000 listed companies were implementing IFRS in 2005, but more than 5 million SMEs are required to prepare their financial statements in accordance with various national GAAP, resulting in lack of comparability across this sector of financial reporting entities. Reportedly, more than 50 different sets of standards govern private reporting in the 27 EU nations.

It had long been asserted, although often without solid evidence, that the complexity of the full body of IFRS (and, even more so, of full US GAAP) imposes a high and unwelcome cost on implementing and applying these standards, and that many or most external users of the resulting financial statements did not see value commensurate with the cost and effort associated with their preparation. Whether or not this is true, many now believe that *IFRS for SMEs* will provide companies with an easier transition to the full IFRS, thus serving to accomplish, in the longer term, a more thorough and broadly based move toward universal reporting under a single set of financial reporting standards.

Opponents of a separate set of standards for SMEs believe that all entities should follow the same basic set of accounting principles for the preparation of general-purpose financial statements, whether that set of standards be IFRS or US GAAP. Some have noted that complexity in accounting is merely a symptom—the inevitable result of the ever-increasing complexity of transactional structures, such as the widespread use of “engineered” financial products. Based on observations of the difficulties faced by companies implementing and applying the full IFRS, others have concluded that the problem is not that SMEs need simpler accounting, but that all reporting entities would benefit from reporting requirements that are less complex and more principles-based. Since this latter goal seemed to be perpetually unattainable, momentum ultimately shifted in favor of having a simplified stand-alone standard for either smaller or nonpublic companies. *IFRS for SMEs*, available for use by non-publicly accountable entities of any size, is the solution that has been rendered by IASB to this chronic problem.

Because the IASB lacks the power to require any company to use its standards, the adoption of *IFRS for SMEs* is a matter for each country to decide. The issue must be resolved by a country’s government legislators and regulators, or by an independent standards setter, or by a professional accountancy body. Each country will need to establish criteria to determine eligibility of reporting entities seeking to qualify under this new standard as a “small or medium-sized” entity.

### Definition of SMEs

*IFRS for SMEs* is intended for entities that do not have public accountability. An entity has public accountability—and therefore would not be permitted to use the full IFRS—if it meets either of the following conditions: (1) it has issued debt or equity securities in a public market; or (2) it holds assets in a fiduciary capacity, as its primary purpose of business, for a broad group of outsiders. The latter category of entity would include banks, insurance companies, securities broker/dealers, pension funds, mutual funds, and investment banks. The standard does not impose a size test in defining SMEs, notwithstanding the nomenclature used.

The standard also states that the standard is intended for entities that publish financial statements for external users; as with IFRS and US GAAP, in other words, the standard is not intended to govern internal or managerial reporting (although there is nothing to prevent such reporting from fully conforming to such standards).

A subsidiary of an entity that employs full IFRS, or an entity that is part of a consolidated entity that reports in compliance with IFRS may report, on a stand-alone basis, in accordance with *IFRS for SMEs*, if the financial statements are so identified, and if the subsidiary does not have public accountability itself. If this is done, that standard must be fully complied with, which could mean that the subsidiary’s stand-alone financial statements would differ from how they are presented within the parent’s consolidated financial statements; for example, in the subsidiary’s financial statements prepared in accordance with *IFRS for SMEs*, borrowing costs incurred in connection with construction of long-lived assets would be expensed as incurred, but those same borrowing costs would be capitalized in the consolidated financial statements, since IAS 23 as most recently revised no longer provides the option of immediate expensing. In the authors’ view, this would not be optimal financial reporting, and the goals of consistency and comparability would be better served if the stand-alone financial statements of the subsidiary also were based on full IFRS.

### ***IFRS for SMEs Is a Complete, Self-Contained Set of Requirements***

*IFRS for SMEs* is a complete and comprehensive standard, and accordingly contains much or most of the vital guidance provided by the full IFRS. For example, it defines the qualities that are needed for IFRS-compliant financial reporting (reliability, understandability, et al.), the elements of financial statements (assets, liabilities, et al.), the required minimum captions in the required full set of financial statements, the mandate for comparative reporting, and so forth. There is no need for an entity reporting under this standard to refer elsewhere (other than for guidance in IAS 39, discussed below), and indeed it would be improper to do so.

An entity having no public accountability that elects to report in conformity with *IFRS for SMEs* must make an “explicit and unreserved” declaration to that effect in the notes to the financial statements. As with a representation that the financial statements comply with (full) IFRS, if this representation is made, the entity must comply fully with all relevant requirements in the standard(s).

Many options under full IFRS remain under *IFRS for SMEs*. For example, a single statement of comprehensive income can be presented, with profit or loss being an intermediate step in the derivation of the period’s comprehensive income or loss, or alternatively a separate statement of income can be displayed, with profit or loss (the “bottom line” in that statement) then being the opening item in the separate statement of comprehensive income. Likewise, most of the mandates under full IFRS, such as the need to consolidate special-purpose entities that are controlled by the reporting entity, also exist under *IFRS for SMEs*.

### **Modifications of Full IFRS Made for *IFRS for SMEs***

Compared to the full IFRS, the aggregate length of the standards, in terms of number of words, has been reduced by more than 90%. This was achieved by eliminating topics deemed to not be generally relevant to SMEs, by eliminating certain choices of accounting treatments, and by simplifying methods for recognition and measurement. These three sets of modifications to the content of the full IFRS, which are discussed below, respond to both the perceived needs of users of SMEs’ financial statements and to cost-benefit concerns. According to the IASB, the set of standards in the *IFRS for SMEs* will be suitable for a typical enterprise having 50 employees, and will also be valid for so-called microentities having only a single or a few employees. However, no size limits are stipulated in the standard, and thus even very large entities could conceivably elect to apply *IFRS for SMEs*, assuming they have no public accountability as defined in the standard, and that no objections are raised by their various other stakeholders, such as lenders, customers, vendors, or joint venture partners.

**Omitted topics.** Certain topics covered in the full IFRS were viewed as not being relevant to typical SMEs (e.g., rules pertaining to transactions that were thought to be unlikely to occur in an SME context), and have accordingly been omitted from the standard. This leaves open the question of whether SMEs could optionally seek expanded guidance in the full IFRS. Originally, when the Exposure Draft of *IFRS for SMEs* was released, cross-references to the full IFRS were retained, so that SMEs would not be precluded from applying any of the financial reporting standards and methods found in IFRS, essentially making the *IFRS for SMEs* standard entirely optional on a component-by-component basis. However, in the final *IFRS for SMEs* standard all of these cross-references have been removed, with the exception of a reference to IAS 39, *Financial Instruments: Recognition and Measurement*, thus making *IFRS for SMEs* a fully stand-alone document, not to be used in conjunction with the full IFRS. An entity that would qualify for use of *IFRS for SMEs* must therefore make a decision to use full IFRS or *IFRS for SMEs* exclusively.

Topics addressed in the full IFRS that are entirely omitted from the IFRS for SME standard are as follows:

- Earnings per share;
- Interim reporting;
- Segment reporting;
- Special accounting for assets held for sale.
- Insurance (since, because of public accountability, such entities would be precluded from using *IFRS for SMEs* in any event).

Thus, for example, if a reporting entity concluded that its stakeholders wanted presentation of segment reporting information, and the entity's management wished to provide that to them, it would elect to prepare financial statements in conformity with the full set of IFRS, eschewing use of *IFRS for SMEs*.

**Only the simpler option included.** Where full IFRS provide an accounting policy choice, generally only the simpler option is included in *IFRS for SMEs*. SMEs will not be permitted to employ the other option(s) provided by the full IFRS, as had been envisioned by the Exposure Draft that preceded this standard, as all cross-references to the full IFRS have been eliminated.

The simpler options selected for inclusion in *IFRS for SMEs* are as follow, with the excluded alternatives noted:

- For investment property, measurement is driven by circumstances rather than a choice between the cost and fair value models, both of which are permitted under IAS 40, *Investment Property*. Under provisions of *IFRS for SMEs*, if the fair value of investment property can be measured reliably without undue cost or effort, the fair value model must be used. Otherwise, the cost method is required.
- Use of the cost-amortization-impairment model for property, plant, and equipment and intangibles is required; the revaluation model set forth by IAS 16, *Property, Plant, and Equipment*, and IAS 38, *Intangible Assets*, is not allowed.
- Immediate expensing of borrowing costs is required; the capitalization model stipulated under revised IAS 23 is not deemed appropriate for SMEs.
- Jointly controlled entities cannot be accounted for under the proportionate consolidation method under *IFRS for SMEs*, but can be under full IFRS as they presently exist. *IFRS for SMEs* does permit the use of the fair-value-through-earnings method as well as the equity method, and even the cost method can be used when it is not possible to obtain price or value data.
- Entities electing to employ *IFRS for SMEs* are required to expense development costs as they are incurred, together with all research costs. Full IFRS necessitates making a distinction between research and development costs, with the former expensed and the latter capitalized and then amortized over an appropriate period receiving economic benefits.

It should be noted that the Exposure Draft that preceded *IFRS for SMEs* would have required that the direct method for the presentation of operating cash flows be used, to the exclusion of the less desirable, but vastly more popular, indirect method. The final standard has retreated from this position and permits both methods, so it includes necessary guidance on application of the indirect method, which was absent from the draft.

All references to full IFRS found in the draft of this standard have been eliminated, except for the reference to IAS 39, which may be used, optionally, by entities reporting under *IFRS for SMEs*. The general expectation is that few reporting entities will opt to do this, since the enormous complexity of that standard was a primary impetus to the development of the streamlined *IFRS for SMEs*.

It is inevitable that some financial accounting or reporting situations will arise for which *IFRS for SMEs* itself will not provide complete guidance. The standard provides a hierarchy, of sorts, of additional literature upon which reliance could be placed, in the absence of definitive rules contained in *IFRS for SMEs*. First, the requirements and guidance that is set forth for highly similar or closely related circumstances would be consulted within *IFRS for SMEs*. Second, the *Concepts and Pervasive Principles* section (Section 2) of the standard would be consulted, in the hopes that definitions, recognition criteria, and measurement concepts (e.g., for assets, revenues) would provide the preparer with sufficient guidance to reason out a valid solution. Third and last, full IFRS is identified explicitly as a source of instruction. Although reference to US (or other) GAAP is not suggested as a tactic, since full IFRS permits preparers to consider the requirements of national GAAP, if based on a framework similar to full IFRS, this omission may not be fully dispositive.

**Recognition and measurement simplifications.** For purposes of *IFRS for SMEs*, IASB has made significant simplifications to the recognition and measurement principles included in full IFRS. Examples of the simplifications to the recognition and measurement principles found in IFRS are as follows:

1. Financial instruments:

- a. *Classification of financial instruments.* Only two categories for financial assets (cost or amortized cost, and fair value through profit or loss) are provided, rather than the four found in full IFRS. Because the available-for-sale and held-to-maturity classifications under IAS 39 are not available, there will be no need to deal with all of the “intent-driven” held-to-maturity rules, or related “tainting” concerns, with no need for an option to recognize changes in value of available-for-sale securities in current profit or loss instead of as an item of other comprehensive income.
- (1) *IFRS for SMEs* requires an amortized cost model for most debt instruments, using the effective interest rate as of initial recognition. The effective rate should consider all contractual terms, such as prepayment options. Investments in nonconvertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably are to be measured at fair value with changes in value reported in current earnings. Most other basic financial instruments are to be reported at cost less any impairment recognized. Impairment or uncollectibility must always be assessed, and, if identified, recognized immediately in profit or loss; recoveries to the extent of losses previously taken are also recognized in profit or loss.
- (2) For more complex financial instruments (such as derivatives), fair value through profit or loss is generally the applicable measurement method, with cost less impairment being prescribed for those instruments (such as equity instruments lacking an objectively determinable fair value) for which fair value cannot be ascertained.
- (3) Assets that would generally not meet the criteria as being basic financial instruments include (a) asset-backed securities, such as collateralized mortgage obligations, repurchase agreements and securitized packages of receivables; (b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument; (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in the standard; (d) commitments to make a loan to another entity; and (e) com-

mitments to receive a loan if the commitment can be net settled in cash. Such instruments would include (a) an investment in another entity's equity instruments other than nonconvertible preference shares and nonputtable ordinary and preference shares; (b) an interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow; (c) options and forward contracts, because returns to the holder are not fixed; (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates; and (e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change.

- b. *Derecognition.* In general, the principle to be applied is that, if the transferor retains any significant risks or rewards of ownership, derecognition is not permitted, although if full control over the asset is transferred, derecognition is valid even if some very limited risks or rewards are retained. The complex "passthrough testing" and "control retention testing" of IAS 39 thus can be omitted, unless full IAS 39 is optionally elected by the reporting entity. For financial liabilities, derecognition is permitted only when the obligation is discharged, cancelled, or expires.
- c. *Simplified hedge accounting.* Much more simplified hedge accounting and less strict requirements for periodic recognition and measurement of hedge effectiveness are specified than those set forth by IAS 39.
- d. *Embedded Derivatives.* No separate accounting for embedded derivatives is required.
  - (1) *Goodwill impairment:* An indicator approach has been adopted to supersede the mandatory annual impairment calculations in IFRS 3, *Business Combinations*. Additionally, goodwill and other indefinite-lived assets are considered to have finite lives, thus reducing the difficulty of assessing impairment.
  - (2) *All research and development costs are expensed* as incurred (IAS 38 requires capitalization after commercial viability has been assessed).
  - (3) *The cost method or fair value through profit or loss of accounting for associates and joint ventures* may be used (rather than the equity method or proportionate consolidation).
  - (4) *Simplified accounting for deferred taxes:* The "temporary difference approach" for recognition of deferred taxes under IAS 12, *Income Taxes*, is allowed with a minor modification. Current and deferred taxes are required to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed.
  - (5) *Less use of fair value for agriculture* (being required only if fair value is readily determinable without undue cost or effort).
  - (6) *Defined benefit plans.* Two of the four options available under IAS 19, *Employee Benefits*, are allowed, that is, to recognize actuarial gains and losses in full in profit and loss when they occur, or to recognize these in full directly in other comprehensive income when they occur. The complex "corridor approach" has been deleted under *IFRS for SMEs*.

- (7) *Share-based payment*: Equity-settled share-based payments should always be recognized as an expense and the expense should be measured on the basis of observable market prices, if available. When there is a choice of settlement, the entity should account for the transaction as a cash-settled transaction, except under certain circumstances.
- (8) *Finance leases*: A simplified measurement of lessee's rights and obligations is prescribed.
- (9) *First-time adoption*. Less prior period data would have to be restated than under IFRS 1, *First-time Adoption of International Financial Reporting Standards*. An impracticability exemption has also been included.

Because the default measurement of financial instruments would be fair value through profit and loss under *IFRS for SMEs*, some SMEs may actually be required to apply more fair value measurements than do entities reporting under full IFRS.

### **Disclosure Requirements under *IFRS for SMEs***

There are indeed certain reductions in disclosure requirements under *IFRS for SMEs* vis-à-vis full IFRS, but these are relatively minor and alone would not drive a decision to adopt this standard. Furthermore, key stakeholders, such as banks, often prescribe supplemental disclosures (e.g., major contracts, compensation agreements) that transcend what is required under IFRS, and this would likely continue to be true under *IFRS for SMEs*.

### **Maintenance of the *IFRS for SMEs***

SMEs have expressed concerns not only over the complexity of IFRS, but also about the frequency of changes to standards. To respond to these issues, IASB intends to update *IFRS for SMEs* approximately once every three years via an "omnibus" standard, with the expectation that any new requirements would not have mandatory application dates sooner than one year from issuance. Users are thus being assured of having a moderately stable platform of requirements.

### **Implications of the *IFRS for SMEs***

*IFRS for SMEs* is a significant development that may have real impact on the future accounting and auditing standards issued by organizations participating in the standard-setting process.

On March 6, 2007, the FASB and the AICPA announced that the newly established Private Company Financial Reporting Committee (PCFRC) will address the financial reporting needs of private companies and of the users of their financial statements. The primary objective of PCFRC will be to help the FASB determine whether and where there should be specific differences in prospective and existing accounting standards for private companies.

In many Continental European countries a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of SME Standards will require breaking the traditional bond between the financial statements and the income tax return, and may well trigger a need to amend company laws.

Since it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards, differential accounting for SMEs will affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the SEC. *IFRS for SMEs* may be a welcome relief for auditors as it will decrease the inherent risk that results from the numerous choices and judgment required by management when utilizing the full version of IFRS. The success of *IFRS for SMEs* will depend on the extent to which users, preparers and their auditors believe the standards meet their needs.

## APPENDIX D

## CASE STUDY TRANSITIONING FROM US GAAP TO IFRS

## Background

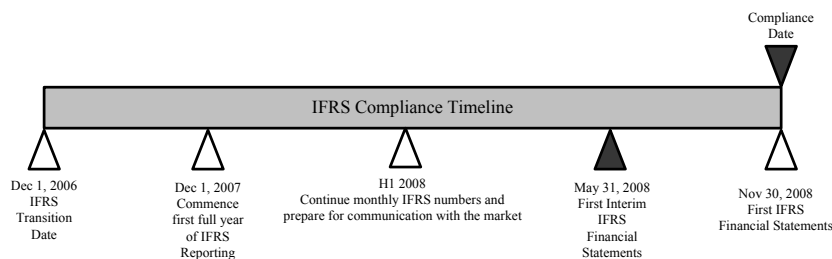
Stolt-Nielsen S.A. (SNSA or the “Company”) is one of the world’s leading providers of transportation services for bulk liquid chemicals, edible oils, acids, and other specialty liquids. The Company, through the parcel tanker, tank container, terminal, rail and barge services of its wholly owned subsidiary Stolt Tankers & Terminals and Stolt Tank Containers, provides integrated transportation solutions for its customers. Stolt Sea Farm, wholly owned by the Company, produces and markets high-quality turbot, sole, sturgeon, and caviar. SNSA is currently listed on the Oslo Stock Exchange under the ticker SNI, and was also listed in the US on the NASDAQ.

On April 19, 2007, the Company announced its intention to voluntarily delist from the NASDAQ Global Select Market with effect from May 21, 2007. Further, it was no longer subject to the registration and reporting obligations under the Securities Exchange Act. The Company continued its listing in Norway on the Oslo Børs. Accordingly, the Company was required to present its financial statements under International Financial Reporting Standards (“IFRS”) for the financial year ending November 30, 2008, and thereafter.

## Legal Structure and Impact on IFRS Transition

SNSA is a Luxembourg registered company, with a “primary” listing on the Oslo Børs following its delisting from NASDAQ and deregistration from the US SEC. Since its flotation on the NASDAQ in 1987, SNSA prepared its financial statements in accordance with generally accepted accounting principles in the United States (“US GAAP”).

European Union Directive 1606/2002 required all listed companies in the European Union<sup>1</sup> to apply IFRS for accounting periods beginning on or after January 1, 2005, along with comparatives for 2004, for annual consolidated financial statements. Article 9 of the Directive provides an exemption to defer preparation of IFRS financial statements for periods beginning on or after January 1, 2007, for companies that prepare financial statements under US GAAP. Luxembourg incorporated this exemption in its commercial legislation. Accordingly, SNSA was required to publish its first audited IFRS financial statements for the year ending November 30, 2008, with prior year comparatives under IFRS for the year ending November 30, 2007. In addition, quarterly financial statements under IFRS are required for each quarter of the years ending November 30, 2007 and 2008. Accordingly, the implementation timeline can be summarized as follows.



<sup>1</sup> At the time of the issue of this Directive, the European Union comprised 15 nations, which had grown to 27 nations as of January 1, 2007, which is the current status as of late 2009.

## Key Dates

IFRS 1 defines specific milestones in the preparation of the first financial statements of a company. The important areas to note while considering the transition date are discussed in the following paragraphs.

Most stock exchanges around the world, including the Oslo Børs, require that the interim or quarterly financial information released to the market should conform to the same accounting standards applied in the presentation of the annual financial statements. For SNSA, this meant that though the first audited IFRS financial statements were only due for the year ending November 30, 2008, the first interim unaudited financial information to be released under IFRS was for the quarter ended February 29, 2008! In effect, this is nine months less than what would appear required under IFRS 1. Furthermore, this also means that the comparative quarterly financial statements for February 28, 2007, must also be prepared in accordance with IFRS.

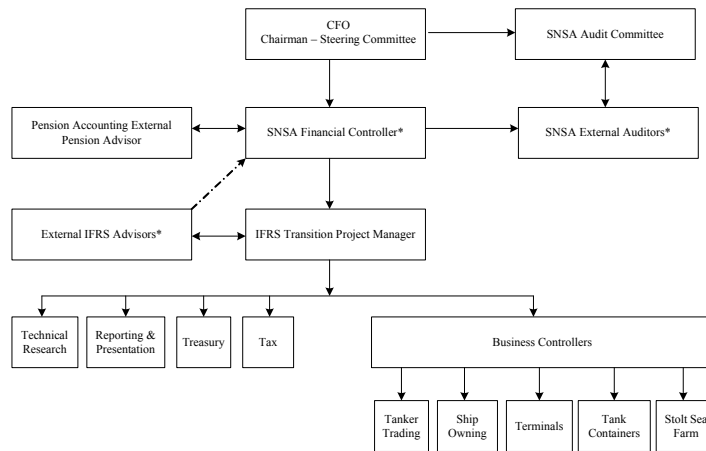
Another important aspect to bear in mind is that IFRS should be applied in full to the financial statements for all the periods presented.

The key dates for financial reporting in accordance with IFRS for SNSA thus were as follows:

Dec 1, 2006	Opening IFRS balance sheet (date of transition) <ul style="list-style-type: none"> <li>• Select policies</li> <li>• Recognize and measure all items using IFRS</li> <li>• Not published</li> </ul>
May 31, 2007	First unaudited Interim Financial Statements <ul style="list-style-type: none"> <li>• Only balance sheet and income statement</li> <li>• Required for comparative information for 2008</li> </ul>
Nov 30, 2007	IFRS comparatives <ul style="list-style-type: none"> <li>• For 2008 full year audited IFRS financial</li> </ul>
Nov 30, 2008	First IFRS Reporting Date <ul style="list-style-type: none"> <li>• Use Standards in force at this date</li> <li>• First full audited IFRS financial statements published along with 2007 comparatives</li> </ul>

## Project Structure and Implementation Approach

One of the key determinants of the success of the implementation was tight project management and a project structure that ensured clear reporting lines and accountability for each step. The project team structure is summarized below.



Overall, the implementation approach involved a mixed team of external advisors, external auditors and a strong in-house team at the Corporate Office to provide project management support and technical accounting support. In addition, the implementation approach involved each of the business controllers along with an external firm to provide hands-on support and technical expertise, both locally and at Corporate, to support the transition process. This ensured that the ultimate ownership of an IFRS issue would rest with the business unit, but with strong support from the Corporate Team. The business controllers were required to provide resource, input and accept responsibility for the IFRS financial statements but were given extensive support both from the Corporate Team and involvement from the external firm. SNSA did not have sufficient resources in the business to implement a project of this scale, complexity, and risk. Further, a number of steps in the transition were “one-off” in nature, and support from an external firm enabled the company to meet its objectives.

To project manage this effectively, a detailed project plan was developed, with week-by-week targets for achievement and responsibilities assigned for deliverables. While there were slippages, no issue was allowed to remain open for over two weeks. The project plan and the implementation were monitored through weekly conference calls of the core team members, including auditors and advisors.

### External Auditor Involvement

SNSA’s external auditors were integrally involved with the transition project to confirm technical accounting issues and agree treatment upfront. There are a number of areas where the external audit firm was able to assist management as an advisor in the IFRS Transition project. However, in order to maintain the requisite independence as auditors, the auditors would not assist management with preparation of financial statements and detailed accounting advice. This independence requirement, while understandable, did make it more difficult for both external auditors and management to achieve the key tasks within the IFRS transition project. In order to mitigate this, the company decided to appoint another Big 4 firm as its advisor on the IFRS Transition Project.

### Training

Management conducted five IFRS Transition Training Workshops, including one for the Audit Committee, where the CEO was present. This was critical to establish buy-in and commitment from the top at the early stage of the project. Each of the workshops was targeted a different audience so there was a significant amount of customization to the training

program. The importance of this phase cannot be overemphasized: it is vitally important to plan this in advance. In addition to the training there were a significant element of change management issues surrounding knowledge transfer and the ability of accounting staff to come to a new understanding of the building blocks (or DNA) of SNSA's financial statements.

### **So Where Did SNSA's IFRS Project Team Start?**

After SNSA launched the IFRS Transition Project as noted above, its first step was to understand how different the then-current US GAAP accounting treatments were when compared to IFRS. This was again a critical success factor in our transition. A detailed comparison of IFRS and US GAAP was prepared, with assistance from both external advisors and external auditors. This list of similarities and differences was then applied to each of SNSA's four different businesses.

When IFRS implementation commences, a frequent lament may be heard—"IFRS is similar but not the same." The devil of the differences was in the detailed comparison of IFRS and US GAAP. The insight gained was this: the better and more detailed the comparison diagnostic, the better and smoother will be the IFRS transition. In most cases, SNSA's transition team continued with the US GAAP accounting treatment, albeit with some enhanced disclosures being added. Where IFRS offered an accounting treatment similar to US GAAP, SNSA adopted that method. This minimized the final list of differences when transitioning to IFRS to the following:

1. Areas of significant impact under IFRS 1:
  - Business combinations;
  - Actuarial gains and losses;
  - Reset of cumulative translation adjustment.
  - Significant differences from US GAAP which may impact SNSA's financial statements:
  - Property, Plant, and Equipment—component accounting, residual values;
  - Lease accounting;
  - Consolidation of entities;
  - Equity Accounting and FIN 46[R] compared to SIC 12;
  - Fair valuation of inventories of biological assets at Stolt Sea Farm;
2. Other possible areas which could result in a difference from US GAAP on implementation:
  - Impairment—two-step impairment evaluation process under US GAAP and only a single-step discounted cash flow process under IFRS.
  - Provisions—midpoint of an estimate under IFRS not the "best estimate" under US GAAP.
  - Probabilistic evaluation of provisions—higher threshold of "probable" under US GAAP than under IFRS.
  - Business Combinations.
  - Employee Benefits—Defined benefit pension schemes.
  - Financial instruments, including onerous disclosure requirements under IFRS 7.
  - Deferred Tax assets—classification and measurement.
  - Stock options—under IFRS, graded vesting of options must be accounted for using the accelerated attribution method not straight-line method.

When each and every accounting policy, treatment or disclosure is carefully considered as the transition to IFRS progresses, there will still be some risk that there may have been errors in the implementation of US GAAP.

SNSA also ran the comparative diagnostic on its equity method investees and joint ventures. One significant change from US GAAP noted during transition was that the equity method investees and joint ventures not only had to comply with IFRS, but had to have IFRS accounting policies which were consistent with those of the rest of the company. In addition, the accounting period had to be coterminous to the year-end of the parent. This also raised a number of IFRS 1 issues in relation to when a subsidiary adopts IFRS and how the change to IFRS could affect the dividend distribution ability of that subsidiary. This matter is particularly important if there is a local legal requirement to have sufficient distributable reserves, which under IFRS could be lower than under current local accounting standards.

After completing the comparison diagnostic, we identified four additional areas to consider when transitioning to IFRS.

- Corporate finance—if key numbers on which certain debt covenants are based change due to the transition to IFRS then early discussion and negotiation with the banks is critical.
- Tax—involvement of the tax team at the early stages so that they are aware of the transition differences and the impact on tax.
- Human resources—impact of transition to IFRS on key metrics and incentive plans.
- Technology—changes required in the consolidation systems and in the general ledger accounting systems.
- Internal controls—IFRS requires a higher level of judgement and estimation than US GAAP. This means the controls and process surrounding accounting judgements and estimate must be robust since it will be challenged by the internal controls testing process.
- Investor relations—it is never too early to start thinking about how the message of transitioning to IFRS will be communicated to the market. There are a number of excellent examples of European Companies that made detailed presentations to investors in 2005 and 2006 to show how they moved from their local GAAP to IFRS.

### **Materiality**

When the GAAP comparison diagnostic is completed, it is extremely important to consider those areas where the measurement differences between US GAAP and IFRS might be “not material.” The difficulty with ignoring some differences on the grounds of “materiality” is that the external audit firms will continue to collect these differences on their schedule of passed audit adjustments. Such “not material” differences could become material under the guidance of SAB 99 and SAB 108.

### **Treatment of Significant Accounting Differences on Transition Opening Balance Sheet under IFRS**

An IFRS Transition generally has two kinds of difference—the first one is the difference only on transition and then does not occur each year. The second difference is the one that is a recurring difference. Both these differences need to be recorded in the accounting ledgers in the respective entities.

SNSA’s reconciliation of shareholders’ equity from US GAAP to IFRS at each of its key transition dates is summarized below.

<i>In millions</i>		<i>Dec. 1, 2006</i>	<i>May 31, 2007</i>	<i>Nov. 30, 2007</i>
<b>Consolidated US GAAP equity</b>		<b>\$1,172.6</b>	<b>\$1,295.2</b>	<b>\$1,354.5</b>
IAS 37 – Record provision in accordance with IFRS	(a)	(1.9)	--	--
IFRS 1/IAS 19 – Pension and Other Postretirement Employee Benefits (“OPEB”) adjustment	(b)	(19.3)	(14.4)	(0.7)
IAS 41 – Fair value of biological assets	(c)	22.9	10.8	12.4
IAS 16 – Componentization of Tankers’ ships	(d)	(8.1)	(8.2)	(8.4)
IAS 16 – Adjustment to residual value of tank containers	(e)	5.6	6.0	6.7
Reclassification of minority interest to equity		0.3	2.3	10.9
Other items		<u>(0.8)</u>	<u>(0.2)</u>	<u>(5.6)</u>
<b>Net changes</b>		<b><u>(1.3)</u></b>	<b><u>(3.7)</u></b>	<b><u>15.3</u></b>
<b>Consolidated equity under IFRS</b>		<b><u>\$1,171.3</u></b>	<b><u>\$1,291.5</u></b>	<b><u>\$1,369.8</u></b>

*(a) Measurement of Provisions in accordance with IFRS*

Under US GAAP, if a range of estimates is present and no amount in the range is more likely than any other amount in the range, the provision should be measured at the minimum of the range. However, in these circumstances, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, requires the midpoint in the range to be used if all outcomes are equally likely. At December 1, 2006, SNSA had entered into negotiations with certain customers with regard to their claims in which the lower range of possible settlements was recognized under US GAAP. The use of the midpoint in the range had resulted in a \$1.9 million reduction in retained earnings under IFRS at December 1, 2006 and an increase in revenue of the same amount for the year ended November 30, 2007, as this amount was recognized in the quarters ended February 28, 2007 and May 31, 2007 under US GAAP.

*(b) Recognition of Previously Unrecognized Actuarial Losses on Pension and Other Postretirement Employee Benefits*

Under US GAAP, the SNSA applied the “corridor” method in relation to the recognition of actuarial gains and losses through the profit and loss. Under this approach, only actuarial gains and losses that fall outside 10% of the projected benefit obligation or, if greater, pension assets are recognized through the profit and loss over the expected average remaining working lives of employees participating in the plan. In accordance with IFRS 1, SNSA recognized all cumulative actuarial gains and losses at December 1, 2006, resulting in a reduction of \$23.3 million to retained earnings.

In addition, US GAAP allows the amortization of prior service costs over the expected service life of the employees involved, while IFRS requires prior service costs to be recognized immediately, if they are already vested. IFRS also requires that all plans have the same measurement date as the SNSA’s year-end, which resulted in a change in the present value of the funded obligations for one plan. Both of these items have resulted in a \$4.0 million credit to retained earnings at December 1, 2006. SNSA had adopted FAS 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans* for the year ended November 30, 2007. FAS 158 requires an employer to recognize the funded status of a defined benefit plan, measured as the difference between plan assets and the projected benefit obligation, in its consolidated balance sheet.

For this reason, the net change between the numbers previously reported under US GAAP and those reported under IFRS was only about \$0.7 million at November 30, 2007, and \$0.8 million for the six months ended May 31, 2007.

(c) *Fair Value of Biological Assets*

Under US GAAP, SNSA reported its biological assets at cost and classified them as part of inventories. Under IAS 41, *Agriculture*, biological assets are required to be recorded at fair value and separately disclosed on the balance sheet. This resulted in an increase in current assets of \$17.2 million and \$13.0 million (with a deferred tax effect of \$5.0 million and \$4.5 million) at November 30, 2007, and December 1, 2006, respectively. For the six months ended May 31, 2007, this resulted in a \$13.7 million decrease in net profit. Similarly, there was a \$14.4 million increase to Investment in and Loans to Marine Harvest at December 1, 2006. This represents SNSA's 25% share of the fair value of biological assets in respect of Marine Harvest. This adjustment also reduced the gain recorded under IFRS on sale of investment in discontinued operations for the year ended November 30, 2007, from \$21.8 million to \$7.4 million.

(d) *Componentization of Ships*

Under IAS 16, *Property, Plant, and Equipment*, each component of an asset that has an expected useful life that is significantly different in relation to the total cost of the asset must be depreciated separately, while US GAAP does not explicitly require this treatment (although widely practiced). Following this policy for Tankers' ship components (including ships held by unconsolidated joint ventures) resulted in a decrease in retained earnings of \$8.1 million at December 1, 2006. The effect of this adjustment for the six months ended May 31, 2007, was an increase in depreciation expense of approximately \$0.1 million.

(e) *Residual Value of Tank Containers*

Under US GAAP, estimates of residual value of assets are reviewed only when events or changes in circumstances indicate that the current estimates are no longer appropriate, while IFRS requires that estimates of residual values are reviewed at least at each annual reporting date. Applying this policy and assessing the current expected residual value of the SNSA's tank containers at December 1, 2006, resulted in an increase in retained earnings of \$5.6 million at transition date, \$6.0 million at May 31, 2007, and \$6.7 million at November 30, 2007. The effect for the six months ended May 31, 2007, of this adjustment is approximately \$0.5 million decrease in depreciation expense.

Reconciliations of the consolidated balance sheets as of December 1, 2006, and November 30, 2007, and consolidated income statements for the four quarters and year ended November 30, 2007, from US GAAP to IFRS are included at the Company's Web site ([www.stolt-nielsen.com/Investor-Relations/Accounting-Policies.aspx](http://www.stolt-nielsen.com/Investor-Relations/Accounting-Policies.aspx))

(f) *Application of IFRS 1 Exemption to Adjust Currency Translation Reserve to Zero*

Under US GAAP, on consolidation, assets and liabilities of subsidiaries are translated into US dollars from their functional currencies at the exchange rates in effect at the balance sheet date while revenues and expenses are translated at the average rate prevailing during the year. The resulting translation adjustments are recorded in a separate component of "Accumulated Other Comprehensive Income (Loss), net." While this is not different from IFRS, the Company has utilized an exemption in IFRS 1, which allows the cumulative translation reserve to be set to zero at the date of transition for all its foreign operations. Consequently, subsequent to the date of transition, amounts previously recognized in net income under US GAAP as a result of the sale of foreign operations of \$3.1 million, have been reversed under IFRS.

**Other significant accounting differences on transition.*****Additional share option expense in relation to stock options with graded vesting features.***

The Company grants several share options to its employees that contain graded vesting conditions. Graded vesting conditions exist whereby options granted vest in equal annual tranches over a specified period, equal tranches of 25% of the options granted each year over a four-year period.

Under US GAAP, the compensation cost of stock options with graded vesting features is amortized on a straight-line basis over the longest vesting period for the entire share option grant.

Under IFRS 2, each of the tranches must be treated as a separate option grant and the compensation cost is recognized as the options vest for each tranche. Therefore, the IFRS approach accelerates the compensation cost amortization to earlier periods in the overall vesting period. As a result, an adjustment has been recorded to retained earnings as of December 1, 2006, for \$3.6 million of additional stock option compensation costs for options granted since 2000, and a further \$1.0 million expense recorded for the year-end November 30, 2007.

***Impairment of goodwill.*** Under US GAAP, goodwill is tested for impairment at the reporting unit level, which is an operating segment or one step below while under IAS 36, *Impairment of Assets*, goodwill is tested at the cash generating unit level that represents the lowest level at which goodwill is monitored by management. The use of the cash generating unit level has resulted in the full impairment of goodwill for one cash-generating unit at the date of transition.

***Adjustment to equity investment for gain on ship sale.*** Under US GAAP, when a company sells an asset and immediately leases it back under an operating lease, a proportion of the gain is deferred on the balance sheet when certain conditions are met. The deferred amount is amortized in proportion to the method through which the related gross rental is charged to expense over the lease life.

Under IFRS, if the asset was sold at fair value, any gain or loss is recognized immediately. In the fourth quarter of 2007, the Company's 50% owned joint venture, NYK Stolt Tankers S.A. ("NST"), sold the Stolt Alliance at fair value and immediately leased it back. This resulted in a \$5.8 million gain of which \$3.8 million was deferred on the balance sheet under US GAAP.

Under IFRS, this amount, \$3.8 million, of which the Company's share is \$1.9 million, has been recognized in Other Income.

***Severance accrual.*** Under US GAAP, if employees are required to render services beyond a minimum period until they are terminated in order to receive a termination payment, a liability for terminated benefits is measured initially at the date of communication to the relevant employees, based on the fair value of the liability as of the termination date. The liability is then recognized ratably over the future service period. Under IFRS, the liability is recorded immediately. Adoption of this policy resulted in a decrease in retained earnings at November 30, 2007, of \$0.8 million and a decrease in net profit for 2007 of \$0.7 million.

***Balance sheet and income statement reclassifications.*** The following represents additional balance sheet and income statement reclassifications required by IFRS.

***Deconsolidation of Lingang Terminal.*** The Company has a 65% ownership in Tianjin Stolthaven Lingang Terminal Co. ("Lingang Terminal") which is a development stage entity and in the process of building a terminal facility. Under US GAAP, the Company is required to consolidate this entity as it was considered to be a variable interest entity under FIN 46(R), *Consolidation of Variable Interest Entities*, and the Company was the primary beneficiary.

However, under IFRS the Lingang Terminal meets the definition of a joint venture as there is joint control over the entity, and so the entity has been accounted for under equity accounting.

**Reclassification of minority interest to equity.** Under US GAAP, minority interest is displayed as a long-term liability. IAS 1, *Presentation of Financial Statements*, and IAS 27, *Consolidated and Separate Financial Statements*, require minority interests to be presented within equity.

**Reclassification of software to intangible assets.** Under US GAAP, computer software is included in property, plant and equipment. In accordance with IAS 38, *Intangible Assets*, when the software is not an integral part of the related hardware, computer software should be classified as an intangible asset. Accordingly, \$3.3 million and \$3.1 million of computer software that is not integral to any associated hardware were reclassified from property, plant and equipment to intangible assets on transition to IFRS at November 30, 2007 and December 1, 2006, respectively.

**Reclassification of drydocking asset to property, plant, and equipment.** Capitalized costs related to the drydocking of ships are treated as a separate component of tankers under IAS 16, *Property, Plant and Equipment*. Accordingly they are classified as property, plant and equipment under IFRS while they are recorded as an Other Long-Term Asset under US GAAP.

**Reclassification of short-term deferred tax assets and liabilities.** Under US GAAP, deferred tax assets and liabilities are classified as either current or noncurrent based upon the classification of the related asset or liability.

A deferred tax liability or asset that is not related to an asset or liability recognised in the balance sheet such as losses carryforwards, is classified according to the expected reversal date of the temporary difference. Under IAS 12, *Income Taxes*, all deferred tax assets and liabilities are classified as noncurrent regardless of the classification of the related asset or liability and regardless of the expected timing of reversal of the temporary difference.

**Reclassification of debt issuance costs against current portion of long-term debt and long-term debt.** Under IAS 39, *Financial Instruments: Recognition and Measurement*, transaction costs directly attributable to a debt are recorded against the debt on initial recognition. Under US GAAP, debt issuance costs are recognized as Other Assets. This has required a reclassification of \$5.1 million and \$6.1 million from Other Assets to both the Current Portion of Long-Term Debt and to Long-Term Debt at November 30, 2007, and December 1, 2006, respectively.

**Transfer of minimum pension liability adjustments to retained earnings.** Under US GAAP, if the accumulated benefit obligation is greater than the value of the plan assets, a minimum liability must be recognized in the balance sheet for the unfunded accumulated pension liability. In cases where an additional minimum liability is required, a portion is recognized as a component of other comprehensive income.

There is no concept of an additional minimum pension liability under IAS 19, *Employee Benefits*. Therefore, amounts recognized in other comprehensive income under US GAAP have been reclassified to retained earnings on adoption of IFRS.

More detailed information on SNSA's IFRS Transition, including accounting policies, reconciliations of the consolidated balance sheets as of December 1, 2006, and November 30, 2007, and consolidated income statements for the four quarters and year ended November 30, 2007, from US GAAP to IFRS are included in the Company's Web site: <http://www.stolt-nielsen.com/Investor-Relations/Accounting-Policies.aspx>.

## APPENDIX E

### USE OF PRESENT VALUE IN ACCOUNTING

Present value is a pervasive concept that has many applications in accounting. Most significantly, present value of future cash flows is widely recognized and accepted as one approach to the assessment of fair value, which is commonly invoked in various accounting standards. Currently, IFRS does not provide specific guidance to this subject matter, but in recognition of its importance, guidance drawn from US GAAP's Concepts Statement 7 (CON 7) is summarized on the following pages.

CON 7 provides a framework for using estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently remeasured at fair value (fresh-start measurements). It also provides a framework for using the interest method of amortization. It provides the principles that govern measurement using present value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and events should be valued using present value measures or when fresh-start measurements are appropriate.

Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be fair value, absent evidence to the contrary. For fresh-start measurements, a price that is observed in the marketplace for an essentially similar asset or liability is fair value. If purchase prices and market prices are available, there is no need to use alternative measurement techniques to approximate fair value. However, if alternative measurement techniques must be used for initial recognition and for fresh-start measurements, those techniques should attempt to capture the elements that when taken together would comprise a market price if one existed. The objective is to estimate the price likely to exist in the marketplace if there were a marketplace—fair value.

CON 7 states that the only objective of using present value in accounting measurements is fair value. It is necessary to capture, to the extent possible, the economic differences in the marketplace between sets of estimated future cash flows. A present value measurement that fully captures those differences must include the following elements:

1. An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times
2. Expectations about possible variations in the amount or timing of those cash flows
3. The time value of money, represented by the risk-free rate of interest
4. The risk premium—the price for bearing the uncertainty inherent in the asset or liability
5. Other factors, including illiquidity and market imperfections

**How CON 7 measures differ from previously utilized present value techniques.** Previously employed present value techniques typically used a single set of estimated cash flows and a single discount (interest) rate. In applying those techniques, adjustments for factors 2. through 5. described in the previous paragraph are incorporated in the selection of the discount rate. In the CON 7 approach, only the third factor listed (the time value of money) is included in the discount rate; the other factors cause adjustments in arriving at risk-adjusted expected cash flows. CON 7 introduces the probability-weighted, expected cash flow approach, which focuses on the range of possible estimated cash flows and estimates of their respective probabilities of occurrence.

Previous techniques used to compute present value used estimates of the cash flows most likely to occur. CON 7 refines and enhances the precision of this model by weighting

different cash flow scenarios (regarding the amounts and timing of cash flows) by their estimated probabilities of occurrence and factoring these scenarios into the ultimate determination of fair value. The difference is that values are assigned to the cash flows other than the most likely one. To illustrate, a cash flow might be €100, €200, or €300 with probabilities of 10%, 50% and 40%, respectively. The most likely cash flow is the one with 50% probability, or €200. The expected cash flow is €230 ( $= €100 \times .1 + €200 \times .5 + €300 \times .4$ ).

The CON 7 method, unlike previous present value techniques, can also accommodate uncertainty in the timing of cash flows. For example, a cash flow of €10,000 may be received in one year, two years, or three years with probabilities of 15%, 60%, and 25%, respectively. Traditional present value techniques would compute the present value using the most likely timing of the payment—two years. The example below shows the computation of present value using the CON 7 method. Again, the expected present value of €9,030 differs from the traditional notion of a best estimate of €9,070 (the 60% probability) in this example.

Present value of €10,000 in one year discounted at 5%	€9,523	
Multiplied by 15% probability		€1,428
Present value of €10,000 in two years discounted at 5%	9,070	
Multiplied by 60% probability		5,442
Present value of €10,000 in three years discounted at 5%	8,638	
Multiplied by 25% probability		<u>2,160</u>
Probability weighted expected present value		<u>€9,030</u>

**Measuring liabilities.** The measurement of liabilities involves different problems from the measurement of assets; however, the underlying objective is the same. When using present value techniques to estimate the fair value of a liability, the objective is to estimate the value of the assets required currently to (1) settle the liability with the holder or (2) transfer the liability to an entity of comparable credit standing. To estimate the fair value of an entity's notes or bonds payable, accountants look to the price at which other entities are willing to hold the entity's liabilities as assets. For example, the proceeds of a loan are the price that a lender paid to hold the borrower's promise of future cash flows as an asset.

The most relevant measurement of an entity's liabilities should always reflect the credit standing of the entity. An entity with a good credit standing will receive more cash for its promise to pay than an entity with a poor credit standing. For example, if two entities both promise to pay €750 in three years with no stated interest payable in the interim, Entity A, with a good credit standing, might receive about €630 (a 6% interest rate). Entity B, with a poor credit standing, might receive about €533 (a 12% interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity's credit standing.

Present value techniques can also be used to value a guarantee of a liability. Assume that Entity B in the above example owes Entity C. If Entity A were to assume the debt, it would want to be compensated €630—the amount that it could get in the marketplace for its promise to pay €750 in three years. The difference between what Entity A would want to take the place of Entity B (€630) and the amount that Entity B receives (€533) is the value of the guarantee (€97).

**Interest method of allocation.** CON 7 describes the factors that suggest that an interest method of allocation should be used. It states that the interest method of allocation is more relevant than other methods of cost allocation when it is applied to assets and liabilities that exhibit one or more of the following characteristics:

1. The transaction is, in substance, a borrowing and lending transaction.

2. Period-to-period allocation of similar assets or liabilities employs an interest method.
3. A particular set of estimated future cash flows is closely associated with the asset or liability.
4. The measurement at initial recognition was based on present value.

**Accounting for changes in expected cash flows.** If the timing or amount of estimated cash flows changes and the asset or liability is not remeasured at a fresh-start measure, the interest method of allocation should be altered by a catch-up approach. That approach adjusts the carrying amount to the present value of the revised estimated future cash flows, discounted at the original effective interest rate.

**Application of present value tables and formulas.**

**Present value of a single future amount.** To take the present value of a single amount that will be paid in the future, apply the following formula; where *PV* is the present value of €1 paid in the future, *r* is the interest rate per period, and *n* is the number of periods between the current date and the future date when the amount will be realized.

$$PV = \frac{1}{(1 + r)^n}$$

In many cases the results of this formula are summarized in a present value factor table.

<i>(n)</i> <i>Periods</i>	<i>2%</i>	<i>3%</i>	<i>4%</i>	<i>5%</i>	<i>6%</i>	<i>7%</i>	<i>8%</i>	<i>9%</i>	<i>10%</i>
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	0.9612	0.9426	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8265
3	0.9423	0.9151	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513
4	0.9239	0.8885	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830
5	0.9057	0.8626	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209

**Example**

Suppose one wishes to determine how much would need to be invested today to have €10,000 in five years if the sum invested would earn 8%. Looking across the row with *n* = 5 and finding the present value factor for the *r* = 8% column, the factor of 0.6806 would be identified. Multiplying €10,000 by 0.6806 results in €6,806, the amount that would need to be invested today to have €10,000 at the end of five years. Alternatively, using a calculator and applying the present value of a single sum formula, one could multiply €10,000 by  $1/(1 + .08)^5$ , which would also give the same answer—€6,806.

**Present value of a series of equal payments (an annuity).** Many times in business situations a series of equal payments paid at equal time intervals is required. Examples of these include payments of semiannual bond interest and principal or lease payments. The present value of each of these payments could be added up to find the present value of this annuity, or alternatively a much simpler approach is available. The formula for calculating the present value of an annuity of €1 payments over *n* periodic payments, at a periodic interest rate of *r* is

$$PV \text{ Annuity} = \left( 1 - \frac{1}{(1 + r)^n} \right)$$

The results of this formula are summarized in an annuity present value factor table.

<i>(n)</i> <i>Periods</i>	<i>2%</i>	<i>3%</i>	<i>4%</i>	<i>5%</i>	<i>6%</i>	<i>7%</i>	<i>8%</i>	<i>9%</i>	<i>10%</i>
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	1.9416	1.9135	1.8861	1.8594	1.8334	1.8080	1.7833	1.7591	1.7355
3	2.8839	2.8286	2.7751	2.7233	2.6730	2.6243	2.5771	2.5313	2.4869
4	3.8077	3.7171	3.6299	3.5460	3.4651	3.3872	3.3121	3.2397	3.1699
5	4.7135	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908

### Example

Suppose four annual payments of €1,000 will be needed to satisfy an agreement with a supplier. What would be the amount of the liability today if the interest rate the supplier is charging is 6% per year? Using the table to get the present value factor, then  $n = 4$  periods row, and the 6% column, gives you a factor of 3.4651. Multiply this by €1,000 and you get a liability of €3,465.10 that should be recorded. Using the formula would also give you the same answer with  $r = 6\%$  and  $n = 4$ .

Caution must be exercised when payments are not to be made on an annual basis. If payments are on a semiannual basis  $n = 8$ , but  $r$  is now 3%. This is because  $r$  is the periodic interest rate, and the semiannual rate would not be 6%, but half of the 6% annual rate. Note that this is somewhat simplified, since due to the effect of compound interest 3% semiannually is slightly more than a 6% annual rate.

### Example of the relevance of present values

A measurement based on the present value of estimated future cash flows provides more relevant information than a measurement based on the undiscounted sum of those cash flows. For example, consider the following four future cash flows, all of which have an undiscounted value of €100,000:

1. Asset A has a fixed contractual cash flow of €100,000 due tomorrow. The cash flow is certain of receipt.
2. Asset B has a fixed contractual cash flow of €100,000 due in twenty years. The cash flow is certain of receipt.
3. Asset C has a fixed contractual cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is an 80% probability that the entire €100,000 will be received. There is a 20% probability that €80,000 will be received.
4. Asset D has an *expected* cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is a 25% probability that €120,000 will be received. There is a 50% probability that €100,000 will be received. There is a 25% probability that €80,000 will be received.

Assuming a 5% risk-free rate of return, the present values of the assets are

1. Asset A has a present value of €99,986. The time value of money assigned to the one-day period is €14 ( $€100,000 \times .05/365$  days).
2. Asset B has a present value of €37,689 [ $€100,000/(1 + .05)^{20}$ ].
3. Asset C has a present value of €36,181 [ $(€100,000 \times .8 + 80,000 \times .2)/(1 + .05)^{20}$ ].
4. Asset D has a present value of €37,689 [ $€120,000 \times .25 + 100,000 \times .5 + 80,000 \times .25)/(1 + .05)^{20}$ ].

Although each of these assets has the same undiscounted cash flows, few would argue that they are economically the same or that a rational investor would pay the same price for each. Investors require compensation for the time value of money. They also require a risk premium. That is, given a choice between Asset B with expected cash flows that are certain and Asset D with cash flows of the same expected amount that are uncertain, investors will place a higher value on Asset B, even though they have the same expected present value. CON 7 says that the risk premium should be subtracted from the expected cash flows before applying the discount rate.

Thus, if the risk premium for Asset D was €500, the risk-adjusted present values would be €37,500  $\{[(€120,000 \times .25 + 100,000 \times .5 + 80,000 \times .25) - 500]/(1 + .05)^{20}\}$ .

**Practical matters.** Like any accounting measurement, the application of an expected cash flow approach is subject to a cost-benefit constraint. The cost of obtaining additional information must be weighed against the additional reliability that information will bring to the measurement. As a practical matter, an entity that uses present value measurements often has little or no information about some or all of the assumptions that investors would use in assessing the fair value of an asset or a liability. Instead, the entity must use the information that is available to it without undue cost and effort when it develops cash flow estimates. The entity's own assumptions about future cash flows can be used to estimate fair value using present value techniques, as long as there are no contrary data indicating that investors would use different assumptions. However, if contrary data exist, the entity must adjust its assumptions to incorporate that market information.