1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The year 2005 marked the start 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 25 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, will also 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 will now be reporting under one or the other of these two comprehensive systems of accounting and financial reporting rules.

Most other national GAAP standards have been reduced in importance or are being phased out as nations all over the worlds are now embracing IFRS. For example, Canada has announced that Canadian GAAP (which was very similar to US GAAP) will be eliminated and replaced by IFRS by 2011. More immediately, China will require listed companies to employ IFRS in 2007. It is quite predictable that only US GAAP will (for the foreseeable future) remain as a competitive force in the accounting standards arena, and even that situation will be more a formality than a substantive reality, given the formal commitment (and substantial progress made to date) to "converge" US GAAP and IFRS.

The impetus to convergence of presently 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 be 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 huge obstacle to investor confidence. Additionally, the ability to list a company's securities on a stock exchange has generally required filings with national regulatory authorities that have insisted on either conformity with local GAAP or 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 in short supply, many otherwise anxious would-be registrants forwent the opportunity to broaden their investor bases.

These difficulties may be coming to an end, however. This historic 2002 Norwalk Agreement between the US standard setter, FASB, and the IASB called for "convergence" of the two 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. It may well be that, by the end of the current decade, the distinctions between US GAAP and IFRS are more nominal than real, although there remain challenging issues to be resolved. (For example, while IFRS has banned the use of LIFO costing for inventories, it remains a favored 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.)

The United States remains the world's largest capital market, and accordingly the ultimate success of the convergence process will be measured by the willingness of the US securities regulator, the SEC, to permit registrants to file financial statements prepared in accordance with IFRS, without the presently mandated reconciliations of earnings and net worth to US GAAP. There is good reason to be optimistic about this, and it could well happen within the next few years. This is discussed further later in this chapter.

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 balance sheet 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 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 accounting 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 successfully persuaded them that they should leave recognition and measurement rules to the IASC. However, having established itself as the unique international rule maker, IASC had great difficulty in persuading anyone 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, 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 was to narrow the range of acceptable alternatives, although uniformity was not anticipated in the near term. 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 difficulities 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, amongst 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.

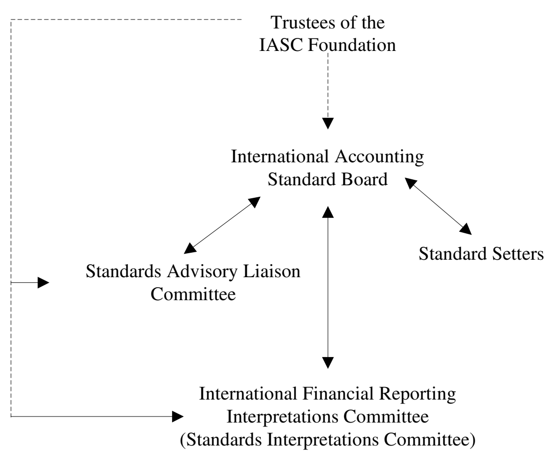
If IASC was to be the standard setter endorsed by the world's stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the 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, IOSCO members voted at their annual meeting 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 New 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 at 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 geographical representativeness. 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 October 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 is not enshrined in either the Constitution or the IASB's operating procedures, both are under review at the moment and changes may be in place for 2005.

Process of IFRS Standard Setting

The IASB has a formal due process which is set out in the *Preface to IFRS*, revised in 2001. As 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 dominated in the years after 2001 by the need to round out the legacy standards, so 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 as of 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 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 like financial instruments) specific Board members are allocated a 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 re-debated, 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 enterprises. 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. When revising IAS 39, *Financial Instruments: Recognition and Measurement* in 2003, it 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 is *convergence*. In October 2002 the IASB signed an agreement with the FASB (the 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 have since issued Exposure Drafts and several final standards changing their rules to converge with the other on certain issues. It also involves long-term development of joint projects (business combinations, performance reporting, revenue recognition, etc.). More "short term convergence" proposals are promised by both FASB and IASB.

This desire for convergence is driven by the perception that international investment is made more risky by the use of multiple reporting frameworks, and that the global market needs a single global reporting base—but also specifically by the knowledge that European companies wish to be listed in the US, and have to provide reconciliations of their equity and earnings to US GAAP when they do this (foreign companies registered with the SEC have to prepare the annual filing on Form 20-F which, if the entity does not prepare reports under US GAAP, requires a reconciliation between the entity's IFRS or national GAAP and US GAAP for earnings and equity. This reconciliation is costly to prepare and leads to companies publishing in effect two different operating results for the year, which is not always understood or appreciated by the market). If IFRS were substantially the same as US GAAP, the Form 20-F reconciliations hopefully would fade away (and the SEC has confirmed this is the likely outcome), so for many European companies, convergence with US GAAP is an important issue. An agreed-to "road map" between the SEC and the EU calls for eventual elimination of this requirement, and the SEC is studying filings by US-registered EU companies now applying IFRS to assess this matter.

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* (discussed below). Thereafter, there may be a conflict between being consistent with US GAAP and being consistent with existing 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* and need to be changed (e.g., IAS 20 on government grants), 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 inconsistent with US GAAP, which will then have to be reconsidered as part of the convergence program.

Those members of IASB who have worked in North America are concerned that standards avoid creating abuse opportunities. Experience has sadly shown that there often will be attempts by preparers to evade the intended result of accounting standards, using "financial engineering," in order to be able to achieve the earnings or balance sheet presentations 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 many exceptions to a simple and basic rule (for example: report property rights and debt obligations implicit in all lease arrangements).

IASB also manifests some concerns about the practicality of the solutions it mandates. While 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 mentioned in debate, 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, otherwise there would have to be re-exposure of the material. This means that where there are several solutions possible, or 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 later redebating 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 enterprise 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 enterprise 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*, states that financial statements are to present fairly the financial position, financial performance and cash flows of the reporting entity, and that the achievement of a fair presentation requires the faithful representation of the effects of the reporting entity's transactions, other events and conditions.

Of great importance are the definitions of assets and liabilities. According to IASB, "an asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." A liability is a "present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying future benefits." Equity is simply a residual arrived at by deducting the liabilities from assets. Neither asset nor liability are recognized in the financial statements unless they have a cost or value that can be measured reliably—which, as the *Framework* acknowledges, means that some assets and liabilities may remain 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 negative goodwill is identified in a business combination, this should be released to the income statement immediately—IAS 22 treated it as a deferred credit, which however does not meet the criterion for recognition as a liability.

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 which both 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 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 are presently 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 in 2005 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 is promised for late 2006. Discussion has now 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, with a discussion paper promised for the first half of 2007. Other components of the conceptual framework project, which will address measurement, reporting entity, presentation and disclosure, purpose and status, and application to not-for-profit entities will follow, but the timing is uncertain.

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 intended normally 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, judgement is to be used to develop and apply an accounting policy that is relevant to the economic decision-making needs of the users, and is reliable in that the financial statements: represent faithfully the financial position, financial performance and cash flows of the reporting entity; reflect the economic substance of transactions, events and conditions, rather than merely the legal forms thereof; are neutral; are prudent; and are complete in all material respects.
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 higher level guidance.
4. Only if that also fails should the preparer look to the IASB *Framework* directly.

In effect, therefore, if IFRS do not cover a subject, the preparer should look to national GAAP, and 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 use of US GAAP removes reconciliation items on the Form 20-F for foreign SEC registrants). 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 were also silent on the matter needing clarification.

The IASB and the US

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only at the beginning of the 1990s that FASB started to become interested in IASC. This was the period when IASC was starting 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 look to the international, 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 significance for foreign issuers in terms of the US market. 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 markets would be greatly facilitated. The SEC has therefore been a key actor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987. It also observed that there were too many options under IAS. When IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) saying that, to be acceptable, IFRS must satisfy three criteria.

1. They must include a core set of standards that constituted a comprehensive basis of accounting;
2. The standards must be high quality, and enable investors to analyze performance meaningfully both across time periods and between companies; and
3. The standards must be rigorously interpreted and applied, because otherwise comparability and transparency would not be achieved.

The plan was predicated on the completion of a core set of standards, then handing these over to IOSCO, which in turn would ask its members to evaluate them, and finally IOSCO would issue its verdict. It was in this context the SEC issued a "concept release" in 2000, in which it asked for comments on the acceptability of the core set of standards, but crucially on whether there was a sufficient compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, that auditors would ensure this and stock exchange regulators would check compliance.

This latter element is something which remains beyond the control of IASB, which is the domain of national bodies or professional organizations in each jurisdiction. The Standards Interpretations Committee was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to build liaison channels with stock exchange regulators and national interpretations bodies, but the rest is in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies. The SEC concepts release resulted in many comment letters, which can be viewed on the SEC Web site (www.sec.gov), but in the five years since its issue, the SEC has taken no definitive position.

The SEC's stance at the time was that it genuinely wanted to see IFRS used by foreign registrants, but that it prefered convergence (so that no reconciliation would be necessary) to acceptance without reconciliation of the IFRS as they were in 2000. In the years since, the SEC in its public pronouncements regularly supports convergence and has strongly implied that reconciliations might be waived as soon as 2008 if convergence progress continues to be made. Thus, for example, the SEC welcomed publicly the changes to US standards proposed by the FASB in December 2003, made to converge with IFRS.

Relations between FASB and IASB have grown warmer since IASB was restructured. The FASB joined the IASB for informal meetings in the early 1990s, and this led to the creation of the G4+1 group of Anglo-Saxon standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer) in which FASB was an active participant. IASB and FASB signed the Norwalk Agreement in October 2002, which set out a program of convergence, and their staffs now work together on a number of projects, including business combinations and revenue recognition. Video links are used to enable staff to observe and participate in board meetings. 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, there remain problems, largely of the structural variety. FASB works in 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 removed). FASB also has a tradition of issuing very detailed, prescriptive ("rules-based") standards that give bright line audit guidance, which are intended to make compliance control easier and remove uncertainties. In the post-Enron world, after it became clear that such prescriptive rules had been abused, there was a flurry of interest in standards that supposedly express an objective and then explain how to reach it ("principles-based" standards), without attempting to prescribe responses to every conceivable fact pattern. However, as the SEC study into principles-based standards observed, use of principles alone, without detailed guidance, reduces comparability. The litigation environment in the US also makes companies and auditors reluctant to step into areas where judgments have to be taken in uncertain conditions.

The IASB and Europe

While France, Germany, the Netherlands and the UK were founding members of IASC and have remained heavily involved, the European Commission as such has generally had a difficult 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 surprising in that, to be effective in legal terms, IFRS have to become enshrined in EU statute law, creating a situation where the EU is in effect rubber-stamping laws created by a small, self-appointed, private sector body. This is a delicate situation, which has proved within a very short time that it contains the seeds of unending disagreements: politicians are being asked in effect to endorse something over which they have no control, and are being lobbied by corporate interests who have failed to influence IASB directly to achieve their objectives. The EU endorsement of IFRS turns out to have the cost of exposing IASB to political pressures in the same way that FASB has at times been the focus of congressional manipulations in the US (e.g., over stock-based compensation accounting rules).

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, as the formal conduit for EU inputs to IASB. The European Financial Reporting Advisory Group (EFRAG) was formed in 2001 by a collection of European representative organizations (for details see www.efrag.org), including the European Accounting Federation (FEE) and European employer organization (UNICE). This in turn formed a small Technical Expert Group (TEG) which 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 inputs 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 should state whether the standard has the required qualities and is in conformity with the European company law directives. The European Commission then asks a new committee, 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; it should not take a strategic or policy view. However, the European Parliament also has the right to comment, if it 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 intentions of issuing 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 represented about 90% of IASB's constituents in the early 2000s. It is easy to feel in this context that EFRAG is seen at IASB as a single respondent, so people who have made the effort to work through EFRAG feel under-represented. In addition, EFRAG is bound to 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, has 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 were exhaustively debated—but they have since become once more a political football. 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 macrohedging. The IASB agreed to do this, even though that meant the issuance of a new 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 while 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 make banks' figures volatile, would destabilize the European economy, and should not be approved. He also said that the Commission did not have a sufficient input to the standard setting process.

This manipulation of IAS 39 was further compounded 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, and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although again this meant issuing an Exposure Draft and a further amendment to IAS 39 which was not finalized until mid-2005. IASB, when it debated the issue, took a pragmatic line that no compromise of principle was involved, and 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 have not been delighted.

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 consider that the EU might abandon IFRS, but this is not a realistic possibility, given that the EU has already tried and rejected the regional standard setting route. What is more probable is that we are enduring a period of adjustment, with both regulators and lobbyists uncertain as to how exactly the system works, testing its limits, but with some *modus vivendi* evolving over time. However, it is severe distraction for IASB that financial instruments, arguably the controversy of the 1990s, is still causing trouble, when it has on its agenda more radical ideas in the areas of revenue recognition, performance reporting and insurance contracts.

The Future Agenda for IFRS

The matter of performance reporting (now called financial statement presentation) is a priority project for IASB. It was divided into two phases, of which the first, dealing with what financial statements are to be presented, led to the issuance of an Exposure Draft in mid-2006. The second phase, which will address presentation on the face of the financial statements, is expected to result in a discussion paper no sooner than 2007. This joint undertaking with FASB has potential for making significant changes to financial reporting, including distinguishing "remeasurements" from other types of income and expense. The currently outstanding draft would, if adopted, bring IFRS-based financial reporting into near-conformity with US GAAP, particularly with FAS 130 (which distinguishes "other comprehensive income" items to be reported directly in stockholders' equity). The proposed *statement of recognized income and expense* would closely parallel the *statement of comprehensive income* prescribed under US GAAP, whereby current period earnings are one component which, together with other items such as changes in revaluation surplus and translation gains and losses, constitute the *nonowner movements in equity*.

IASB is also involved in a revenue recognition project. This project is trying 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 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, and IASB is projecting that an exposure draft would not be released until 2008.

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 liabilities and equity.

IASB is continuing its revisions of its business combinations standards in coordination with FASB. Both Boards are nearing completion of Phase II of their projects. IASB has tentatively agreed that where there are minority interests, these should be included in group equity and that goodwill should be calculated for 100% of the shareholders, not for just the majority holding. It is still working on the definitions of contingent assets and liabilities acquired in a combination. IASB is also working on the criteria for consolidation (IAS 27) which it hopes to develop to deal more effectively with issues such as latent control and special-purpose entities. This may also turn into a joint project with FASB.

IASB is currently working on its own in the area of SME accounting (tailored standards for small and medium-sized entities), but this has now been taken up as well by the US standard setter and accounting profession. Broadly, the intention of this project (which was the subject of an IASB Discussion Paper in 2004) is to produce a single accounting standard for SME which consists of simplified versions of the existing IFRS, analogous to what was done in the UK some years ago (and revised several times, as new GAAP was promulgated). 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, that this was an urgent need. The crucial issue of what is an SME is couched in conceptual terms, as being an entity in which there is no public interest, but precise size terms are left to individual jurisdictions to determine. The definition excludes entities with listed equity or debt as well as those that which are economically significant.

The SME standard will likely be based on the "black letter paragraphs" of IFRS, with additional material as necessary. Where a preparer does not find the treatment needed, the entity should then refer to the substantive IFRS, although this does not then imply an obligation to comply with all the IFRS. The entity will be required to describe itself as reporting in accordance with the SME standard, and not as reporting in accordance with IFRS. The proposal is very similar to that of the UN's expert group, which provided a guideline to its member states on differential reporting and an abbreviated form of IFRS in 2001. (See appendix to this chapter for further thoughts on the SME project.)

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, which it had hoped to have in place by 2008, although this now seems unlikely. 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.

A project addressing IAS 30 disclosure requirements came to fruition in mid-2005 with the issuance of IFRS 7, covered in this publication. It eliminates IAS 30 disclosures and merges them with those formerly in IAS 39, all of which are now incorporated into the new standard.

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 the abuses commonly called providing "cookie jar reserves" during periods of corporate downsizing, when generous estimates were often made of future related costs, which in some instances served to absorb costs properly chargeable to future periods. In other cases, excess reserves (provisions) would later be released into income, thereby overstating operating results of the later periods. FAS 146 applies strict criteria so that reserves that do not meet the definition of liabilities at the balance sheet date cannot be recorded, since they do not represent present obligations of the reporting entity. The proposal also will hew 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 (which is discussed in great detail in Chapter 12) 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.

IASB also has expressed its intent to replace IAS 20, and an Exposure Draft had been promised for late 2005. However, it now appears that this project will not be addressed for perhaps several more years, since the first conceptualized approach, using the model in IAS 41, has now been seen as inadequate. (See discussion in Chapter 26.)

Yet another short-term convergence project will, if adopted, eliminate from IAS 23 the current option of expensing borrowing costs associated with long-term asset construction efforts. IAS 23 would thus converge to the parallel US GAAP standard (FAS 34), which required capitalization of interest under defined circumstances.

Income taxes and segment disclosures are additional subject areas where IASB will likely converge to the US GAAP positions in the near future. As to income taxes, both IFRS and US GAAP embrace comprehensive interperiod allocation using the liability method, but there are certain exceptions permitted, which are expected to be narrowed or eliminated. Also to be conformed is the computation of deferred tax assets and liabilities, and the treatment of uncertain tax positions (US GAAP has recently been revised to address this, while IFRS has yet to do so. As to segment disclosures, IFRS will likely be altered to parrot US GAAP, which is expected to ease the current challenge of developing segment data under IFRS.

Finally, accounting requirements for joint ventures will be changed to delete the currently available option of using the proportionate consolidation method, thus mandating only the equity method, as 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.)

Europe 2006 Update

The IASB's long effort to gain acceptance for IFRS began to bear fruit several years ago, when the EU briefly considered and then abandoned a quest to develop Euro-GAAP, and when IOSCO endorsed, with some qualifications, the "core set of standards" following major revisions to most of the then-extant IFRS. A significant impediment remains, however, as the US Securities and Exchange Commission still refuses to permit filings of financial statements prepared on the basis of IFRS without reconciliation of major items to US GAAP. However, the EU's decision to require IFRS-based filings will provide a further impetus to acceptance—as will the IASB-FASB agreement to work toward full convergence of the standards.

Beginning January 1, 2005, all European Union (EU) 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 or will affect approximately 7,000 companies, of which some 3,000 are in the United Kingdom. In all or almost all instances, comparative financial statements were also required, meaning that restatement of 2004 financials was necessary in the first year's (2005) presentations.

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 enterprises or charities. Additionally, it is possible that most of the EU states will permit IFRS in the annual (i.e., not consolidated) accounts of all companies, again 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 balance sheets 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.

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 means cost. One survey of 1,000 European companies indicates that the average compliance cost across UK companies will be about £360,000. This figure rises to £446,000 for a top-500 company; £625,000 for companies with a market capitalization value between £1bn-£2bn; and over £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 profit and loss statements or balance sheets. 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.

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 re-examine 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 balance sheet 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 the income statement.

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 which 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. As a result, companies, their lawyers and accountants will have to re-examine 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 2005, effective 2007)
IAS 2	Inventories (revised 2003, effective 2005)
IAS 7	Cash Flow Statements
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors (revised 2003, effective 2005)
IAS 10	Events After the Balance Sheet Date (revised 2003, effective 2005)
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 14	Reporting Financial Information by Segment
IAS 16	Property, Plant, and Equipment (revised 2003, effective 2005)
IAS 17	Accounting for Leases (revised 2003, effective 2005)
IAS 18	Revenue
IAS 19	Employee Benefits (revised 2004)
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates (revised 2003, effective 2005; minor further amendment 2005)
IAS 23	Borrowing Costs
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 2003, effective 2005)
IAS 28	Accounting for Investments in Associates (revised 2003, effective 2005)
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Financial Reporting of Interests in Joint Ventures (revised 2003, effective 2005)
IAS 32	Financial Instruments: Presentation (revised 2003, effective 2005; disclosure requirements removed to IFRS 7 effective 2007)
IAS 33	Earnings Per Share (revised 2003, effective 2005)
IAS 34	Interim Financial Reporting
IAS 36	Impairments of Assets (revised 2004)
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets
IAS 38	Intangible Assets (revised 2004)
IAS 39	Financial Instruments: Recognition and Measurement (amended 2005)
IAS 40	Investment Property (revised 2003, effective 2005)
IAS 41	Agriculture

IFRS 1	First-Time Adoption of IFRS (minor amendment 2005)
IFRS 2	Share-Based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Noncurrent Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
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, *Financial Reporting in Hyperinflationary Economies*
IFRIC 8	Scope of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment

APPENDIX B: CASE STUDY

BELGACOM: GOING PRIVATE AND IMPLEMENTING IFRS

IFRS Project

Companies going through the transition to IFRS may draw on the experience of companies which adopted IFRS voluntarily before the 2005 deadline for EU publicly traded companies. Belgacom, Belgium's leading telecom company, implemented IFRS in consolidated financial statements for the year 2003 with two comparative years. These statements were published for both the 2003 annual report and the prospectus for the IPO (March 2004). Belgacom was convinced that the use of IFRS in the prospectus would contribute to the success of the IPO through the communication of financial information that is more transparent, relevant and internationally comparable. Apart from increased financial flexibility, successful entrance to Euronext Brussels strengthened the company's position in the European telecom sector.

Belgium was among seven EU nations (also Austria, France, Finland, Germany, Italy, and Luxembourg) which in the mid-1990s made provisions allowing companies under specific prerequisites to prepare their consolidated accounts in accordance with a non-Belgian GAAP. As a result of this legislation, Belgian listed and non-listed companies had the possibility of obtaining an exemption from applying Belgian GAAP when preparing their consolidated financial statements. Such an exemption was subject to authorization by the Banking Finance and Insurance Commission (for holdings, financial institutions and insurance companies) or by the Minister of Economic Affairs (for all other companies) in cases where the group might be considered a "global player." If such authorization was granted, instead of applying Belgian GAAP, the so-called "global players" could apply another internationally recognized GAAP. Such international framework, generally understood to be either IFRS or US GAAP, could only be applied to the extent that it complied with the 4th and 7th European Directives. This "global players exemption" became obsolete in 2005 for listed European companies, since they were all required to implement IFRS based on the IAS Regulation.

The telecommunications industry is capital-intensive, with operators investing heavily in licenses and network infrastructure. Deregulation, increased competition, and technological advances characterize the industry. Telecom operators have responded by offering complex bundled arrangements to customers through a range of different distribution channels, and by investing in the acquisition and retention of customers.

Significant accounting issues arise for telecommunications operators in the area of property, plant, and equipment constructed, purchased or swapped, and operators often have complex revenue recognition issues, in particular for bundled (or multiple-element) arrangements.

The transition of Belgacom from a privately owned company to a publicly listed one required changes to its corporate culture, including creating greater transparency vis-à-vis the market. The decision to implement IFRS was not considered as a technical stand-alone project of the accounting department but as a crucial decision to support the quality and success of IPO.

Since 1993, the company had been preparing a monthly reconciliation of equity under Belgian GAAP to equity under US GAAP. The financial statements determined in accordance with US GAAP were published with the annual report, and quarterly reporting of certain specific US GAAP disclosure requirements for former private shareholders was provided. The experience with preparing reports under US GAAP helped the company's finance staff to understand the importance of transparent international financial reporting and made the later IFRS conversion easier.

In 2000, a dedicated group of finance staff started the IFRS project with the objective of publishing the 2003 consolidated financial statements in accordance with IFRS. The primary driver behind the project was the internationalization of the telecom industry, which was taking place at a rapid pace. Also contributing to this action was the belief that future IPO would be more credible and successful under IFRS than under Belgian GAAP because of greater financial transparency and investor interest. The formal IFRS project started in 2001, with an in-depth analysis of each international accounting standard and its possible impact on the financials of the Group. US GAAP was not considered as an alternative because of the European Commission's expressed preferences and the subsequent decision to require the use of IFRS for consolidated financial statements of EU listed companies, the intended convergence of IFRS and US GAAP, and the growing prominence of IFRS for cross-border listings.

Approach to Implementing IFRS

Financial reporting standards, such as IFRS, are directed to general-purpose external reports, and do not necessarily constrain the methodology employed by entities for their bookkeeping systems. Accordingly, listed EU companies subject to the IAS Regulation can first prepare consolidated financial statements under their national accounting standards and then convert them to IFRS. Alternatively, they can implement IFRS in their respective accounting processes across the entire organization. The second option allows for harmonization of internal and external reporting and creation of a single accounting "language" across the business, which is often listed among the most important benefits of the conversion.

Beginning in January 2003, the financials used for internal reporting and performance measurement in Belgacom were based on IFRS, together with comparative figures for 2002. The internal reporting focuses on the financial position and performance of the Group and its business segments. Although the subsidiaries continued to report to the consolidation team under Belgian GAAP, they were required to identify adjustments to IFRS which were allocated to the business units. This approach, with reconciliation between national GAAP and IFRS at the individual accounts level and, later, consolidation of the IFRS-based individual accounts, is the most commonly observed practice among European listed companies today.

The parent company and subsidiaries are still publishing their individual financial statements under Belgian accounting standards for statutory purposes, since those accounts, based on the national accounting standards, are used for purposes of taxation, profit distribution and financial services supervision. This circumstance necessitates the costly parallel operation of two accounting systems for companies, and creates some confusion and insecurity among the users of the annual financial statements.

Eddy Van Den Berghe, Belgacom's Director of Group Accounting and Financial Control, has stated that the transition from Belgian accounting rules to IFRS impacted most of the balance sheet and income statement captions in terms of recognition, measurement and/or presentation, in addition to the much more extensive disclosure requirements under IFRS. In order to implement and computerize such changes, minor changes of systems were necessary, but first new processes were set up to document transactions and to collect information. The most important system change was related to the depreciation of property, plant, and equipment, as well as amortization of intangible assets, on a pro rata basis instead of in accordance with tax rules. In addition to the Belgian GAAP chart of accounts, additional accounts were created under IFRS accounting, e.g., for financial instruments valued at fair value. New procedures had to be established for collecting information needed for new external reporting disclosures, including those addressing related parties, deferred taxes, rights and commitments, fixed assets, and segment information.

Impacts on Profit and Equity

The impact of the implementation of IFRS on firms' financial results and position was expected to be significant, particularly in Continental European countries. Traditionally, in these countries legal compliance, with an emphasis on capital maintenance and creditor protection, was of greater importance than fair presentation. Belgian accounting is characterized by its basis in Company Law, its emphasis on financial reporting conformity with tax regulations, protection of creditors, conservatism, broad stakeholder orientation, and focus on the balance sheet and the use of provisions to smooth earnings.

In the 2003 annual report, Belgacom disclosed the impact of the implementation of IFRS on its equity on the transition date, January 1, 2001, and at the end of the latest period presented under Belgian GAAP, December 31, 2002. In conformity with IFRS 1, reconciliation of the Belgian GAAP profit and loss account with the restated amounts under IFRS for the year ended December 31, 2002, was also reported. Belgacom reported a decrease in consolidated equity of €319 million (a 13% decrease from Belgian GAAP-based equity) as the impact of the introduction of IFRS as of January 1, 2001.

The following shows the reconciliation of Belgacom's consolidated equity reported under Belgian GAAP to its equity under IFRS at January 1, 2001, and December 31, 2002.

(In euros millions)	*1/1/2001* €	*1/1/2001* %	*12/31/2002* €	*12/31/2002* %
Stockholders' equity under Belgian GAAP	**2,626**	**100**	**2,900**	**100**
Pensions and other postemployment benefits	(1,124)	(43)	(612)	(21)
Depreciation and amortization of intangible assets and property, plant, and equipment	214	+8	313	+11
Remeasurement of financial instruments	2	+0.1	21	+1
Dividends	231	+8	280	+9
Provisions	(42)	(1)	(40)	(1)
Other adjustments	(5)	(0.1)	2	
Deferred taxes	423	+16	142	+5
Minority interests	(17)	(1)	(27)	(1)
Stockholders' equity under IFRS	**2,307**	**87**	**2,978**	**102**

Belgacom reported a positive impact on consolidated net income of €231 million (a 25% increase versus Belgian GAAP) as a result of the conversion to IFRS for the fiscal year 2002. The following identifies the differences in 2002 between consolidated net income under IFRS and according to Belgian GAAP.

	Year ended December 31, 2002	
(In euros millions)	€	%
Net income under Belgian GAAP	**911**	**100**
Pensions and other postretirement benefits	264	+29
Depreciation and amortization of intangible assets and property, plant, and equipment	25	+3
Remeasurement of financial instruments	(14)	(2)
Business combinations	200	+22
Provisions	(11)	(1)
Other adjustments	(2)	(0.5)
Deferred taxes	(228)	(25)
Minority interests	(2)	(0.5)
Net income under IFRS	**1,142**	**125**

Major factors causing the difference in the amount of equity and net income between that reported under IFRS and that reported under Belgian GAAP, for Belgacom, included accounting for pensions and other postemployment benefits, intangible assets and property, plant and equipment, deferred taxes, dividends payable, financial instruments and business combinations.

The table below reports Belgacom's returns on equity under Belgian GAAP and under IFRS for the year ended December 31, 2002. As a result of conversion to IFRS the company's reported return on equity increased by 6.9%.

	Under Belgian GAAP	Under IFRS	*Effect of implementing* IFRS on ROE
Return on equity	911÷ 2,900 = 31.4%	1,142 ÷ 2,978 = 38.3%	6.9% increase

In the following tabulation, the principal differences between IFRS and Belgian GAAP, which had a major impact on implementing IFRS, are set forth. Information presented in the table is based on the notes to the reconciliation adjustments in the annual report of several Belgian companies, the accounting regulation, and the other published sources.

CATEGORY	IFRS	BELGIAN GAAP
Deferred taxes	IAS 12 requires recognizing deferred tax liabilities and assets on all temporary differences between the carrying amount of an asset or liability in the balance sheet and its tax base.	No specific guidance exists to recognize deferred tax assets. The prudence principle encourages not recording deferred tax assets.
Pension costs	IAS 19 requires a company's net pension obligation, or asset, to be reported on the balance sheet as service is rendered and measured at the expected amount to be paid.	Amounts paid to pension funds or insurance companies subject to funding requirements based on specific regulations are reported in the income statement upon payment.
Provisions	IAS 37 refers to the existence of a legal or constructive obligation towards a third party at the reporting date as one of the recognition criteria for a provision.	No need to have an obligation at the reporting date to recognize a provision, which may be based on the prudence principle.
Dividends	IAS 1 prescribes only the disclosure of dividends proposed or declared after the balance sheet date.	Dividends proposed and to be approved by shareholders are presented as a liability.
Inventory valuation	IAS 2 requires all directly attributable costs to be included in the cost of inventories.	Indirect production costs may be excluded from the cost of inventories
Impairment of assets	IAS 36 considers that an asset is impaired when its carrying amount exceeds it recoverable amount.	No specific guidance in this area. Requirement to record "exceptional" depreciation if a permanent diminution in value of a fixed asset occurs.
Depreciation of fixed assets	IAS 16 requires that depreciation methods reflect the pattern in which the asset's economic benefits are consumed by the enterprise.	Tax-driven depreciation methods and rates are used.
Impairment of goodwill	IFRS 3 proposes that goodwill should not be amortized. It should be accounted for at cost less any accumulated impairment losses. Impairment tests should be performed under IAS 36.	Goodwill amortized over its useful life. When useful life exceeds 5 years, a justification should be provided in the notes.
Capitalization of development costs	IAS 38 requires capitalization of development costs if specific criteria are met.	Development costs may be recognized as intangible assets if they do not exceed a prudent estimate of their usefulness or future profitability.
Financial instruments and hedging	IAS 39 requires all financial derivatives to be reported on the balance sheet at fair value, and the resulting gains and losses to be reported either in the income statement or directly through equity.	Unrealized gains (except for unrealized exchange gains) on financial derivatives should not be reported in the balance sheet.

Treasury shares	IAS 1 requires that treasury shares be presented in the balance sheet as a deduction from equity. No gain or loss on sale should be recognized in the income statement.	Presented in the balance sheet as short-term financial assets. Gains or losses arising on sale of treasury shares are recognized in the income statement.
Investment grant	IAS 20 requires recognizing the grant as income using an appropriate and systematic allocation basis.	Grants related to nondepreciable assets are not reported in income until the assets are disposed of.
Share-based payment	IFRS 2 requires companies to recognize the fair value of share-based payments as an expense in the income statement.	Disclosure required.
Earnings per share	IAS 33 requires companies to disclose basic and diluted net income per ordinary share on the face of the income statement.	No specific guidance provided.
Segment reporting	IAS 14 requires that companies report results by business and geographic segment.	Not required.
Cash flow statements	IAS 7 requires presenting the cash flow statement.	Not required to be presented.

Benefits and Challenges

IFRS financial statements provide better information to external users on the economic evolution of the company as well as how the company is managed and how management is informed, according to Belgacom's Eddy Van Den Berghe. Among the advantages of IFRS-based reporting is the fact that internal and external segment reporting now mirror each other. Consequently, these IFRS statements provide telecom analysts and other users with a more powerful tool to benchmark the company's results, balance sheet structure and cash flow against industry peers, increasing comparability of consolidated statements as well as levels of transparency.

A key challenge resulting from the transition to IFRS is managing the company's apparently increased volatility, particularly that due to the use of fair value measurements. The IASB advocates its fair value approach on the grounds of relevance, but the approach brings increased volatility in the reported values of net assets as well as earnings. Other factors that might lead to increased volatility in IFRS financial results as compared to results that would have been reported under national standards include more rigorous asset impairment reviews; a compulsory annual impairment test of goodwill; the requirement to recognize actuarial gains and losses outside the permitted "corridor" in the financial statements; and stricter rules on the requirement to consolidate special-purpose vehicles or similar structures on the balance sheet. Consequently, net income and net assets, key inputs to financial ratios assessing performance, could look significantly different under IFRS.

The most difficult IFRS to implement for Belgacom were IAS 32 and 39, including following up the latest changes to these standards, and establishing information flow, documentation and disclosure requirements. Taking into account the significant amounts of intangible assets and property, plant, and equipment on the company's books, it also took time to develop appropriate internal policies in respect to movements of assets, including asset retirements and disposals, impairment testing, reduction of estimated economic lives, and cross-border lease arrangements.

Education, training and knowledge of IFRS are important challenges of conversion, if the Belgacom experience is a guide. A training program for staff across a company is needed to let them adopt an entirely different system of business operations, performance measurement and communication with the markets. This training is an ongoing exercise since IFRS is a moving target. At the level of segments, changing the mindset has proven difficult at Belgacom. Audit firms play a crucial role in this training program and Belgacom's external auditors contributed significantly to the success of the IFRS project.

The introduction of IFRS should lead to an improvement in the quality of reported financial amounts, and to greater comparability among entities. Nevertheless, the Belgian legislators have opted to make IFRS only obligatory for consolidated financial statements of listed companies, and its use is, at this time, even forbidden for individual financial statements. This double-standard system can cause confusion among the users of annual reports and additional costs for companies. Decoupling annual financial reporting from taxation could substantially simplify the debate about the introduction of IFRS for individual financial statements. Implementing IFRS for consolidated statements and allowing countries to require national GAAP for individual accounts adds complexity to accounting systems and constitutes an impediment to global accounting harmonization.

APPENDIX C

US GAAP RECONCILIATION AND RESTATEMENT—CASE STUDY

Nokia Oy prepares its financial statement in accordance with IFRS but also files in the US, where is must reconcile certain financial statement captions to the US GAAP basis. The following is taken from Nokia's 2005 financial statements.

	Year ended December 31,					
	2001 (EUR)	*2002 (EUR)*	*2003* (EUR)*	*2004* (EUR)*	*2005 (EUR)*	*2005 (EUR)*
	(In millions, except per share data)					
Profit and Loss Account Data						
Amounts in accordance with IFRS						
Net sales	31,191	30,016	29,533	29,371	34,191	40,489
Operating profit	3,362	4,780	4,960	4,326	4,639	5,494
Profit before tax	3,475	4,917	5,294	4,705	4,971	5,887
Profit attributable to equity holders of the parent	2,200	3,381	3,543	3,192	3,616	4,282
Earnings per share (for profit attributable to equity holders of the parent)						
Basic earnings per share	0.47	0.71	0.74	0.69	0.83	0.98
Diluted earnings per share	0.46	0.71	0.74	0.69	0.83	0.98
Cash dividends per share [(1)]	0.27	0.28	0.30	0.33	0.37	0.44
Average number of shares (millions of shares)						
Basic	4,703	4,751	4,761	4,593	4,366	4,366
Diluted	4,787	4,788	4,761	4,600	4,371	4,371
Amounts in accordance with US GAAP						
Net income	1,903	3,603	4,097	3,343	3,582	4,242
Earnings per share (net income)						
Basic earnings per share	0.40	0.76	0.86	0.73	0.82	0.97
Diluted earnings per share	0.40	0.75	0.86	0.73	0.82	0.97
Balance Sheet Data						
Amounts in accordance with IFRS						
Fixed assets and other noncurrent assets	6,912	5,742	3,837	3,161	3,347	3,964
Cash and other liquid assets [(2)]	6,125	9,351	11,296	11,542	9,910	11,735
Other current assets	9,390	8,234	8,787	7,966	9,041	10,706
Total assets	22,427	23,327	23,920	22,669	22,298	26,405
Capital and reserves attributable to equity holders of the parent	12,205	14,281	15,148	14,231	12,155	14,394
Minority interests	196	173	164	168	205	243
Long-term interest-bearing liabilities	207	187	20	19	21	25
Other long term liabilities	253	274	308	275	247	292
Borrowing due within one year	831	377	471	215	377	446
Other current liabilities	8,735	8,035	7,809	7,761	9,293	11,005
Total shareholders' equity and liabilities	22,427	23,327	23,920	22,669	22,298	26,405
Net interest-bearing debt [(3)]	(5,087)	(8,787)	(10,805)	(11,308)	(9,512)	(11,264)
Share capital	284	287	288	280	266	315
Amounts in accordance with US GAAP						
Total assets	22,038	22,977	24,045	22,921	22,661	26,835
Shareholders' equity	12,021	14,150	15,437	14,576	12,558	14,871

* *2003 and 2004 financial accounts reflect the retrospective implementations of IFRS 2 and IAS 39(R). 2001 and 2002 data has not been adjusted from that reported in prior years, and therefore is not always comparable with data for years 2003 to 2005.*

(1) *The cash dividend for 2005 is what the Board of Directors will propose for approval at the Annual General Meeting convening on March 30, 2006.*

(2) *Cash and other liquid assets consist of the following captions from our consolidated balance sheets: (1) bank and cash, (2) available-for-sale investments, cash equivalents and (3) available-for-sale investments, liquid assets.*

(3) *Net interest-bearing debt consists of borrowings due within one year and long-term interest-bearing liabilities, less cash and other liquid assets.*

APPENDIX D

USE OF PRESENT VALUE IN ACCOUNTING

Present value is a pervasive concept that has many applications in accounting. 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 × .1) + (€200 × .5) + (€300 × .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		2,160
Probability weighted expected present value		€9,030

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.

(n) Periods	2%	3%	4%	5%	6%	7%	8%	9%	10%
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

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

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

(n) Periods	2%	3%	4%	5%	6%	7%	8%	9%	10%
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 × .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 × .8 + 80,000 × .2)/$(1 + .05)^{20}$].
4. Asset D has a present value of €37,689 [€120,000 × .25 + 100,000 × .5 + 80,000 × .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 × .25 + 100,000 × .5 + 80,000 × .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.

APPENDIX E

IFRS FOR NON–PUBLICLY ACCOUNTABLE ENTITIES

A long-running debate, which gathered considerable steam over the past several years, may be headed for a resolution over the near term. This pertains to the movement to either develop a unique set of financial reporting standards for what many refer to as smaller and medium-sized entities (SMEs), or to extract from existing IFRS a slimmed-down set of requirements to be referenced by such reporting entities as their primary source of guidance. An antecedent for this can be found in UK GAAP, which in late 1997 developed as FRSSE (Financial Reporting Standards for Smaller Entities) a single standard containing excerpts from many, but not all, existing UK GAAP standards. (A proposed amendment to FRSSE is currently being considered, essentially updating the original pronouncement for certain new standards promulgated since its most recent full revision.) The debate took on added urgency when the "principles-based vs. rules-based" squabble erupted, stimulated by the flurry of financial reporting frauds in the US in the late 1990s and early 2000s, which some IFRS enthusiasts cited as evidence for the proposition that detailed guidance based on a plethora of mechanical rules actually offered more, not less, opportunity for financial reporting shenanigans. The US standard-setting bodies, FASB and AICPA, subsequently undertook a SME project, as well.

The stimulus for this undertaking seems to center on the perceived complexity of modern financial accounting requirements, which some believe exceed the abilities of financial statement preparers and auditors to fully comprehend, and which arguably serve to make financial statements and accompanying footnote disclosures incomprehensible to both entity management and other, external users. This is a highly debatable proposition, however, since it is not the unilateral actions by accounting rule-makers but rather the ever-increasing complexity of business transactions that have, for the most part, necessitated the creation of newer and admittedly complex requirements. For one obvious example, the growing use, even by smaller businesses, of "engineered instruments" such as forwards and options (e.g., currency forwards used by importers of products to protect against currency fluctuations when purchase obligations are denominated in foreign currencies) has resulted in necessarily complex standards on hedging transactions. (Note that adoption of comprehensive fair value accounting would obviate the need for special hedge accounting, but post-Enron this goal seems to have become less attainable, politically.)

Other complex accounting standards have been the (some would say, unfortunate) result of standard setters' accession to preparers' demands for deferrals and various other smoothing techniques. A prime example: accounting for defined benefit pension and other postretirement benefit programs. Were market-driven fluctuations in the values of investments, changes in interest rates, and revisions to actuarially determined amounts such as life expectancies fully and immediately reflected, pension accounting would be radically simplified, albeit still subject to estimations that are certain to change over time. The willingness of FASB, IASB and various other national standard setters to countenance various smoothing strategies has resulted in many complex standards—and, not coincidentally, late-blooming recriminations about the broader societal impacts such departures from reporting economic reality have caused or contributed to.

Nonetheless, a popular demand has arisen for "simplified" financial reporting, which often cites the fact that the vast majority of all reporting entities are not large or publicly held companies, suggesting that since most users of financial statements will be management and other "insiders" having access to such details as they may optionally desire to obtain, a stripped-down set of financial reporting rules should suffice, easing the task of preparing and auditing such financial reports. Similar efforts in past decades, often labeled as the debate between "Big GAAP" and "Little GAAP," have (with the exception of the FRSSE standard under UK GAAP) not been successful, since even advocates of differential standards have largely conceded that *recognition* and *measurement* standards cannot vary, if all preparers' financial statements are to be found "fairly presented." The differential disclosures that have been identified even by proponents of "Little GAAP" have been very few, indeed. In short, once it is acknowledged (as it seems destined to have to be) that recognition and measurement cannot logically vary based merely on the entity's size or its status as a private or public company, the effort largely devolves to a debate over the extent of required informative disclosures.

Before addressing the specifics of IASB's SME project (as it stands as of mid-2006), there are a few final observations to make regarding the wisdom of differentiating accounting standards based upon some criterion concerning the preparers' size or the extent to which it is "publicly accountable" (i.e., reports to outsiders lacking the ability to obtain further information directly from management). In the authors' opinion, the only rational basis for differentiation of GAAP or IFRS is based on the economic transactions and activities engaged in by the reporting entities themselves.

If the entity engages, say, in hedging activities, then the promulgated standards directing how such transactions are to be accounted for need to apply, whether the entity happens to have outside shareholders or not. Leaving aside the question of whether, say, IAS 39 is too complicated, or based on unsound principles (which matters should be addressed directly by revising or amending the standard), it may well be true, and appropriate, that a large, publicly held entity that does not engage in hedging activities could present less complex financial statements than a small, private company that does engage in such activities.

There should be one single set of high-quality global financial reporting standards, and companies should not be permitted choices in selecting their financial reporting standards. The primary objective of the IASB, as set out in its *Constitution* and in the *Preface to International Financial Reporting Standards*, is "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards…" The word "single" implies that the IASB's proposal on SMEs conflicts with its constitution. An unfortunate consequence of this approach is that some IASB constitutions may defend the need for another accounting treatment in their particular circumstances, as occurred with European banking interests with regard to IAS 39. If, in addition, SME are permitted to choose to follow SME standards or IFRS or a combination of the two, this may result in SME financial statements that are not comparable to those of non-SMEs and possibly not even comparable to other SMEs, potentially impairing the usefulness of financial information.

Furthermore, the parallel existence of what will be widely viewed as two sets of financial reporting standards will contribute to the creation of a two-tiered accounting profession, with some practitioners seen as being qualified for SME but not for "real" IFRS. This could even have impacts on the educational system, perhaps with an abbreviated course of study for those who will become qualified for the SME level of work, versus a longer program for those aspiring to be expert at "full" IFRS. The problem with this is that it will artificially isolate some, probably smaller, practitioners, who may come to find their credibility (say, with bankers) has become attenuated as a result.

The possibly most deleterious consequence, although likely the least obvious one, will be the higher cost of capital to be borne by smaller entities—those using "second class" IFRS and being audited or reviewed by "second tier" accountants. Cost of capital (bank loans, trade credit, equity infusions) reflects the perceived riskiness of the investment, which in turn is directly impacted by the quality of information made available to investors and creditors.

The poorer or more incomplete such information is, the higher the perceived risk and hence the higher the cost of capital, which diminishes the expected residual return to the owners. In short, the capital markets will punish companies that opt for less than "full" IFRS, even as (according to the standard setters' survey data) they support the abstract idea of "simplified GAAP."

In the authors' view, this is an unnecessary and ill-advised risk. To the extent that promulgated IFRS (or national GAAP) is wrong, fix it. To the extent that preparers struggle with complex rules, independent accountants should help them gain the needed understanding. If lenders and other users of the financial statements cannot cope with the increasing profusion of complex standards, then perhaps the education system is inadequate to the task, or a more rigorous set of requirements for the continuing education of practicing professionals needs imposition. None of these symptoms, however, necessarily imply that certain standards are inappropriate for *certain* classes of preparers.

With this background in mind, and with the authors' view clearly stated, however, note that standard setters (both in the US and the IASB) seem determined, this time, to produce a stand-alone standard (or compendium of rules) that would appease advocates for simplified GAAP or IFRS. The goal appears to be to at least eliminate some, perhaps much, of the verbiage now found in the full text of existing standards, perhaps also dropping examples and other less essential guidance, so that at least the aura of responsiveness to a perceived public demand can be created. This may be as much a "political" undertaking as a technical one, but given the precarious position of the private-sector standard setters—particularly in the US, where the quasi-official but nominally private Public Company Accounting Oversight Board (PCAOB), established under mandate of the Sarbanes-Oxley Act (which itself was a response to the shocking epidemic of financial reporting frauds largely, but not entirely, committed by US-based publicly held companies) could expand its mandate to set accounting, as well as auditing, standards—it is understandable.

It seems that there is significant support by accounting standard setters and preparers of financial statements around the world for a separate set of internationally accepted accounting standards for SMEs, giving consideration to the different needs of users and costs of compliance faced by these entities. This support stems from the fact that in most countries in the world, unlike the US, all or most companies are legally required to prepare financial statements that conform to accounting principles that are generally accepted in their home country (national GAAP), and the vast majority of those companies are SMEs. For instance, the Accounting Law and *plan comptable* in France apply to financial statements of all legal entities, including SMEs. We note that significant differences exist in the regulation of financial reporting in the US and in IASB countries. In the US, market forces influence private company financial reporting in response to user needs and cost-benefit trade-offs. Since in several IASB countries market forces are restricted, a separate set of IASB Standards may appear to be justified.

On a more positive note, in the EU, IASB Standards are now required for consolidated financial statements of approximately 7,000 listed companies, while more than 7,000,000 unlisted SMEs will most likely continue to follow diverse national standards, based on the EU's directives, at least for the near term. Thus, there may not be a satisfactory level of comparability across national boundaries, or even within a country. Within the EU, SMEs have considerable economic significance. Thus a set of global standards for SMEs could ease the transition to a full set of financial reporting requirements for entities that are growing and wish to enter the public capital markets as well as play an important role with respect to developing countries, in helping them attract foreign investment. These countries, often with limited accountancy resources, have numerous SMEs and special difficulty in applying the full set of IFRS. Consequently, this SME project may prove to be important politically for the acceptance of IASB around the world.

The IASB SME effort actually began as early as 2001. As de facto standard setter for many developing nations, some of which have fewer cadres of trained accountants and thus, perhaps, greater challenges in implementing the more complex standards, it was sensitive to charges that its rules were more responsive to needs of the more industrialized and developed nations, which (before the recent surge of interest in *converging* national GAAP with IFRS) in fact were not the major users of IFRS. Following the lead of the UK standard setter, the initial, albeit short-lived, stated objective was to develop standards for small and medium-sized entities. Currently, the objectives of the SME project, as stated by the IASB, include the development of high-quality, understandable and enforceable accounting standards suitable for SMEs globally, to reduce the financial reporting burden on SMEs that want to use global standards, and meet the needs of users of SME financial statements. As early as 2003, the IASB agreed to a four-step plan to

1. Extract from all existing IFRS and Interpretations the *basic principles* in those standards. Given the then-practice of setting forth major principles in "black letter" (i.e., bold-face) text, with explanatory materials in "grey letter" (nonbold) text, it would have been rather simple to thus excerpt the principles in the "black letter" paragraphs of those standards, plus key elements of the *Framework*, plus some principles in IASB and IFRIC EDs that were not yet finalized.
2. Reorganize those excerpts topically (perhaps in financial statement order) if it was concluded that this would make the presentation of the principles more user friendly.
3. Review those for principles or guidance that had been omitted in the original extraction but that, on review, might be deemed to be essential to operationalize the standards for SMEs, and add those to the principles already extracted.
4. Review the results with a view to identifying helpful simplifications for SMEs, and then present those potential simplifications to an Advisory Group and the IASB for deliberation.

This action plan quickly ran up against the reality of the fact that even a superficially simple goal of assisting "small" businesses would have to address the difficulty of defining "small" and "medium"—and that even if this could be done, it could not be presumed that such entities were not engaging in relatively complex economic transactions. It short order, IASB concluded that a size-based test was not advisable, and that another threshold criterion would be preferable. The fact of "public accountability" by the reporting entity was seen as being a more meaningful distinction, where public accountability soon was defined, subject to determinations ultimately to be made by national regulatory authorities, in terms such as as public stock ownership and plans to "go public" in the near term. It was also concluded in 2003 that no changes would be made to recognition or measurement concepts established by the full set of IFRS.

As work progressed, it soon evolved that the ultimate SME version of IFRS would incorporate some, but not all, of the fundamental requirements of IFRS, with a prescription that financial statement preparers using the new standard would, in the absence of complete guidance in the new SME standard, be required to look to standard ("full") IFRS for direction. In other words, the SME version of IFRS would hopefully contain enough guidance for many, perhaps most, of the reporting entities meeting the to-be-developed qualifications for its use (i.e., those not having "public accountability"), but if such preparers were engaged in economic activities of greater complexity, they would have to refer to the original standards and be bound to comply with them. The SME guidance could thus be seen as providing a handy compendium, but not as a distinct set of financial reporting rules.

IASB later expanded on the concept of "public accountability" as follows:

> The "public accountability" principle implies that an entity is publicly accountable if
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> 1. There is a high degree of outside interest in the entity, from investors or other stakeholders;
> 2. The entity may have a social responsibility because of the nature of its operations; and
> 3. The substantial majority of stakeholders depend on external financial reporting, as they have no other way of obtaining financial information about the entity.
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> IASB also agreed to adopt presumptive indicators of public accountability. A business entity would be regarded as having public accountability if it meets any one of the following criteria:
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> 1. It has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.
> 2. It holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities brokerage, pension fund, mutual fund, or investment banking entity.
> 3. It is a public utility or similar entity that provides an essential public service.
> 4. It is of economic significance in the jurisdiction in which it is domiciled.
> 5. One or more of its owners has expressed objection to the entity's decision to use SME standards rather than full IFRSs (all owners, including those not otherwise entitled to vote, having been informed of that decision).

Some have indicated that this definition is not the appropriate way to define a differential regime for SMEs because it does not describe the vast majority of smaller, less complex SMEs. Concerns were expressed that by using a definition based on public accountability, the IASB will develop a financial reporting regime for SMEs that is comparable to full IFRS minus IAS 14 (Segment Reporting) and 33 (Earnings Per Share).

It is interesting to note that IASB discussed a number of possible situations where SME requirements could have been "simplified" versus full IFRS. For example, it considered the alternative classification of expenses permitted in the income statement, the optional use of classified or nonclassified balance sheets, and the provision of illustrative examples, all found in the original IFRS, and determined that all these attributes were to be preserved in the SME version. IASB was apparently discovering, as had others before it, that actual differentiation of SME from full-blown standards is more difficult to achieve than is apparent when first embracing the concept of "slimmed down" guidance.

In June 2004, IASB published a Discussion Paper on the Board's Preliminary Views on Accounting Standards for Small and Medium-Sized Entities. The Discussion Paper focused on issues relating to IASB's approach to the project, but did not include proposals for specific financial reporting standards for SMEs, which were promised for a later discussion document. Among other basic concepts this document set forth, it stated that a subsidiary, joint venture, or associate of a publicly accountable entity should use full IFRS in any standalone financial reporting it engaged in, as well.

Subsequently, IASB addressed the possible SME versions of a number of standards, and it was clearly established that these would exclude many details, and that users would be directed back to the underlying standards for further guidance, should they encounter the need for such. For example, the SME version of IAS 16 was to exclude discussion of the revaluation model, which would, nevertheless, be available to SME adherents, who would have to refer to IAS 16 itself for instructions. Likewise, the SME version of IAS 23 would permit either interest capitalization (where warranted) or immediate expensing, but would only discuss expensing, with readers directed to the parent standard for guidance on capitalization.

Despite earlier rejection of differential recognition or measurement, in April 2005, IASB published a staff questionnaire on possible modifications of the recognition and measurement principles in IFRS for use in IASB standards for small and medium-sized entities. To date, however, the idea of differentiating recognition or measurement has not gained traction, and as of mid-2006 all attention has been directed at disclosures and, especially, at the level of detail to be included in a compendium of standards for SME.

IASB claims there is wide support for it to issue global SME standards, and indeed wide support for simplifications apart from those affecting recognition and measurement (e.g., eliminating difficult options, scope exceptions that require calculations or complex judgments, and eliminating guidance not relevant to SMEs). IASB has also found wide support for recognition and measurement simplifications, but posing difficulties is the fact that different constituents support different recognition and measurements simplifications, for a variety of different reasons. These likely are irreconcilable and, in any event, of dubious validity.

In attempting to deal with specific IFRS and how possible SME versions of those standards might differ from their parents, IASB has observed that standards such as IAS 2 (inventories), IA 7 (cash flow reporting), IAS 11 (construction contracts), IAS 16 (long-lived assets), IAS 18 (revenue recognition), IAS 27 (consolidated financial reporting), IFRS 2 (share-based payment), and IFRS 3 (business combinations) would not vary. On the other hand, there was some sentiment for simplifications of standards such as IAS 12 (income taxes), IAS 36 (impairment), and IAS 19 (pensions), but this was far from unanimous. There was also some support for simplifying IAS 17 (leases), but that would likely require treating all leases as financings—which likely would not please preparers. (A separate IASB-FASB project may well result in elimination of most operating leases, nonetheless.)

As of mid-2006, IASB remains engaged in fine-tuning the proposed draft, *International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)*. It essentially has agreed that

1. The SME standard will be intended as a stand-alone document for a typical entity with about 50 employees (although no size test will be imposed).
2. Where IFRS provide an accounting policy, IASB has concluded that SME should have the same options. The simpler option is to be set forth in the IFRS for SME, and the other option or options are permitted by cross-reference to IFRS.
3. The IFRS for SME will omit some accounting topics that are addressed in the full IFRS, because IASB believes that the typical SME is not likely to encounter such transactions. However the IFRS for SME has an explicit cross-reference telling an SME that happens to encounter such a transaction to look to a particular IFRS.
4. The SME standard will state that if the IFRS for SME does not address a transaction, event, or condition, or provide an explicit cross-reference back to an IFRS, the SME should select an accounting policy that results in relevant and reliable information.
    a. In making this judgment, an SME should consider, first, whether appropriate accounting can be determined by analogizing from the principles in the IFRS for SMEs.

b. Only if no analogies can be derived, the full text of IFRS should be consulted as a "fallback." IASB considered whether the second tier of the hierarchy would be operational as auditors are likely to force preparers to apply the full IFRS guidance if no specific guidance exists in the SME Standard.
c. IASB acknowledged that the approach it was taking could result in different accounting for similar transactions if entered into by entities following the SME Standard and those following the full IFRSs.

5. In adopting the IFRS for SMEs, a jurisdiction (e.g., national standard setters) could elect to add, as an appendix to the IFRS for SMEs, the full text of an IFRS that they deem especially relevant to SMEs in that jurisdiction, even though in the IFRS for SMEs itself that IFRS is cross-referenced rather than included. For example, in hyperinflationary economies, the full text of IAS 29 might be incorporated into the SME standard for such jurisdictions.
6. IFRS will seek views from constituents about whether all of the options in full IFRS should be available to SMEs or, if not, which option(s) should be retained.

Among extant standards that are quite complex and in apparent need of reconsideration are some that the IASB believes may require substantial editing or even fundamental revision. These include those that address accounting for financial instruments (IAS 32/39), provisions (IAS 37), employee benefits (IAS 19), income taxes (IAS 12), and business combinations (IFRS 3).

Regarding IAS 39, the current thinking (which could change) is that there would be two classes of financial instruments, accounted for, respectively, at fair value with changes recognized in earnings, and at amortized cost. The current draft sets a threshold for financial instrument derecognition that would be higher than under IAS 39, so that only the transfers of essentially all risks and rewards would warrant derecognition. While this proposed requirement has the salutary characteristic of being simple, it would likely also preclude derecognition in many securitization situations. Reportedly, there would also be relief from the IAS 39 accounting requirements for certain types of hedge transactions that are deemed most likely of being engaged in by SME.

IASB is making some modifications to an SME version of the cash flow reporting standard, adding guidance on cash equivalents, on when cash flows may be reported net, and on how cash flows associated with acquisitions and dispositions of subsidiaries are to be reported. A new disclosure requirement, for local taxes paid, may be added.

Other decisions include one favoring inclusion of the full requirements of IFRS for consolidation in the SME standard, instead of merely cross-referencing IAS 27, although there is some thought that full IAS 27 itself can be usefully abbreviated. Despite concerns about accounting for finance leases, this has yet to be addressed, and discussion about lessor accounting for finance leases will likely be replaced by a cross-reference to IAS 17. The SME standard will also provide guidance to only the expensing option for internally generated goodwill, with a cross-reference to IAS 38 for those seeking instructions on the capitalization model.

Another highly charged topic is accounting for employee benefits, and the current thinking is to have the SME standard self-contained as to this topic, with no need for further reference to "full" IFRS.

The IASB's *Financial Statement Presentation* project is expected to mandate inclusion of an opening balance sheet in every complete set of financial statements (i.e., the balance sheet at the start of the period(s) being reported upon); this will likely be waived for entities qualifying as SME.

The final ED is expected to be released in the fourth quarter of 2006, but to date the IASB has been unwilling to countenance many, if any, actual departures from IFRS for the sake of simplifying financial reporting requirements for smaller or privately held businesses. As of this writing, there are 40 Sections, totaling 233 pages, in the draft ED. Concerns have already been raised that the resulting standards for SMEs would be of limited practical use, would not address the needs of SMEs and would not reduce significantly the number of separate accounting regimes for SMEs, around the world.

The major accomplishment, if this standard ultimately sees the light of day, will have been that excess verbiage may have been trimmed from certain, but not all, of the standards. The price to be paid will be that for some of the more complicated reporting matters, there will be certain items of fundamental guidance that will not be included in the stand-alone SME standard, necessitating continuing reference to full IFRS. Whether this single achievement will be judged as having been worth over five years of effort remains an open question. Preliminary decisions to date exhibit a largely ad hoc approach (include full and little or no real change to the fundamental—and complicated—recognition and measurement rules are likely to be identified. This may reveal, once and for all, that accounting must and should be merely reactive, and at its best can only hope to create an accurate image of economic activities engaged in by reporting entities, regardless of company size or economic environment, and not to abet the multiplicity of political and other motivations subscribed by information preparers and users.