Special Report

IFRS and International Accounting Convergence: Revolution or Evolution?

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■ Summary

The European Union (EU) will adopt International Financial Reporting Standards (IFRS) for consolidated statements of all companies with quoted equity for financial years beginning after Dec. 31, 2004 and for those with quoted debt two years later. IFRS is a comprehensive system of accounting standards and interpretations intended to provide global accounting consistency and comparability. Most countries outside the EU, including the U.S., Australia, and China, have made clear their intentions to converge their unique accounting systems with IFRS. Many companies already have converted to IFRS, mostly for market-based reasons. For example, some of these companies are headquartered in countries whose accounting standards lack global acceptance, but they desire access to the international capital markets. These multinationals include financial institutions such as UBS and corporates such as Nokia.

While the most revolutionary aspects of IFRS — those involving financial instruments and hedging — may be delayed in the EU conversion, the transition will nonetheless require careful management on the part of reporting companies and some knowledge of the technical changes on the part of analysts. Neither of these is without risk, and investors may be uncertain about how to interpret IFRS-based financial statements early on. Additionally, while Fitch Ratings does not doubt that the financial statements of EU companies will ultimately become more useful and certainly more consistent across countries, short-term risk of misstatement is high, although somewhat tempered by what will likely be an extended transition period. Moreover, given the uncertainties associated with unified auditing and enforcement regimes for IFRS, this risk could extend even further into the future unless decisive steps are taken to put these infrastructures in place and ensure their effectiveness and consistent application. Fitch believes that investors should consider these factors carefully in their analysis of listed EU companies.

■ Highlights

- The impact of the proposed IFRS standards for financial instruments on Fitch's ratings is expected to be neutral. This reflects Fitch's long-standing approach of typically removing noncash volatility in the analytical process and focusing on actual cash flow, leverage, and other appropriate measures. However, the level of noncash volatility may provide information that could, in exceptional cases, signify future circumstances affecting ratings. Fitch notes that IFRS standards for financial instruments have not been finalized.

- IFRS is a principles-based system, somewhat open to interpretation and subject to cultural differences in the transition from country-specific accounting standards to a common financial reporting system. Therefore, the likelihood of inconsistencies between companies will be high.
- Despite being embodied in law, IFRS itself contains no mechanisms for audit or enforcement, and the EU's current plans to provide for these critical infrastructures are in an embryonic state. Therefore, the transition to IFRS, outside the early adopters, may be more evolutionary than revolutionary.
- The aforementioned factors may necessitate the creation of more specific guidance within IFRS to provide auditability, enforceability, and consistency. Without this, true comparability may not be achieved for some time, and restatements resulting from differing or evolving interpretations of the standards could persist for a considerable period.
- IFRS has much in common with U.S. generally accepted accounting principles (GAAP), and many of the most controversial aspects of IFRS are based on U.S. GAAP concepts that have been implemented with much difficulty in the U.S., especially in the areas of financial instruments and hedging activities. If the experience in the U.S. is any guide, EU companies could be in for a difficult transition.
- While income determination is important, Fitch is less concerned with the selection of an income determination model than with robust disclosure, particularly in areas affecting cash flows. Therefore, from Fitch's perspective, disclosure considerations will often be a deciding factor in whether a given standard is seen as incrementally better than another. Proposed IFRS disclosure standards for financial instruments are superior to those of U.S. GAAP and many other countries' GAAP systems.

Transition Risk and Ratings Implications

In Fitch's view, the International Accounting Standards Board's (IASB) efforts to bring greater financial statement comparability to EU member states are laudable. Further, Fitch is hopeful that the new regime will eventually provide the necessary comparability to achieve the goal of a one-market view of the EU. However, given the infrastructural challenges described in this report and the time necessary to bring all these issues together, the EU will likely be in a transitional phase with respect to IFRS for several years while existing national accounting standards continue to play a prominent role.

Fitch does not expect the implementation of IFRS to have any material effect on ratings, except to the extent that previously unidentified problems are flushed out in the conversion. Several large European corporations and financial institutions rated by Fitch already have adopted IFRS, and the transitions have been smooth. With respect to reported volatility associated with mark-to-market and hedge accounting, Fitch typically strips out any such noncash volatility in the calculation of cash flow and debt service measures. However, accounting volatility could conceivably provide useful information that may indicate future circumstances affecting ratings. For example, if a company accumulates large unrealized losses on cash flow hedges in its other comprehensive income account, this may indicate, under certain circumstances, future exposure to interest rate movements that could impact cash flow. Sufficient disclosure will be critical to an understanding of noncash volatility.

IFRS may have other unintended consequences for companies. For example, while having no impact on underlying cash flows, the increase in reported earnings volatility could change a company's ability to access capital or engage in merger and acquisition activity due to changing perceptions in the market. Also, Fitch is concerned about potential actions by management to manage the volatility associated with transitioning to IFRS. The resistance in Europe to International Accounting Standard (IAS) 39 mark-to-market and hedge accounting provisions could indicate that some entities may be willing to go to great lengths to mitigate the financial statement impact of those provisions.

Implementation of IFRS will create stresses on systems and personnel. Additionally, the fact that any conversion serves, to some extent, to test the integrity of existing records means that great potential exists for the identification of previously unknown financial reporting errors and irregularities. Further, IFRS is prone to interpretive errors in implementation due to its lack of concise rules. No one can predict the magnitude of these problems, but it is fairly certain they will exist and could result in restatements.

Principles Versus Rules

Fundamentally, IFRS is designed as a principles-based system. U.S. GAAP is also a principles-based system, but over the years has had layers of rules added,

generally in response to demand from financial statement preparers and their auditors. Although the IFRS framework is similar to the Financial Accounting Standards Board's (FASB) conceptual framework, it addresses two basic issues that, curiously, are not dealt with in the FASB conceptual framework. These are: substance over form, which is only mentioned indirectly by the FASB, and the true and fair view exception, which does not appear at all in the FASB conceptual framework. This latter critically important concept is appended to the U.S. auditing rules. The vital concept of accounting for transactions in accordance with their substance instead of merely their legal form, as well as that of making an exception to the application of an accounting principle if the application of that principle would render the financial statement misleading, are addressed explicitly within the IFRS framework.

There are currently 25 member states of the EU that will adopt IFRS in January 2005 for consolidated financial statements of companies with quoted equity. The EU member states currently have widely divergent accounting practices and financial reporting standards. Outside of France, Spain, Italy, and the U.K., many large EU corporations and financial institutions either report on a U.S. GAAP basis or already have converted to IFRS. The early IFRS adopters have, in most cases, implemented all of its provisions. However, looking at the EU as a single unit, the vast majority of debt issuers have yet to convert from their native country's GAAP. The differences between local GAAP and IFRS vary from country to country. They are less pronounced in the U.K. and Ireland, where accounting standards are principles-based, than in most continental European countries, where accounting is driven by law.

What does this mass conversion mean for investors? That depends on what course the EU and its member states collectively take subsequent to the Jan. 1, 2005 conversion date. Given the current state of affairs (roughly six months from the conversion date), Fitch believes the most likely outcome is that immediate changes to existing practice will be minimal. Very broad interpretations will inevitably be applied to the principles-based standards in different countries, such that financial reporting practices for companies coming onto IFRS will converge gradually toward a common regime. This will necessarily be the case for some listed companies that lack the resources to make required systems changes and provide adequate employee training on such a tight timeline. The ultimate transition of all, or even most, listed EU companies onto a substantially equivalent reporting system will require three things for successful consummation: more specific interpretations of the principles in IFRS (i.e. rules); a unified auditing and enforcement apparatus; and time to train employees and convert systems.

The first of these issues will be handled by the International Financial Reporting Interpretations Committee (IFRIC) of the IASB and the IASB itself. The IFRIC replaced the Standing Interpretations Committee (SIC) in conjunction with the new IASB constitution in March 2002. In the course of its four-year existence, the SIC issued 33 interpretations, which generally follow the principles-based focus of IFRS. For example, in Interpretation SIC-12, Consolidation of Special Purpose Entities (SPEs), the consensus consists of three short paragraphs, the first of which states: "An SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise." Compare this with the equivalent literature in U.S. GAAP: FASB Interpretation No. 46, Consolidation of Variable Interest Entities, issued in the wake of the Enron scandal. Many practitioners in the U.S. have found this interpretation difficult to implement, and it has been subject to numerous revisions and corrections.

Fitch does not believe the IASB should seek to emulate U.S. GAAP or other rules-laden country GAAP regimes in providing prescriptive guidance. Indeed, the principles-based nature of IFRS is among its more appealing attributes. However, Fitch believes the IFRIC will have its work cut out for it as conversion progresses, as a certain amount of interpretation of principles is necessary to any system of financial reporting. This is particularly true when the companies coming onto IFRS are from such disparate environments as the EU member states. Obviously, this process cannot and should not be rushed — an organic, evolutionary conversion will provide more stability than a hard changeover. Although this process is important and necessary for true consistency to be achieved, overreliance on rules-based guidance could result in financial engineering opportunities resulting in material misstatements.

■ Infrastructure

Auditing

IFRS will shift the onus more to auditors to provide guidance on how the principles should be applied. Without the rules auditors are accustomed to in some

countries to support them, they will have to stand firm in making sometimes unpleasant decisions about how a company should be reporting. This could be especially problematical if the European auditors become as reluctant as their U.S. counterparts in the wake of the Sarbanes-Oxley Act to dispense advice on the proper interpretation of accounting principles.

Accountancy firms will frequently face issues similar to those of the companies they audit in the changeover to IFRS. Chief among these will be the lack of individuals skilled in applying IFRS. It will take several audit seasons to build up the necessary skill base within the firms to bring consistency to reporting. Additionally, the dearth of bright-line rules in IFRS will make it more difficult for auditors to convince their clients to change practices.

Audit firms will have difficulty bringing their clients into consistent practices across national borders in the absence of interpretations and guidance from the IASB. Fitch believes that, similar to the experience in the U.S., the auditing community will be one of the primary drivers of demand for interpretive rules and guidance from the IASB. However, the lack of specific rules in the short run could mean that comparability will not be apparent immediately.

Enforcement

Enforcement activities will continue to be performed by authorities operating within the context of the standards and practices of their individual jurisdictions. In June 2004, the Committee of European Securities Regulators (CESR), a consortium of EU securities regulators, provided a proposal for a cooperative approach to enforcement. The CESR hopes to reach agreements with its members and the U.S. Securities and Exchange Commission regarding the cooperative enforcement of IFRS, but the establishment of a true enforcement infrastructure will take several years. Lack of rigorous enforcement and audit functions could leave the majority of the EU markets in an extended period of transition, in which restatement risk will persist.

As enforcement activity ramps up, the legal community also will press the IASB to issue clarifications and interpretive guidance. Law enforcement agencies tend to desire a single answer for the application of the law — or for purposes of this discussion, accounting standards. This will contribute to the call for more rules to be layered onto the IFRS system. The process of developing these rules and the legal precedents to support them could take several years, and a good deal of enforcement activity will probably be required to really develop and implement rules that work.

How well the IASB manages the tension between its desire to preserve the principles-based nature of IFRS and the infrastructural demand for bright-line rules will play a large part in determining its success. If the experience of the FASB is an indication, the IASB should dispense rules frugally and defend the supremacy of substance over form and the true and fair view exception.

Commonalities with U.S. and Other Countries' GAAP

IFRS is largely based on principles found in U.S. GAAP. This is especially true of the yet-to-be-adopted IAS 39, which contains an amalgamation of the most innovative concepts in accounting for financial instruments in U.S. and other countries' GAAP from the past decade. From a U.S. GAAP perspective, IAS 39 combines mark-to-market accounting concepts from Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities; derivative and hedge accounting concepts from SFAS 133, Accounting for Derivative Instruments and Hedging Activities; and deconsolidation and securitization concepts from SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. These concepts have created tremendous turmoil in U.S. markets and together have taken a full 10 years and thousands of pages of guidance from regulators and standard-setters to implement.

Certain EU member states have voiced strenuous objections to IAS 39, which has led to delays in adoption of IAS 39 by the EU. However, some corporations and financial institutions are already reporting in conformity with IAS 39, and this has not resulted in significant restatements or downgrades. Then again, the fact that the entities adopting IAS 39 did so voluntarily suggests that they may not be a representative cross-section of EU companies. Fitch believes the key provisions of IAS 39 eventually will be adopted in some form by the EU. When this happens, EU companies will have to report on what is essentially a U.S. GAAP-equivalent basis for financial instruments. If the experience in the U.S. is any guide, this forced migration to a radically different accounting model, with all the potential issues associated with mark-to-market, hedge accounting, and off balance sheet securitization, will likely cause problems. Misinterpretations and misapplications of

the equivalent standards in U.S. GAAP have been associated with some of the largest restatements in U.S. history.

IFRS offers other incremental improvements over U.S. GAAP. Examples include:

- **Interim Reporting:** U.S. GAAP treats interim periods, such as quarters or half years, as integral to the annual period. Accounting Principles Board Opinion No. 28, Interim Financial Reporting, allows interperiod expense allocation (spreading expenses across periods arbitrarily), which allows legal earnings management within fiscal years. However, this standard seems an anachronism with the current focus on quarterly earnings. IFRS, on the other hand, treats interim periods as discrete, stand-alone accounting periods. Fitch notes, however, that the frequency of interim reporting is not addressed within the IFRS regime but left to regulators at the national level.
- **Impairment of Assets:** U.S. GAAP includes a somewhat peculiar two-step impairment process. In U.S. GAAP, tests for impairment of assets are triggered when the carrying value of an asset exceeds its undiscounted future cash flows. However, when the triggering event occurs, the asset is written down to its fair value. This creates a situation in which an asset's carrying value can float freely below its fair value as long as the carrying value does not exceed the value of its undiscounted cash flows. IFRS takes the rather refreshing and economically sound position that an asset is impaired when its carrying value exceeds its fair value, and an impaired asset should be written down to fair value. The evaluation must take place each reporting period.
- **Leasing:** SFAS 13, Accounting for Leases, created what is recognized today as a purely form-driven accounting model. The IFRS standard (IAS 17, Leases) takes a principles-based approach, stating that a lease should be classified as a finance (capital) lease if it transfers substantially all of the risks and rewards of ownership to the lessee. While this should, theoretically at least, reduce inappropriate financial engineering in the area of leases, it will clearly result in inconsistencies as practitioners struggle to define "substantially all of the risks and rewards."

Convergence and the Importance of Disclosure

As Fitch has noted in previous research dealing with derivatives, disclosure requirements under U.S. GAAP and other countries' GAAP often provide insufficient information to truly understand an entity's risk. For example, U.S. GAAP companies are no longer required to disclose the notional amount of their derivatives. Some U.S. companies have stopped disclosing notional amount and have claimed that the measure is not relevant for financial analysis. This is consistent with the FASB's position that "fair value is the only relevant measure for derivatives." Fitch does not entirely agree. Although fair value is certainly the most relevant measure for purposes of determining net income, other aspects of derivatives are useful to financial analysis. For example, notional amounts provide vital information with respect to an entity's hedging strategies and downside risk. Notional amount is often the "multiplier" that determines where fair values will go. There are many other critical elements of disclosure that are not required under SFAS 133 but which Fitch believes are important.

IAS 32 is the IFRS standard for disclosure of financial instruments. Like IAS 39, it is principles-based, requiring disclosure of anything that would be important and relevant to investors. However, the standard does suggest several measures that may be important to investors in assessing derivatives use by an entity. Because Fitch believes IAS 32 will provide disclosure for financial instruments that is superior to that required under U.S. GAAP, Fitch believes it is desirable for U.S. GAAP and other countries' GAAP to converge toward this standard.

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