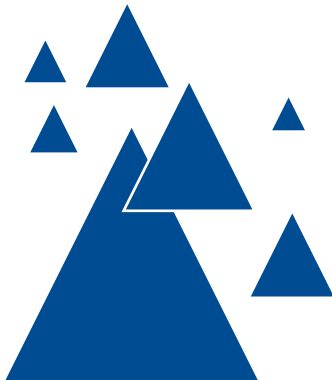




The Implementation of IFRS in the UK, Ireland and Italy

Summary



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THE IMPLEMENTATION OF IFRS IN THE UK, IRELAND AND ITALY

Introduction

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

A study funded by The Scottish Accountancy Trust for Education and Research (SATER), to be published by The Institute of Chartered Accountants of Scotland (ICAS) in the Spring of 2008, has examined the implementation of IFRS in three countries: the UK, Ireland and Italy. The study focused on these three countries because it was expected that companies in countries with a similar national accounting environment, such as the UK and Ireland, would experience similar reporting changes following the adoption of IFRS, and that companies in countries with a very different reporting environment, legal system and culture, such as Italy, would be affected differently by the adoption of IFRS. For example, the UK and Ireland are common law countries with accounting standards that focus primarily on the needs of shareholders, while Italy has a legal system based on civil law where traditionally creditors are viewed as being the most important users of financial statements. Thus, it was expected that the implementation of IFRS, with its shareholder focus, would require more of a cultural change in Italy than in the UK or Ireland.

Three different methods of analysis were used to examine the introduction of IFRS: a content analysis of annual reports; an analysis of the reconciliation statement between IFRS and national GAAP; and a multiple-stakeholder perspective on the adoption of IFRS using interviews with preparers, auditors, analysts and regulators. Each of these three methods provides an international comparison on the adoption of IFRS between the UK, Ireland and Italy.

Three main research questions are addressed, all within the framework of decision-usefulness. The first two methods quantify the nature and extent of the changes in financial reporting that have been experienced as a result of IFRS adoption. In particular, the study examines the increase in disclosure relating to these new accounting standards as well as the changes to net profit and equity when comparing national GAAP to IFRS GAAP. Secondly, the issue of usefulness is considered within the context of the implementation costs associated with the production and publication of the new information and the standards that caused the most problems for preparers and users to implement, including education and training, changes to valuation models and a general understanding of the accounting requirements and concepts. The third research question considers the usefulness of IFRS information from the perspective of both the preparers and the users of financial statements, both from the usefulness of the contents being mandated as well as the formats in which the additional information must be disclosed. The key question is whether the information required under IFRS is decision-useful for stakeholders. While each part of the project is reported separately to address the three research questions, there emerges a comprehensive evaluation of whether the adoption of IFRS has been useful in each of the three countries. This approach contrasts with much of the extant literature which deals with specific issues or standards.

A content analysis of annual reports

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

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

IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures* accounted for a large proportion of the extra disclosure. Overall, roughly one third of the extra disclosure related to financial instruments. In the UK and Ireland an extra four and six pages respectively were devoted to disclosures related to these three standards. In Italy the effect was even more pronounced with disclosure relating to the derivatives standards running to 32 pages. In the UK and Ireland the next most frequently discussed topic related to IAS 19 *Employee Benefits*, with about one page devoted to pension disclosure. In Italy this standard ranked third but the associated disclosure was still larger than

that typically provided in the other two countries, covering three pages. The second biggest disclosure topic in Italy related to IAS 14 *Segment Reporting*. The area of segmental reporting was not covered by a specific accounting standard in Italy prior to the introduction of IFRS; thus, on average six additional pages of a typical Italian firm's annual reports were used to comply with IAS 14 requirements.

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

A breakdown by market listing and industry sector was analysed for the UK companies. This disaggregation revealed that FTSE 100 companies accounted for most of the disclosure, typically providing 16 pages of information; FTSE 250 companies typically presented half this level of disclosure. The sectoral analysis indicated that oil and gas as well as utility companies supplied more IFRS-related disclosure than other industrial groupings in the UK.

Impact of IFRS on profit and equity

The implementation of IFRS increased the reported profit of companies in the UK, Ireland and Italy such that national GAAP was only 66%, 89% and 85% of the IFRS profit respectively. The main standards that caused this increase were IFRS 3 *Business Combinations*, IAS 10 *Events After The Balance Sheet Date*, IAS 17 *Leases*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property*. Two standards had a significant negative impact; IAS 12 *Income Taxes* and IAS 32/39 *Financial Instruments* such that national GAAP was higher. However, the effect on profit varied greatly across the sample companies; for example, the

impact of IAS 40 on national GAAP profit ranged from an increase of over 2500% to a less than 1% decrease.

By contrast, the net equity of the average company was less under IFRS, such that national GAAP net equity was higher by as much as 153% in the UK and 106% in Ireland but was slightly lower in Italy where national GAAP net equity was only 97% of IFRS equity. This reduction in IFRS net equity was mainly attributable to the effects of IAS 19 *Employee Benefits* and IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* in Italy. IFRS 2 *Share-Based Payment*, IFRS 3 *Business Combinations*, IAS 10 *Events After The Balance Sheet Date*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* impacted net equity favourably from a gearing perspective under IFRS; all five standards increased the IFRS reported net equity. However, the range of the impact of some of these standards was enormous; for example, the implementation of IFRS 3 resulted in a decrease of almost 1500% in net equity for one company while another firm experienced an increase in net equity of 30% as a result of this standard.

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

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

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

The impact of IFRS on the reported profit and net equity of the sample companies is summarised in Tables 1 and 2.

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

	UK	Ireland	Italy
Overall change	66	89	85
IFRS 2	100	101	101
IFRS 3	79	90	82
IAS 10	95	100	100
IAS 12	102	98	101
IAS 17	99	100	100
IAS 38	97	100	98
IAS 39	101	100	104
IAS 40	96	100	100

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

	UK	Ireland	Italy
Overall change	153	106	97
IFRS 2	99	100	100
IFRS 3	96	98	97
IAS 10	87	96	100
IAS 12	104	107	99
IAS 16	99	100	99
IAS 19	167	104	102
IAS 32	100	100	101
IAS 38	99	100	99

Implementation costs and problems

From the 32 interviews that were conducted with various stakeholders, the biggest problem in all three countries when implementing IFRS related to the time commitment in getting up to speed on reading and understanding all the standards and assessing which ones would require the most work. A lot of time and money was spent on training staff and assimilating the new accounting requirements. This was particularly the case in Italy where a cultural change was required in order to shift from a creditor to a shareholder focus. Companies with multinational operations often held internal conferences where staff could get together for training sessions and receive feedback on implementation problems. Some standards were considered to be very technical in nature and required the assimilation of new and specific skills. This was especially the case for IAS 39, IAS 19 and the impairment testing requirements of IAS 36. Often external consultants were engaged to provide the requisite skills that were not always available internally within companies.

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

The language barrier created particular problems in Italy as all of the standards had to be translated from English into Italian and these translations were not always made available on a timely basis by the IASB. The availability of standards in all languages on a timely basis is essential requirement and an increase in the funding of the IASB may be necessary to produce these translations and to make them freely available on the IASB website. Indeed, the interpretation of standards across the many diverse cultures and languages that can exist within multinational organisations was a problem; internal conferences were often used by group companies to ensure that all their national offices possessed the same understanding of the key issues. There were also cultural differences evident in the accounting treatment choices that companies made in different countries. For example, in Italy, companies were more likely to choose the corridor approach available under IAS 19 than their UK or Irish counterparts, partly because the latter countries were already familiar with a similar standard with no corridor approach IFRS 17 *Retirement Benefits*.

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

statements of companies that have already adopted IFRS and then decide how to deal with the requirements of certain standards.

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

Usefulness to users

The intention of the IASB has been to produce financial statements that are useful for decision-making. Rather than taking a narrower shareholder focus this study sought to examine their usefulness to a wider group of stakeholders. The study found that the impact on users in Italy was far greater than in the UK and Ireland. In Italy, analysts were more enthusiastic about the impact of IFRS and suggested that a common set of standards would facilitate comparability between companies and countries. In Italy, the users were very positive that IFRS now required financial statements to be aimed at investors and not creditors. For example, Italian GAAP does not require an earnings per share figure to be shown in the financial statements and the provision of this extra information via IAS 33 was greeted favourably by the users. In Italy, the increase in disclosure was seen to be a positive feature of IFRS and there was better, clearer classification of information under the new standards

that enabled value-creation to be more clearly assessed. Further, fair values were considered to be more useful as forward-looking information that allowed the “hidden value to emerge”. The reduced choice of accounting options from Italian GAAP also helped users compare financial statements and the increase in disclosure allowed the results of operations to be better evaluated because of IAS 14. The cultural shift in Italy was also helpful as, previously, Italian companies had often merely complied with the law and disclosed as little as possible, but now the law had changed and they had to disclose far more information under IFRS, despite the fact that IFRS does not state that companies should give the reader of financial statements everything that they might find useful!

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

Policy implications

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

- Annual reports have increased in size and now typically included more complex information. Shorter documents that highlight management performance and that can be used as a basis for assessing the future prospects of companies would be helpful.
- The internet could become a useful repository for accessing more complex and detailed regulatory filings.
- Enhanced comparability of financial reports would be beneficial. The choices of accounting treatments, for example in IAS 19 *Employee Benefits*, needs to be limited so that the performance of global companies operating on an international basis can be assessed by all stakeholders.
- The large reduction in net equity for UK companies may have implications for companies wishing to raise additional finance if the strength of their balance sheets has been eroded, with higher gearing levels and greater perceptions of risk. This may prove especially so with the recent credit crunch. Companies need to ensure that stakeholders understand the financial strength of their operations and communicate openly with external parties.
- The rise in profitability of companies because of IFRS may affect the stock market values placed on companies by analysts who may capitalise earnings at a given P/E multiple. Users need to understand IFRS to ensure that they do not apply misleading valuations to company securities.

- The effect of IFRS on the content of annual reports was far greater for Italian companies and Italian users than for those based in the UK and Ireland. Language and cultural issues were factors in this difference. The IASB and EU should ensure that diverse cultures and traditions are taken into account in the formulation of new regulations and that translations are made available in a timely manner across all jurisdictions.
- Rules-based technical standards prove difficult to implement and monitor in practice. IAS 39 *Financial Instruments* is a key example as it adopts a more rules-based approach and as a consequence has resulted in many operational problems. However, the evidence in this study shows that the implementation is more problematic than the impact on net profit or net equity.
- Users need to engage more with the financial reporting process in order to enhance the usability of financial reports and to ensure that published reports are useful for decision-making purposes. More extensive communication and encouragement to engage in the IASB's consultation process would help in this regard.
- Companies that do not need to produce IFRS statements are at a competitive advantage in some countries, such as Italy, because of the wider disclosure required by IFRS. With the increasing importance of private equity buyouts many companies may be able to avoid more onerous reporting requirements.
- Guidance should be produced by the IASB for companies that are in the process of adopting IFRS to advise them on which standards to start with when planning the implementation of IFRS.
- The availability of standards in all languages on a timely basis is essential and an increase in the funding of the IASB is needed to produce these translations and to make them freely available on the IASB website.

- Within the EU a common basis for calculating tax could be developed so that the adoption of IFRS does not affect the taxation of companies differently from one country to another under IAS 12 *Income Taxes*.
- Audit firms, in conjunction with the professional bodies such as ICAS, could be encouraged to produce joint documents advising on the interpretation and implementation of standards. Inconsistent advice between audit firms and belated advice have been confusing for preparers and users.

Summary

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



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