IFRS and Values

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Financial Accounting Standards Board (FASB)

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Deloitte, Ernst & Young, European Central Bank,

Grant Thornton, KPMG, PwC,

Securities Exchange Commission,

Are We In for a Market Shock? by Lisa Atva (CICBV)

Background

IFRS = *Principles* GAAP = *Rules*

- As if telling some teenager when to come home:
- *Principle* = at a reasonable time using her judgment.
- For example:
  - 9:00 pm if homework not done
  - 10:00 pm if homework done
  - 10:30 pm if no school the next day
- *Rules* = 9:00 pm, with 10 exceptions

Background

- Accounting is the language of Business with an elaborate vocabulary and grammar.
- As in my country, Canada, the profession has two official languages, GAAP and IFRS, together with a number of dialects and patois.
- The language police, FASB and IASB, have since 2002, been trying to converge their pronouncements into one internationally accepted, high quality set of standards.
- Let's hope it's not "franglais".

Background

Excerpts from speech by Christopher Cox, SEC chair, November 2008

- First, the standards must be crafted in the interest of investors. That has to be their overarching purpose. We all know that a business's *financial reports are relied upon by many other people for many purposes*. Financial statements are used by the managers of the business as an important tool in making decisions. They are relied upon by many outside parties, such as commercial lenders who extend credit to the business.

Background

Excerpts from speech by Christopher Cox, SEC chair, November 2008

- And of course financial reports are important to analysts of all kinds for purposes that go far beyond investing, as for example when economists use them as a basis for reporting about an industry's size and other aggregate statistics. But above all, a public company's financial reports represent a direct communication between the company and its investors. And from the investor's standpoint, accounting standards should promote both *clarity* and *comparability*.

Importance of IFRS

- At the end of 2009 there were 153 jurisdictions with stock markets.
- Of those, 63% already required IFRS for domestic listed companies.
- Major participants
  - Australia, China, European Union members (EU), Gulf Corporation Council companies, Hong Kong, Russia and South Africa
- Lets look at 30 selected IFRS regimes.

Importance of IFRS

Table 1 **SELECTED IFRS STOCK MARKETS** **Page 1 of 2**

	Country		Old GAAP/ IFRS Deviation Score	Dec 2009 Market Capitalization $' billion		Market Cap/ GDP	Listed Companies		Mean Market Capitalization $' million
1	Australia	Com Law	4	1,262	6.4%	127%	1,966	10.9%	642
2	Austria	EU	12	114	0.6%	30%	115	0.6%	991
3	Belgium	EU	13	172	0.9%	37%	171	0.9%	1,006
4	Britain	EU/ Com Law	1	2,796	14.3%	128%	2,792	15.5%	1,001
5	Chile		13	231	1.2%	143%	236	1.3%	979
6	China		9	3,573	18.2%	120%	1,706	9.5%	2,094
7	Denmark	EU	11	180	0.9%	58%	125	0.7%	1,440
8	Egypt		9	91	0.5%	48%	313	1.7%	291
9	Estonia	EU	7	25	0.1%	13%	92	0.5%	272
10	Finland	EU	15	188	1.0%	79%	141	0.8%	1,333
11	France	EU	13	1,521	7.8%	57%	673	3.7%	2,260
12	Germany	EU	11	1,292	6.6%	39%	783	4.3%	1,650
13	Greece	EU	17	113	0.6%	34%	288	1.6%	392
14	Hong Kong	Com Law	3	2,305	11.8%	120%	1,319	7.3%	1,748
15	Hungary	EU	13	30	0.2%	23%	46	0.3%	652

Importance of IFRS

Table 1 **SELECTED IFRS STOCK MARKETS** **Page 2 of 2**

	Country		**Old GAAP/ IFRS Deviation** Score	**Dec 2009 Market Capitalization** $' billion		**Market Cap/ GDP**	**Listed Companies**		**Mean Market Capitalization** $' million
16	Ireland	EU/ Com Law	1	61	0.3%	27%	64	0.4%	953
17	Israel		6	189	1.0%	97%	622	3.5%	304
18	Italy	EU	12	656	3.3%	31%	296	1.6%	2,216
19	Luxembourg	EU	18	105	0.5%	20%	267	1.5%	393
20	Netherlands	EU	4	402	2.1%	51%	211	1.2%	1,905
21	New Zealand	Com Law	3	36	0.2%	31%	165	0.9%	218
22	Norway		7	227	1.2%	59%	238	1.3%	954
23	Peru		1	71	0.4%	56%	241	1.3%	295
24	Poland	EU	12	151	0.8%	35%	486	2.7%	311
25	Portugal	EU	13	57	0.3%	25%	55	0.3%	1,036
26	Slovenia	EU	9	12	0.1%	2%	76	0.4%	158
27	South Africa	Com Law	0	799	4.1%	278%	396	2.2%	2,018
28	Spain	EU	16	1,435	7.3%	98%	3,472	19.3%	413
29	Sweden	EU	10	441	2.3%	109%	310	1.7%	1,423
30	Switzerland		12	1,065	5.4%	215%	339	1.9%	3,142
	Totals			19,600	100.0%		18,004	100.0%	1,089

Importance of IFRS

- Countries using common law (the Anglo-American system) chose Initial Public Offerings to fund business much more frequently than those applying civil codes such as much of EU who prefer bank loans.

- The exception to the previous generalization is Spain.

Importance of IFRS

Let's look at those statistics a little more.

- 30 selected IFRS
  - 18 from the EU
  - 12 Other selected Exchanges
  - 6 Common Law countries
- Many exchanges like Canada's have skewed markets.

Many	Few
Small Listed Companies	Very Large Ones

- Very large ones mainly Financial Institutions and Energy.
- All are small compared with China.

Importance of IFRS

SELECTED IFRS STOCK MARKETS **Table 2**

	Country	Dec 2009 Market Capitalization $' billion		Listed Companies		Average Market Capitalization $' million
18	Major European Union	9,739	49.7%	10,387	57.7%	938
17	Major EU ex Spain	8,304	42.4%	6,915	38.4%	1,201
12	Other Selected Exchanges	9,861	50.3%	7,617	42.3%	1,295
6	Common Law Countries	7,259	37.0%	6,702	37.2%	1,083

- Major EU members' stock markets, except for Spain, are oriented to large entities as are the other selected exchanges.

Importance of IFRS

SELECTED IFRS STOCK MARKETS **Table 3**

	Average Dec 2009 Market Capitalization $' billion	**Dec 2009 Market Capitalization** Low	High	**Ratio**
Major EU ex Spain	541	12	2,796	233
		Slovenia	**Britain**	
Spain	1,435			
Common Law Countries	1,210	36	2,796	78
		New Zealand	**Britain**	
China	3,573			

Importance of IFRS

SELECTED IFRS STOCK MARKETS **Table 4**

	Average Dec 2009 Listed Companies	Dec 2009 Listed Companies Low	High	Ratio
Major EU ex Spain	407	46	2,792	61
		Hungary	**Britain**	
Spain	3,472			
Common Law Countries	1,117	64	2,792	44
		Ireland	**Britain**	
China	1,706			

Who's In? Who's Out?

WORLD STOCK MARKETS **Table 5**

IFRS Adoption	**Country**		**Old GAAP/ IFRS Deviation** Score	**Dec 2009 Market Capitalization** $' billion		**Market Cap/ GDP**	**Listed Companies**		**Mean Market Capitalizatio** $' million
Now	Major European Union		0	9,739	20.4%	74%	10,387	22.9%	938
Now	Other Selected Exchanges		0	9,861	20.6%	na	7,617	16.8%	1,295
Now	Russia		0	736	1.5%	60%	234	0.5%	3,145
2010	Brazil		7	1,337	2.8%	85%	377	0.8%	3,546
2011	Canada	Com Law	5	1,676	3.5%	125%	3,702	8.2%	453
2012	Korea		12	835	1.7%	100%	1,778	3.9%	470
2012-14	India	Com Law	7	2,531	5.3%	205%	6,408	14.1%	395
2010-16	Japan		6	3,306	6.9%	65%	2,751	6.1%	1,202
???	United States	Com Law	17	15,077	31.6%	107%	4,401	9.7%	3,426
na	Miscellaneous			2,685	5.6%	na	7,713	17.0%	348
	World			47,783	100.0%	83%	45,368	100.0%	1,053

Who's In? Who's Out?

- Currently (2009) about 42.5% of world stock market capitalization and 40.2% of listed companies use IFRS.
- By 2012 with Brazil, Canada and Korea added, it will be over half for both measures.
  - $24,184 billion (50.6%) of market capitalization
  - 24,095 (53.1%) of listed companies
  - The mean market capitalization will stay about the same at $1,004 million

Benefits of IFRS

- Brings to light information in a more timely or transparent way.
- Major Examples
  - Investment Properties at Fair Value
  - Faster impairment write-offs
  - All leases shown as liabilities – pending
  - Financial Instruments disclosures
  - Under revenue recognition – pending
- Allows easy comparison across frontiers.

Disadvantages of IFRS

- Greater complexity.
- New measurement basis.
- Lack of comparability with past.
- Existing trend and ratio analyses benchmarks no longer applicable.

Effect of IFRS

AUSTRALIA **Table 6**

Effect on Net Income of Initial Adoptees

Large increase	+10%	65%
Small Increase	-10%	31%
Decrease		4%
Sample Size		113

Effect of IFRS

BRITAIN **Table 7**

Effect on Net Income of Initial Adoptees

Large increase	+10%	33%
Small Increase	-10%	40%
Decrease		27%
Sample Size		182

Effect of IFRS

REDUCE MULTIPLES

Background

Excerpts from comments by European Central Bank Executive Board member Gertrude Tumpel-Gugerell, 27 April 2010

- "What is the use of marking-to-market when there is no market?“
- "With regard to recent assertions made by IASB and FASB that convergence is on track, I would like to highlight that we are not so optimistic"

GAAP to IFRS

FASB/IASB Joint Projects	2010			2011	
Standards	2Q	3Q	4Q	Q1	Q2
Fair Value Measurement	E	R	F		
Consolidation: Policy and Procedures	E	R		F	
Accounting for Financial Instruments		C	R		F
Financial Instruments with Characteristics of Equity	E	R		F	
Financial Statement Presentation	E	R		F	
Insurance Contracts	E	R			F
Leases	E	R		F	

GAAP to IFRS

FASB/IASB Joint Projects	2010			2011	
Standards (continued)	2Q	3Q	4Q	Q1	Q2
Revenue Recognition	E	R		F	
Statement of Comprehensive Income		C			F
Reporting Discontinued Operations	E				
Balance Sheet-Offsetting		E			F
Emissions Trading Schemes				?	?
Earnings Per Share	Not Active				
Income Taxes	Not Active				
Post Retirement Benefit Obligations	Not Active				
Financial Instruments: De-recognition				?	?

GAAP to IFRS

Key:

Comment Period – C

Discussion Paper – D

Exposure Drafts – E

Final Documents – F

Roundtable Meetings - R

Convergence

- IFRS has the advantage of being able to draw on the latest thinking of standard setters around the world.
- They contain elements from a variety of countries.
- Even when an existing US standard was the starting point, IASB was able to take a fresh approach to avoid any perceived problems in FASB document.

Convergence

- Complete convergence is impossible as US lawyers will continue to force CPA's to look for **RULES.**

PRINCIPLES =

JUDGMENTS =

RISKS

Fair Value Sources

- Until now there were different definitions.
  - GAAP = exit price
  - IFRS = willing seller (often entry price)
- New comprehensive standard coming.
- Released by the end of year?
- Likely to have more effect on IFRS which has agreed to adopt GAAP's exit concept.

Fair Value Sources

Three level hierarchy applies everywhere

1. Quoted prices in active markets for identical assets or liabilities.
2. Prices derived from:
   - Less than active markets for identical items
   - Quotations in active markets for similar assets or liabilities – adjusted for the differences
   - Observable market data such as yield curves, credit spreads, etc.

Fair Value Sources

3. Result of a valuation technique using unobservable inputs. Those are not market derived but based on the reporting entities own views as to the assumptions market participants would adopt.

Fair Value Sources

- Fair value is market based reflecting the assumptions that market participants would use in pricing the item.
- In January 2010, the Boards tentatively decided that an entity should consider observable transaction prices unless there is evidence that they were not orderly.
- Even trades on low volumes in thin markets cannot be ignored.

Fair Value Sources

- A transaction price may not represent fair value on initial recognition if, for example
  - It is between related parties
  - Takes places under duress
  - The seller is forced to accept the price
  - Market participants should be assumed to have a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through usual and customary due diligence
  - Prices in related-party transactions may be used as inputs for fair value measurements if the transaction was entered into on market terms

New Fair Value Standard

In February 2010, the Boards tentatively decided:

Highest and Best Use

- Fair value of a nonfinancial asset considers its highest and best use by market participants.
- To establish meanings for
  - "physically possible"
  - "legally permissible"
  - "financially feasible"

New Fair Value Standard

Incremental Value

- No requirement to separate the fair value of an asset group into two components when an asset is applied in a manner other than its highest and best use.
- To require disclosure of information about an asset that is applied in a way that differs from its highest and best use when the fair value is based on that concept.

New Fair Value Standard

Nonfinancial Assets

- Fair value of an individual asset is the price for a sale of the asset alone, not as part of a group of assets or business.
- When the highest and best use of an asset is to form part of a group, its fair value presumes that the sale is to a market participant that has, or can obtain, the necessary "complementary assets" and "complementary liabilities."

New Fair Value Standard

Nonfinancial Assets (continued)

- Complementary liabilities include working capital but not financing.
- To describe the objective of the valuation premise without using the terms "in-use" and "in-exchange" because they are often misunderstood.

New Fair Value Standard

Financial Instruments

- That the concepts of highest and best use and different valuation premises are relevant only for nonfinancial assets and not for financial assets or for liabilities.
- To describe valuation adjustments that entities might need to undertake when using a valuation technique because market participants would make them when pricing a financial asset or liability under the then market conditions.

New Fair Value Standard

Financial Instruments (continued)

- Those were described in IASB's Expert Advisory Panel Report *Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active.*
- Did not decide if the fair value of financial instruments within a portfolio should take into account offsetting positions including credit and market risks.

New Fair Value Standard

Premiums and Discounts

- To clarify what a blockage factor is and to describe how it is different from other types of adjustments, such as a lack of marketability discount, for an individual financial instrument.
- To prohibit applying a blockage factor at any level of the fair value hierarchy.

New Fair Value Standard

Premiums and Discounts

- To specify that measurements in Levels 2 and 3 of the fair value hierarchy consider all premiums and discounts that market participants would apply in pricing an asset or liability at the unit of account specified in the relevant standard (except for a blockage factor).

New Fair Value Standard

Difficult Items

- The converged fair value standard will not include additional guidance for measuring the fair value of difficult to value assets and liabilities including unquoted equity instruments.
- In the future IASB will discuss educational materials to assist entities in applying fair value to such assets and liabilities.

New Fair Value Standard

Revaluation

- Even when GAAP and IFRS result in the same assets appearing on a balance sheet, their attributed values may be different.
- IFRS permits regular revaluations of property, plant & equipment to fair values.
- An entity cannot pick and choose, if it revalues one item within a class of such assets, it must revalue all of them.

New Fair Value Standard

Revaluation

- IFRS credits any increases in such values to a revaluation reserve in the equity section of the balance sheet.
- Decreases are treated as impairment losses to the extent they exceed previous revaluation gains.
- For investment real estate, both GAAP and IFRS prefer historic cost less depreciation and impairment.
- IFRS also permits accounting for such properties at fair value, recognizing changes in profit or loss.

Impairment Testing

- Goodwill and intangible assets with indefinite lives are tested for impairment at least annually and more frequently if any indicator of impairment is present.
- Long-lived assets are tested only when there is a specific indicator.
- Both sets of indicators are similar.
- An asset found to be impaired is written down and an impairment loss recognized.

Impairment Testing

- For GAAP ASC 350 *Intangibles — Goodwill and Other* and the *Impairment or Disposal of Long-Lived Assets* subsections of ASC 360-10 *Property, Plant and Equipment*, as well as IAS 16 *Property, Plant and Equipment* apply to most long-lived and intangible assets.
- IAS 36 *Impairment Testing* is similar in overall objectives.
- Some scope exceptions vary.
- Significant differences in how impairment is reviewed, recognized and especially measured.

Impairment Testing

	GAAP	IFRS
Method of determining impairment — long-lived assets	Two-step method with recoverability test performed first (carrying amount of the asset is compared to the sum of future undiscounted cash flows generated through use and eventual disposition). If the carrying amount is not recoverable, impairment testing is performed.	One-step method to be performed if indicators exist.

Impairment Testing

	GAAP	IFRS
Impairment loss calculation — long-lived assets	The amount by which the carrying amount of the asset exceeds its fair value, as calculated in accordance with ASC 820.	The excess of the carrying amount of the asset over its recoverable amount. This is the higher of (1) fair value less costs to sell, and (2) value in use (the present value of future cash flows including disposal value). The definition of fair value is different from that in ASC 820.
Allocation of goodwill	Goodwill is allocated to a reporting unit, which is an operating segment or one level below an operating segment (component).	Goodwill is allocated to a cash- generating unit (CGU) or group of CGUs which represents the lowest level within the entity at which the goodwill is monitored by management; it cannot be larger than an operating segment as defined in IFRS 8 *Operating Segments*.

Impairment Testing

- In 2008 the Boards deferred further work on impairment until other convergence projects are completed.
- In practice this means NEVER

Questions?