TECH 38/03

THE TRANSITION TO IFRS: INFORMING THE MARKET

Memorandum of comment submitted to the Committee of Securities Regulators in November 2003 concerning Consultation Paper 03-323b, 'Draft Recommendation for Additional Guidance Regarding the Transition to IFRS', published for comment in September 2003

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to Consultation Paper 03-323b, 'Draft Recommendation for Additional Guidance Regarding the Transition to IFRS', published by the Committee of Securities Regulators (CESR) for comment in September 2003.

2. The Institute believes strongly in the benefits to business and investors of the creation of a single set of global standards on accounting. The momentum towards global convergence will be enhanced substantially by a smooth transition in Europe from current national accounting standards to IFRS. A smooth transition is also key to the successful creation of a single European capital market and for strong investor confidence. We therefore welcome CESR's initiative in addressing this important issue, and explain below how a number of changes to the proposals would ensure that they contribute positively to the transition to International Financial Reporting Standards (IFRS) in Europe. We deal first with major points before answering the questions specifically raised by CESR.

MAJOR POINTS

Achieving A Smooth Transition: the Role of Companies

3. In many cases, the switch to a new set of accounting standards - indeed, to a new accounting framework - will involve significant changes to the accounting policies of listed companies. This is acknowledged in IFRS 1, 'First Time Adoption of IFRS', which requires disclosure by reporting entities of extensive reconciliations to explain how the initial application of IFRS affected the reported financial position, financial performance and cash flows (IFRS 1, paragraphs 38 - 40).

4. Companies may first provide IFRS information when presenting their 2005 half-yearly results, rather than in the context of the 2005 annual financial statements. If they choose to report in accordance with IAS 34, 'Interim Financial Reporting', full reconciliations to previous GAAP will have to be provided at that time (IFRS 1, paragraphs 45, 46). In other cases, companies will present a six-monthly report prepared in accordance with the accounting standards to be applied in the 2005 annual financial statements, together with an explanation of the consequential changes to accounting policies (as required, for example, by the UK Listing Rules). In this second situation, reconciliations may not be provided.

5. A smooth transition to IFRS is less likely if investors and analysts are only presented with comprehensive IFRS information for the first time when 2005 annual accounts are presented in early 2006 (or in 2005 six-monthly accounts prepared in line with the provisions of IAS 34). Users need to be able to differentiate real changes in business performance from the impact of the application of a different set of accounting standards, and will look to companies for clear, transparent disclosures to help them to meet this challenge.

6. Companies should, therefore, seek to explain the impact of applying IFRS as soon as practicable, and in a structured, understandable way. This might mean, for example:

- the inclusion in 2003 annual reports of informative narrative on the preparatory process;

- providing narrative explanation of the steps taken to prepare for the transition and key consequential changes to accounting policies in the 2004 annual report or preliminary announcement, or by means of a separate announcement to the market; and

- in a separate and subsequent exercise, publishing restated 2004 numbers and appropriate explanatory material, ideally in advance of the publication of the 2005 six-monthly accounts - this will provide users with the opportunity to understand and reflect on the impact of IFRS on the reported financial performance and position of the company and subsequently to interpret the 2005 numbers more effectively.

7. Companies should work towards publication of IFRS numbers for 2004 as soon as it is possible to restate the previous GAAP numbers comprehensively and the board is confident that the restated information is high quality and reliable. As the restated information should be unlikely to change materially before it is presented as comparative information in the 2005 annual financial statements, the precise timing of the restatement exercise may be affected by a number of factors. These include:

- the IASB's work programme - at present the '2005 versions' of several existing standards have not been finalised and a number of new standards that will be mandatory in 2005 or available for early adoption have yet to be issued;

- selection of accounting policies - as IFRS still contain a number of optional accounting treatments, boards will need to assess the available options and select the treatments to be applied in the 2005 financial statements. IFRS 1 also contains a number of options that boards will need to evaluate; and

- the EU endorsement process - ideally, all restatements of 2004 information should be on the basis of IFRS that have been formally endorsed by the European Commission for use by European listed companies. However, the timing - and in some cases the outcome - of the endorsement process is uncertain.

<u>The Role of National Securities Regulators</u>

8. Securities regulators have a central role to play in the transition through:

- encouraging listed companies to prepare for the transition; and

- setting out best practice in terms of the timing and contents of disclosures regarding the transition.

For example, in September 2003, the Financial Securities Authority wrote to all UK listed companies emphasising the importance of introducing the procedures and processes needed to ensure that they are able to continue to meet UK reporting requirements.

9. Securities regulators should not, however, seek to impose a detailed set of rules for the reporting of information on the transition. Recommendations should not encourage - or, in effect, require - disclosure of information in 2004 and 2005 in an unstructured or piecemeal way. Nor should they lead to disclosure of numbers likely to require amendment at a later date. A need to explain and communicate restatements of previously-announced IFRS numbers may be costly to companies and confusing to users, and risks undermining efforts to restore the credibility of financial reporting.

The Role of CESR

10. CESR's initiative is timely and generally welcome. It would be useful for securities regulators across Europe to be encouraged to issue guidance at an early stage on best practice in relation to transitional disclosures.

11. We would, however, welcome clarification regarding the status of CESR's pronouncements and its future plans in this regard. We reiterate our concern that CESR should remain very clearly separate from the standard setting and interpretation processes. Enforcement should not result – albeit inadvertently - in standard setting, the end result of which might be the creation of a body of accounting interpretations comparable to that built up by the U.S. Securities and Exchange Commission. Any interpretation or extension of the requirements of IFRS should be the sole responsibility of the IASB and IFRIC. Some of CESR's proposals appear to add to the requirements of IFRS, which would be unacceptable.

12. We explain below in our answers to the questions posed in the consultation paper how the considerations set out in paragraphs 3 to 11 affect our assessment of CESR's specific proposals.

Interim Information in 2005

13. We strongly agree with CESR that interim accounts that cover any part of the period of the first IFRS annual financial statements should be prepared in accordance with IFRS recognition and measurement principles. The publication of previous GAAP numbers that will be restated to IFRS in the annual accounts would be unhelpful to the market.

ANSWERS TO CESR QUESTIONS

Question 1

Do you consider it useful that CESR Members provide recommendations to European listed companies on how to disclose financial information to the markets during the phase of transition from local GAAP to IFRS?

14. As explained above, securities regulators should encourage listed companies to prepare for the transition and set out best practice in terms of the timing and contents of disclosures regarding the transition. Recommendations should, however, not encourage - or, in effect, require - disclosure of information in 2004 and 2005 in an unstructured way. Nor should they lead to disclosure of numbers which have to be amended at a later date. These undesirable outcomes might follow if CESR members are advised to issue recommendations to companies o*n how to disclose financial information* during the transition.

Question 2

Do you agree that European listed companies should be encouraged to prepare the transition from local GAAP to IFRS as early as possible?

15. As explained above, in many cases the switch to a new set of accounting standards will involve significant changes to the accounting policies of listed companies. Although the '2005 versions' of several standards have not yet been finalised, much preparatory work can be undertaken now. We strongly agree that companies should be encouraged to prepare for the transition and to modify their plans as necessary as the IASB finalises the suite of standards to be applied in 2005.

Question 3

Do you agree that those companies should also be encouraged to communicate about this transition process? If yes, are the 4 milestones identified by CESR for such communication appropriate?

16. We agree that listed companies should be encouraged to communicate about the transition process. As suggested above, securities regulators might set out best practice in terms of the timing and contents of disclosures.

17. CESR suggests (in paragraph 7 of the consultation paper) that a 'particular effort of financial communication' is required at four milestones that coincide with publication of 2003 financial statements; 2004 annual or six-monthly financial statements; 2005 six-monthly financial statements; and 2005 annual financial statements. We agree that publication of the 2005 six-monthly and annual financial statements will be milestones in this process. However, we explain below that the first two 'milestones' may be less significant and suggest a more flexible approach to the timing and method of disclosure.

Question 4

What are your views on an encouragement to listed companies to disclose narrative information about their process of moving to IFRS and about the major identifiable differences in accounting policies this transition will bring about? Do you consider it appropriate to include such information in the 2003 annual report or in the notes to the 2003 financial statements?

18. We agree in principle that companies should be encouraged to disclose narrative information about their preparations for the transition and the likely impact of IFRS

on key accounting policies. Such disclosures might be made in the *2004* annual report or preliminary announcement or by means of a separate announcement to the market. The inclusion in 2003 annual reports of informative narrative on the preparatory process is likely to be welcomed by users. However, the outcome is likely to be 'boilerplate' narrative and partial financial information if companies feel compelled - particularly at short notice - to make such disclosures. This is likely to confuse rather than enlighten users, particularly as the final shape of some IFRS will still be uncertain at that time.

Question 5

Do you believe that listed companies should be encouraged not to wait until beginning 2006 for communicating about the impact of the transition to IFRS on the 2004 financial statements if such information is available earlier? Do you agree that quantified information in this regard should be given as soon as possible?

19. IFRS 1 requires reconciliations to be presented in the first IFRS financial statements in order to explain the impact of IFRS on the comparative numbers. CESR suggests (in paragraphs 11, 12 of the consultation paper) that companies should be encouraged to disclose that information in their 2004 annual financial statements wherever possible. We do not support this proposal. As explained in more detail above, we believe that companies should be encouraged to publish comprehensive, high quality quantitative information in a separate and subsequent exercise.

Question 6

Is it appropriate to refer to the Implementation Guidance published by IASB in connection with the IFRS1 for defining which quantified information should be disclosed as a result of the recommendations in § 11 and § 12? Do you believe other disclosures should be envisaged? Do you agree with inclusion of such information in the annual report or in the notes to the financial statements?

20. As explained above, we do not support the recommendations in paragraphs 11 and 12. We question, in any case, whether it would be appropriate for CESR to make recommendations based on the Implementation Guidance (IG) to IFRS 1, which does not form part of the standard. In encouraging companies to provide in either the annual report or the notes to the financial statements the information illustrated in paragraph 63 of the IG, it might be argued that CESR is modifying the requirements of the standard on two counts. Firstly, IFRS 1 requires the reconciliations to be provided in the financial statements. And secondly, the IG expressly sets out just 'one way of satisfying' the provisions of the standard.

Question 7

Do you agree with the principle that any interim financial information published as of 2005 by listed companies should be prepared using the accounting standards that are to be used by those companies for the 2005 year end financial reporting, i.e. IFRS, in the way indicated here under?

21. As explained above, we strongly agree with CESR that interim accounts that cover any part of the period of the first IFRS annual financial statements should be prepared in accordance with the recognition and measurement principles of IFRS. The publication of previous GAAP numbers that will be restated to IFRS in the annual accounts will be unhelpful to the market.

Question 8

Do you agree that when listed companies do not elect to apply IAS 34 for quarterly information published in 2005, they should be encouraged to prepare and disclose financial data by applying IFRS recognition and measurement principles to be applicable at year end?

22. We agree that quarterly information published in 2005 should be prepared in accordance with IFRS recognition and measurement principles. We have however urged the European Commission to defer the proposed introduction of mandatory quarterly reporting in 2005 (and a number of other measures proposed in the draft Transparency Directive) in view of the major challenges already faced by listed companies migrating to IFRS in 2005.

Question 9

Do you agree with the proposed encouragement for European listed companies to either fully apply IAS 34 for half yearly reporting as from 2005 or, if this standard is not applied, to prepare the key half-year financial data that are to be published, in conformity with IFRS recognition and measurement principles to be applicable at year end?

23. We agree that in 2005 listed companies that do not report in accordance with IAS 34 should prepare six-monthly information in accordance with IFRS recognition and measurement principles.

Question 10

CESR considered different possibilities for the presentation of comparative information for the corresponding period(s)[in interim reports], but concluded that the above proposed solution could appropriately serve users of financial information without imposing too burdensome requirements on issuers. Do you concur with the proposed solutions? In particular, do you agree with the proposals that

- ***a. comparative figures should be provided and restated using same accounting basis as for the current year;***
- ***b. previously published information for the previous period may be provided again;***
- ***c. explanation of restatement of comparative figures should be given;***
- ***d. in case of presentation of financial statement over 3 successive periods the restatement of the first (earliest) period could not be required;***
- ***e. indicative format ("bridge approach") for the presentation of comparative information on the face of the financial statements when the first period presented is not restated?***

24. We respond to each of the above questions in turn:

(a) We agree that comparative information should be provided in quarterly and six-monthly reports published in 2005. This information should be restated to comply fully with IFRS recognition and measurement principles, subject to recognition of the decision of the IASB that IFRS 1 will not require application of IAS 32 and IAS 39 in 2004 comparatives;

(b) In our view CESR should not encourage presentation of previous GAAP comparatives in 2005, particularly in separate columns on the face of the financial statements. The presentation of IFRS and previous GAAP information in this way risks creating confusion in the market and, in any case, may be impractical on a line-by-line basis in view of differences in formats and presentational requirements;

(c) Yes, companies should provide clear explanatory material relating to the restatement of comparative information;

(d) Restatement of earlier comparatives should not be required where national rules require an issuer to publish financial information for three successive periods. This would go beyond the requirements of IFRS 1 and the benefits to users are likely to be outweighed by the costs to preparers;

(e) Companies should not be encouraged to adopt the ‘bridge approach’ where the earlier period of comparatives is not restated. This approach would involve companies presenting on the face of the financial statements previous GAAP numbers for the earlier period; previous GAAP and IFRS numbers for the middle period; and IFRS numbers for the current period. As indicated above, the presentation of IFRS and previous GAAP information risks creating confusion and may be impractical. Where companies publish previous GAAP information, we would prefer it to be presented in the notes to the accounts.

Question 11

Do you agree that, in addition to the presentation of comparative information in conformity with IFRS1 (i.e. prepared on the basis of IFRS provisions), it could be deemed useful to present again the comparatives prepared on the basis of previously applicable accounting standards?

25. For the reasons explained above, we consider that users are unlikely to benefit from the presentation of previous GAAP information for 2004 in the 2005 annual financial statements. Further, in encouraging companies to provide this information, it could be argued that CESR is modifying the requirements of IFRS 1.

Question 12

Do you agree that, when presentation of financial statements over 3 successive periods is required, it would be acceptable not to require the restatement to IFRS of the first (earliest) period? If yes, do you agree with the indicative format (“bridge approach”) for the presentation of comparative information on the face of the financial statements when the first period presented is not restated?

26. We agree that the earliest period should not be restated since this would go beyond the requirements of IFRS 1 and would not satisfy a cost/benefit analysis. However, as explained above, we do not favour use of a ‘bridge approach’.

Nsj/21 November 2003