



Evaluation of the Application of IFRS in the 2006 Financial Statements of EU companies – Executive summary

Presentation to ARC

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Evaluation of the Application of IFRS in the 2006 Financial Statements of EU companies – Executive summary

▶ Ineum Consulting Overview

▶ IFRS Study 2006

- *Methodology*
- *Key findings*
- *Conclusion*

▶ Q&A

Ineum Consulting – an overview

Key facts

- ▶ 1300 professionals
- ▶ 15 offices over 4 continents
- ▶ 192,5 M€ of turnover in 2008
- ▶ 100% turnover growth in 4 years
- ▶ Part of Management Consulting Group PLC (Turnover 2008 : 432 M€). Listed on the London Stock Exchange. Other branches: Kurt Salmon Associates, Alexander Proudfoot Company

A significant international network



- ▶ Europe: France, Belgium, Netherlands, Luxembourg, Switzerland, United Kingdom and Ireland
- ▶ North America: New-York, Los Angeles
- ▶ Oceania: Sydney, Melbourne
- ▶ Africa: Casablanca, Algiers
- ▶ Alliances in mature markets: Lische in Germany, BIP in Italy, Mac Group in Spain
- ▶ Significant projects in Eastern Europe and Middle East

A unique positioning

From strategy to implementation, Ineum Consulting focuses on transformation

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Our methodology

2 main activities

Technical analysis of 2006 Financial Statements

Comprehensive desk study of 2006 published IFRS financial statements:

- Sample of **270 companies**
- Market capitalization (250 listed companies) was **40% of the total European market capitalization**

The sampling approach aimed at a fair representation of the overall population of European companies:

- **Member State:** the capitalisation of sampled companies **exceeds 20% of each market capitalisation** in each Member State
- **Industry sector:** the capitalisation of sampled companies **exceeds 20% of the market capitalisation of each ICB super-sector** at European level
- **Distribution of company market capitalisation:** 76 large companies, 87 medium, 87 small, and 20 unlisted

Opinion of enforcers and members of professional bodies

We collected input from **seven national enforcers** among the eighteen identified by CESR as performing enforcement activities in full or partial compliance with CESR Standard #1 through:

- Desk review of published conclusions of their reviews of 2006 Financial Statements and/or guidance for 2007 Financial Statements for **Finland, France, Germany, Netherlands, Poland, Portugal and United Kingdom**
- Meeting with enforcers for **Poland, Portugal and United Kingdom** and certain professional bodies.

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Degree of compliance observed

- ▶ **No case of non compliance observed**
- ▶ **Average number of captions disclosed on the face of the Balance sheet, Income Statement, Cash Flow Statement was just under 100 lines**
- ▶ **Certain companies tend to comment in the management report on alternative indicators:**
 - *32 companies comment on an alternative operating result - one quarter failed to provide a reconciliation with the IFRS operating result*

Orientation on options used

- ▶ **The presentation of the income statement shows an equal overall level of choice between function and cost type**

Income Statement Presentation	Industry and Services		Financial activities		Total	
	Number of companies	%	Number of companies	%	Number of companies	%
Analysis by function	100	53 %				
Analysis by nature	85	46 %				
Mixed presentation	3	1 %				
Sub-total Listed companies	188	100 %	62		250	
Analysis by function	8	57%				
Analysis by nature	7	43%				
Mixed presentation	-	-				
Sub-total Non-listed companies	15	100%	5		20	
Total	203		67		270	

Problems identified

- ▶ **Lack of common structure of the notes to financial statements**
 - *Disparities observed make access to detailed information often challenging*
- ▶ **Different forms of Profit and Loss account presentation create difficulties in comparability**
 - *Presentation of costs by function or cost by nature/cost type*
- ▶ **Lack of standardization for financial vocabulary and aggregates**

Conclusion

- ▶ **IFRS presentation of consolidated financial statements has brought an enhanced level of quality and relevance. Some comparability issues remain:**
 - *Disparities in the structure of accompanying notes*
 - *Differences in financial vocabulary used*
 - *Lack of standardization for financial aggregates*
 - *Lack of harmonization linked to the national legacy in terms of reporting requirements*

Presentation of financial statements – IAS1

Choice between function and type of cost

Income Statement Presentation	Industry and Services		Financial activities		Total	
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Degree of compliance observed

- ▶ 252 companies (93% of 270) disclosed segment reporting
- ▶ 100% of these companies reported their revenue by segment
- ▶ Overall, only 71% of the 235 listed companies disclosing primary and or/secondary reporting met the fully IFRS segment disclosure requirements

Problems identified

- ▶ Justification by most non-disclosing companies for absence of segment reporting – “they operate a single business in a single geographical area”
- ▶ Non compliant disclosing companies failed to disclose some of the indicators required by IAS14.51-72, for instance - capital expenditure:
 - Only 85% reported for the primary segment,
 - Only 79% reported for the secondary segment

Orientation on options used

- ▶ Among listed companies, Business segmentation clearly leads Geographical segmentation for primary segment reporting

Segment reporting disclosures and primary formats used	Business as primary segment	%	Geographical as primary segment	%	Matrix	%	Total	%
Primary and secondary segment reporting	157	67%	25	11%	4	2%	186	79%
Only Primary segment reporting	29	12%	13	6%			42	18%
Only Secondary segment reporting	7	3%					7	3%
Total of segment reporting	193	82%	38	16%	4	2%	235	100%

Conclusion

- ▶ Continuing vigilance is needed to ensure that full disclosure as required by IFRS8 is provided by all companies
- ▶ In 2006, among the 69 companies (26% of 270) having estimated the impact of IFRS8, two thirds disclosed they do not expect the application of IFRS8 to lead to adjustments compared to what they disclosed under IAS14

Segment reporting – IAS14

Primary segment preference for Business Segment

Segment reporting disclosures and primary formats used	Business as primary segment	%	Geographical as primary segment	%	Matrix	%	Total	%
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Consolidation – IAS27/IAS28/IAS31/SIC12

Degree of compliance observed

- ▶ **No case of non compliance observed.**
- ▶ **The application of the different consolidation methods based on control and percentage of ownership appears to be well handled overall by the groups in our sample of 270 companies.**
- ▶ **As in the 2005 sample, only a few cases show *de facto* control situations. We found two instances among the 270 companies sampled.**

Orientation on options used

- ▶ **154 companies (57% of the 2006 sample) have disclosed the existence of joint venture entities (as compared to 51% in the 2005 sample)**
 - *Proportionate consolidation was chosen by 63% of companies consolidating joint ventures as opposed to 37% choosing the equity method..*
- ▶ **45% of investment entities use the IAS28 option to account for investments with significant influence but no control as under IAS39 at fair value through P&L account (in lieu of equity accounting)**

Problems identified

- ▶ **Eight cases of entities held at less than 20% and consolidated under the proportionate method or the equity method have been found**
- ▶ **One case of an entity held between 20% and 50%, and carried at cost, has been found**
- ▶ **Seven cases of entities at 50% or more and not fully consolidated have been found**

Conclusion

- ▶ **The relative absence of information regarding structured vehicles (SPE's) in the financial statements of groups under review may be countered by the promulgation of ED10 *Consolidated financial statements***
- ▶ **The treatment of joint venture entities seems not to be consistent with the one favored in ED9 *Joint arrangements***

Goodwill, Intangible assets and impairment – IAS38/IAS36

Degree of compliance observed

- ▶ **No case of non compliance observed**
- ▶ **The total of intangible assets in the balance sheets of the 270 companies selected amounted to EUR 963 billions:**
 - *15% of total assets in Industry and Services*
 - *28% of total assets in Telecommunications*
 - *14% of total assets in the Banking sector*

Orientation on options used

- ▶ **Amongst the 36 companies accounting for an impairment charge in 2006:**
 - *39% stated that the recoverable value is estimated as the higher of the fair value less costs to sell and the value in use*
 - *36% calculated the value in use as the only basis of the recoverable value*
 - *8% used the fair value less costs*
 - *17% did not disclose enough information*

Problems identified

- ▶ **Amortization duration for intangible assets with a finite useful life was spread over a large range**
- ▶ **Amongst the 36 companies accounting for an impairment charge in 2006:**
 - *Most disclosed the required information relating to the key assumptions.*
 - *However - a large range of discount rate values and a diversity in the length of forecasts periods as the basis of the calculation of the cash flows*

Conclusion

- ▶ **Disclosure on the distribution of assets within the useful life range may better represent the company portfolio of assets**

PPE and Investment property – IAS16/IAS40

Degree of compliance observed

- ▶ **No case of non compliance observed**
- ▶ **Total of tangible assets of the 250 listed companies surveyed amounts to EUR 1.288 billions:**
 - *Tangibles represent an average of 30% of total assets in industry and services and 1% in financial activities (bank, insurance and financial services)*
 - *Oil & Gas, Utilities and Telecommunications concentrate 50% of total tangible assets*

Orientation on options used

- ▶ **Further detailed analysis was conducted on 75 listed companies representing more than 80% of the total reported tangible assets**
 - *97% of companies value Property, Plant and Equipment through the cost model; the use of the revaluation model remains marginal*
 - *Among companies disclosing information on investment properties, only one out of five use the Fair value model rather than the cost model*

Problems identified

- ▶ **The wide range of minimum and maximum ranges of estimated useful lives is not in conflict with the IAS16 standard but may not be relevant for the users of the financial statements**

	Number of disclosures	% (out of 75 companies)	Depreciation in years			
			Min	Max	Average Min	Average Max
Buildings	67	89%	1	140	11	49
Fixtures	45	60%	2	50	5	14
Equipment and furniture	66	88%	2	75	6	22
Computer equipment	19	25%	2	17	3	8

Conclusion

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PPE and Investment property – IAS16/IAS40

The wide range of minimum and maximum estimates useful lives

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Financial instruments – IAS32/IAS39

Degree of compliance observed

- ▶ **Some disclosures are incomplete or unclear:**
 - *Disclosures on cash-flow hedges*
 - *Balance sheet classification and presentation of non-consolidated financial investments*
 - *Disclosure of specific accounting policies on impairment of assets*
 - *Information on effective interest rates on financial debt and risk disclosures*

Orientation on options used

- ▶ **Only 30% of large non financial groups and less than 10% of small and medium sized companies used significantly the Fair Value option of IAS39.**
- ▶ **80% of banks have extensively taken advantage of the Fair Value option of IAS39.**
- ▶ **Only 25% of banks used the European carve-out option of the IAS39 for the valuation of macro hedge of portfolio assets and/or liabilities**
 - *None presented the impacts of applying the carve-out approach compared to non application*

Problems identified

- ▶ **The weight of financial statements disclosures can make them unwieldy and difficult for non specialists to comprehend (ex. Banks)**
- ▶ **Enforcers identified a number of issues relating to incomplete or unclear disclosures:**
 - *Impairment testing details*
 - *Identification of the type and nature of instruments and the options used*
 - *Disclosure of risks being hedged*
 - *Difficulties of linkage between balance sheet items and the instruments described in notes*

Conclusion

- ▶ **Enforcers and auditors believe that preparers may need more precise guidance on applying Fair Value accounting and impairment principles**
- ▶ **In the context of the 2008 economic downturn and liquidity crisis on certain markets, the procyclicality of IAS32/IAS39 have been pointed out**
- ▶ **The reduction of the complexity linked to the reporting of financial instruments is currently under review**

Share based payments – IFRS2

Degree of compliance observed

- ▶ **143 companies (53%) disclosed a profit and loss impact under IFRS2 on share-based employee arrangements for a total of EUR 8 127 million**
- ▶ **The major impacts concerned few companies:**
 - *20 companies disclose above EUR 100 million each (3 companies above EUR 500 million each)*
- ▶ **Detailed assumptions input to the valuation model for share based plans are not always given**

Problems identified

- ▶ **The disclosure required by individual plan gives a large amount of information for some groups with many plans and a simpler presentation (ex. tabular format) would be more appropriate**
- ▶ **Locating in the financial statements the amounts relating to share based payments, particularly in the Profit and Loss account, is often difficult**
- ▶ **Groups often apply the “Black-Scholes” model, but do not explain the reasons behind the choice of the model and the implications of using it**

Orientation on options used

- ▶ **265 identified equity, cash settled or combined plans are disclosed by 75 companies representing 82% of the total amount reported**
- ▶ **The occurrences of valuation models used for at least one plan are the following:**

	Equity-settled	Cash-settled
Black-Scholes	39	7
Binomial	15	3
Trinomial	4	0
Monte-Carlo	14	3
Market value of underlying shares	8	0
Other	9	0
Valuation model unstated	9	10

Conclusion

- ▶ **Some improvement in both the content and the application of IFRS2 would seem to be necessary if the financial statements are to provide clear, concise and easily understandable information**

Share based payments – IFRS2

The occurrences of valuation models used

	Equity-settled	Cash-settled
Black-Scholes	39	7
Binomial	15	3
Trinomial	4	0
Monte-Carlo	14	3
Market value of underlying shares	8	0
Other	9	0
Valuation model unstated	9	10

Post-employment benefits – IAS19

Degree of compliance observed

- ▶ **Within the sample of 250 listed companies, the DBO amounts to EUR 755 billion**

Weight of Defined Benefit Obligations (DBO) in European companies (250 entities)	
Total DBO in € Billions	755
Total Turnover in € Billions	3 473
DBO / Turnover	22%
Total Market Cap in € Billions	4 238
DBO / Market Cap	18%

- ▶ **Incomplete or disparate disclosures identified**

Problems identified

- ▶ **Life expectancy assumptions are not fully given and similar environments show discrepancies:**
 - *49% of companies disclosing Defined Benefit Obligations provided life expectancy information*
 - *17% disclosed both the life expectancy assumption and the mortality rate sources*
- ▶ **Only half the companies gave sensitivity analysis on changes in actuarial assumptions and mostly only covered a portion of actuarial information**

Orientation on options used

- ▶ **Several options were selected for the recognition of actuarial gains and losses on post-employment benefits:**
 - *39% of companies selected the “corridor approach”*
 - *49% of companies opted for the “equity model”*
 - *8% selected the “profit and loss model”*
 - *4% did not disclose their accounting policy on the treatment of actuarial gains and losses*

Conclusion

- ▶ **Wide differences in disclosures relating to IAS19 exist. These are partly due to the different ways that the pension mechanisms and obligations are structured in each of the Member States’ laws and economic policies.**
- ▶ **However, more convergence on assumptions and reference bases is needed.**

Post-employment benefits – IAS19

Weight of DBO amounts in the 250 sample of listed companies

Weight of Defined Benefit Obligations (DBO) in European companies (250 entities)	
Total DBO in € Billions	755
Total Turnover in € Billions	3 473
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Environment – IAS37/IFRIC1/IFRIC5/IFRIC6

Degree of compliance observed

- ▶ **No case of non compliance observed**
- ▶ **Provisions for environmental matters amount to EUR 90 billion and are heavily concentrated on two sectors:**
 - *Utilities: EUR 54.5 billion (61% of the total amount)*
 - *Oil & Gas: EUR 23.7 billion (26% of the total amount)*

Orientation on options used

- ▶ **An analysis of companies disclosing environmental liabilities and/or contingent liabilities shows the following pattern:**
 - *About 80% have recognized only provisions*
 - *Only one company has registered only contingent liabilities*
 - *The remaining companies (20%) have disclosed both provisions and contingent liabilities*

Problems identified

- ▶ **The quality and clarity of disclosures vary significantly:**
 - *Some companies do not provide information on the type of risk exposure*
 - *Some companies do explain the risk exposure but do not disclose assumptions used for the calculation of the amount of the provision*

Conclusion

- ▶ **The changes envisaged in the context of the revision of IAS37 may improve the quality of disclosures on environmental topics:**
 - *Removing the probability recognition criterion*
 - *Required disclosures about possible obligations (subject to materiality)*
- ▶ **However, information on risks may still be insufficient**

Insurance contracts – IFRS4

Degree of compliance observed

- ▶ The main provisions of the standard are well applied by 9 out of 10 insurance groups (life and non-life insurance business) in our sample
- ▶ One of the main purposes of IFRS4 is to better define insurance contracts and to differentiate them from investment contracts. 80% of our sample disclose the different types of contracts or explain how they have been classified
- ▶ 8 out of 10 groups did not disclose their policy for impairment tests on reinsurance assets

Problems identified

- ▶ IFRS4 does not provide guidance on certain insurance contract related issues, in particular:
 - *Insurance contract acquisition costs. Different accounting and disclosure methods used*
 - *Profit and loss account presentation of reinsurance costs (deducted from gross premiums or expense below gross premiums)*
 - *The measurement of insurance liabilities is not yet addressed by IFRS*

Orientation on options used

- ▶ The option offered by IAS39 to designate certain assets or certain liabilities at Fair Value through profit and loss account is used by 8 out of the 10 insurance groups included in our sample.
- ▶ The primary reason for using the Fair Value option is to avoid an accounting mismatch in life insurance. 7 of these 8 groups explicitly disclose it, one leaves it to users to understand this fact.
- ▶ Under IFRS4, insurers are permitted but not required to apply “shadow accounting”. 60% of the sample have been found to do so.

Conclusion

- ▶ IFRS4 is well applied by the insurance groups in the sample - as far as it goes.
- ▶ The future standard on Insurance contracts expected in 2011 will hopefully more fully harmonize the reporting practices of insurance companies regarding the accounting treatment of insurance contracts, in particular the measurement of insurance liabilities.

Other key findings

- ▶ The application of IFRS is heading towards meeting the objective of enhancing comparability
 - The overall quality of IFRS financial statements has improved in 2006 compared to 2005
 - Average size of companies is the major driver of differences in compliance between Member States
 - The variety of disclosures between Member States reveals differences in economic and welfare policies across the European Union
 - The choice of presentation options remains under the influence of national accounting cultures
 - Consistency of application across industry sectors is limited by different underlying business models
 - No occurrence was found of companies deeming necessary to depart from the requirement of standards to abide by the objectives set in the IASB Framework
 - The underlying use of options in 2006 financial statements are very similar to those in 2005

Other key findings

Disclosures demonstrate efforts made by Preparers and Auditors

- Disclosures on accounting framework now identify almost unanimously IFRS-EU as the reference for the preparation of the Financial Statements
- Improvements have been made in the presentation of the accounting principles to avoid “boiler plating” copy and paste of financial reporting standards but further progress is needed
- Incomplete disclosures on judgments and estimates remain a concern for a clear understanding of too many financial statements
- The communication of alternative performance measures occurs only for a limited number of companies and they are in most cases reconciled to IFRS results
- Some preparers, operating in regulated financial activities, choose to present additional metrics beyond IFRS requirements

However, small and medium sized companies have shown greater difficulties with IFRS:

- Higher degree of disclosures non compliance
- Higher residual level of “boilerplating”, or policies with no underlying relevant operations
- Reduced numbers of staff to handle the issues is identified as a constraint

Other key findings

- ▶ Enforcement activities show a wide range of situations:
 - CESR report (Ref. 07-352) stated that of the 25 Member States:
 - 10 had conducted enforcement activity in full compliance with CESR Standard No. 1
 - 8 had partially abided by the standard
 - 7 had not conducted enforcement activities
 - We encountered a wide variety of situations while trying to retrieve information from websites
 - Some enforcers contacted stated that they would start to publish in 2009 results of reviews made on 2007 financial statements

Other key findings

Wider application of IFRS faces some major challenges:

- A growing proportion of groups reporting under IFRS are also adopting IFRS for their internal management reporting
- However, the ability for their individual companies to use IFRS for local statutory accounts is not possible in all Member States, therefore creating additional workload
- Need to close the gap between local tax based accounting rules and IFRS
- Significant simplification (reduced span of options, simplified treatment of some IFRS for smaller companies, ...) needed before universal adoption for all companies
- Time and added change management is needed in order to fully embed understanding and acceptance
- The periodic release and cost-effective access to all IFRS-EU standards , related IASB official releases and other bases of conclusions and guidance in each official EU language is paramount to wider application

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Conclusion

Enhanced comparability

- ▶ The application of IFRS in 2006 shows an improvement over the situation in 2005
- ▶ The quality of disclosures improved in 2006, although further efforts are needed to attain full compliance

Growing acceptance (some verbatim)

- ▶ “Our national GAAP were well engineered but nobody could understand them beyond our country”
- ▶ “Our clients now make more easily cross border investments since they understand the figures”
- ▶ “Cooperation and exchange of information through CESR is boosting the enhancement of enforcement of regulations”

Areas of improvement

- ▶ Additional efforts are needed to further enhance the level of enforcement
- ▶ There are number of issues to address with certain of the standards to simplify, adapt and/or make clearer the financial information reported
- ▶ Need to meet the recent G20 requirements (post review situation)

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