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EU IMPLEMENTATION OF IFRS AND THE FAIR VALUE DIRECTIVE

A report for the European Commission

Executive Summary

The Institute of Chartered Accountants in England and Wales (ICAEW) has prepared the report *EU Implementation of IFRS and the Fair Value Directive* at the request of, and with funding from, the European Commission (EC). This document is an Executive Summary of the report. Readers are advised to refer to the report to obtain a more complete understanding of the contents.

Further copies of the Executive Summary and the report may be obtained by calling +44 (0)20 7920 8534 or downloaded by visiting www.icaew.com/ecifrsstudy

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Whilst the contents of the report and this Executive Summary are the ICAEW's sole responsibility, the ICAEW acknowledges its gratitude to all those who have contributed to it, including ICAEW staff and project consultants, roundtable participants, on-line survey respondents, EC staff and representatives of EU member state authorities and professional accountancy bodies.

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Key points from the 24 chapters of the report to the European Commission are reproduced below

1. Objectives, terms and approach

The study is designed to inform debate about the implementation of International Financial Reporting Standards (IFRS) in the EU through the IAS Regulation and about the implementation of the Fair Value Directive. It involves the following principal workstreams:

- analysis of the legal implementation of the IAS Regulation and the Fair Value Directive based on questionnaires sent to interested parties in all member states and subsequent work to try to resolve conflicting responses;
- review of surveys and other literature on EU implementation of IFRS;
- roundtables, principally involving preparers and auditors of IFRS financial statements, held in Düsseldorf, London, Madrid, Paris, Rome and Warsaw and used to test and explore the preliminary findings from our other work;
- an on-line survey which generated usable responses from statistically valid samples of 51 investors, 162 preparers and 141 auditors across 23 member states covering understanding and use of IFRS financial statements, their preparation and audit, and the incremental costs to companies of applying IFRS;
- a review of regulators' statements on EU implementation of IFRS and selected published correspondence between the SEC and EU companies;
- an academic research paper on the relevance of IFRS information in explaining market prices and stock returns of French, Italian, Spanish and UK publicly traded companies;
- the application of the EU Common Methodology to assess the costs of the IAS Regulation;
- detailed technical analysis of the 2005 or first mandatory IFRS consolidated financial statements of a sample of 200 EU publicly traded companies referred to as Sample 1;
- high level technical analysis of the 2005 IFRS consolidated financial statements of 18 EU non-publicly traded companies referred to as Sample 2; and
- high level technical analysis of the 2005 IFRS legal entity financial statements referred to as Sample 3, comprising 32 Sample 1 companies and 18 other companies.

2. Implementation of the Fair Value Directive

The Fair Value Directive and the IAS Regulation both emerged from a debate in the 1990s on the best way of achieving greater accounting harmonisation within the EU at the same time as allowing European companies that wished to access international capital markets to comply with emerging international best practice.

Since 2000, the EU's move towards IAS/IFRS has been implemented in two parallel and interlocking ways: an IAS Regulation approach; and an Accounting Directives approach. The Fair Value Directive belongs to the latter, but the two need to be considered together. A number of member states have implemented the Directive's requirements through their implementation of the Regulation.

The range of options allowed by the Fair Value Directive, together with the IAS Regulation, has created a complex picture across the EU as regards requirements and permissions to use fair value accounting, but as this reflects a deliberate decision to allow diversity, the differences among member states should perhaps be welcomed rather than criticised. However, we note that the use of Directives to track the requirements of IFRS is liable to create lags between international standards and EU practice.

Companies' use of fair value accounting under the Directive appears to have been limited. However, it is difficult to separate the effects of the Directive and the Regulation, and to a large extent compliance with both depends on member state options and companies' choices. Therefore we do not believe that compliance with the Directive merits further study.

3. Implementation of the IAS Regulation

The IAS Regulation directly requires the use of IFRS as adopted by the EU (IFRS-EU) in the consolidated financial statements of publicly traded companies established in EU member states. Each member state may also extend the application of the IAS Regulation to permit or require the use of IFRS-EU in the legal entity financial statements of companies and the consolidated financial statements of non-publicly traded companies.

The IAS Regulation has been effective in achieving the core objective of all publicly traded entities preparing consolidated financial statements in accordance with IFRS-EU, subject to the deferral of implementation in some countries to 2007 for entities with only debt securities admitted to trading or those entities listed on a non-EU market and using internationally accepted standards.

Allowing member states discretion over the extent to which IFRS was to be used outside the consolidated financial statements of publicly traded entities has inevitably resulted in legal positions varying significantly. Some member states are prescriptive on the use of IFRS in the consolidated and legal entity financial statements, others allow some choice. A common theme is a more prescriptive regime for specific types of entity, particularly financial institutions. In many cases the legal position has changed from 2005.

In view of the complex nature of the application of the IAS Regulation in member states and its continuing evolution, we consider it important that the European Commission cooperates with member states, the European Parliament and other organisations to monitor developments to ensure that information on the public record is up to date and accurate.

4. Views of preparers, users and auditors

The following were the key findings from the on-line survey:

- There was widespread agreement that IFRS has made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors.
- 63% of investors thought that IFRS had improved the quality of consolidated financial statements against 24% who thought that IFRS had made it worse. The corresponding figures for preparers were 60% and 14% respectively and for auditors 80% and 8%.
- 49% of investors thought that the switch to IFRS accounting had made financial statements more difficult to understand, although 32% disagreed. Investors found the majority of accounting areas easier to understand, but some specific accounting policies caused difficulty in understanding – particularly financial instruments.
- The move to consolidated IFRS financial statements had influenced the investment decisions of 41% of investors.
- A 51% majority of preparers were either very or fairly confident that fund managers and analysts fully understand the impact of IFRS but a 36% minority were not confident and 13% did not know.
- Preparers' views on board understanding of the financial impact of IFRS were broadly positive, although significant minorities were not confident of the board's understanding or did not express a view.
- 69% of preparers used IFRS accounting for internal reporting and 25% stated that IFRS financial statements had impacted the way the business was run.

The overall message of the roundtables was broadly consistent with the findings of the on-line survey. In particular, IFRS implementation had been challenging but successful; there was an absence of any general loss of confidence in financial reporting and IFRS implementation was generally seen as a positive development for EU financial reporting.

Key findings from the roundtables and supplementary telephone interviews were:

- Larger companies especially had prepared early, and had devoted considerable resources to educating and training their boards, staff and investors. The contribution of the IASB to this process, in making necessary improvements to IFRS in time for 2005 application, was referred to.
- There was broad agreement that the adoption of IFRS across the EU had improved the quality of financial reporting and had substantially increased comparability across countries, competitors and sectors.
- Success tended to be expressed more in terms of recognition and measurement, rather than disclosure, and the value of the significantly increased disclosure requirements was contested. There was general acceptance that 'boilerplate' accounting policies were used and that the disclosures required under IAS 1 *Presentation of Financial Statements* in relation to judgements and estimates presented a challenge for preparers.
- A number of participants argued that it was too early to conclude with certainty that the migration to IFRS had, overall, been a success. In particular, the period under review had witnessed benign economic conditions, which could delay the identification of poor accounting and regulatory practices.

- The experience of smaller quoted companies was often very different from larger companies because, for example, of limited resources and a lack of prior experience of IFRS. Nonetheless, there was little evidence of problems being identified.

- Many participants pointed to the requirements of national legislation and national regulators and the enduring strength of national accounting traditions as factors contributing to the 'local accents' found in IFRS reporting in the EU.

- It was evident that in many jurisdictions the increased amount of judgement required by IFRS as a generally principles-based set of standards presented considerable challenges, and some concerns were expressed about consistency of application.

- Whilst there was a fair degree of satisfaction with the current suite of IFRS, certain standards were singled out for criticism, including IAS 39 *Financial Instruments: Recognition and Measurement*. A number of participants queried whether the valuations of intangibles required under IFRS 3 *Business Combinations* merited the associated costs.

- Participants at all of the roundtables expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values in IFRS and the possibility that convergence with US GAAP may lead to more rules-based standards. These concerns, coupled with awareness of the scale of the effort involved in IFRS implementation and concerns about some aspects of current IFRS, were reflected in a general lack of appetite at present for any wider application of full IFRS.

- The roundtables supported the view that, despite increasing levels of understanding, company boards were still in need of more advice and assistance on accounting matters than was the case prior to the transition.

- Participants at the roundtables supported the view that the audit firms had played a pivotal role in ensuring that the process of transition was generally a smooth one. Some participants and interviewees expressed dissatisfaction with the speed with which early questions of interpretation were addressed by their auditors, whilst recognising that this reflected a desire by audit firms to reach consistent answers.

- Finally, in a number of jurisdictions the issue of the quality of IFRS translations was highlighted as a major concern.

5. The role of regulators

European regulators, along with other stakeholder groups, play a key role in ensuring that IFRS are applied with a degree of consistency appropriate in the context of principles-based accounting standards. Our study includes an analysis of the process that securities regulators have applied in setting up enforcement activity relating to IFRS application in the EU and the outcome of those activities. It does not cover the co-ordination of those processes nor the wider responsibilities of regulators in relation to economic stability.

Our discussions with some securities regulators and our reviews of reports and correspondence confirm our view that the consolidated financial statements of Sample 1 companies generally comply with IFRS-EU, IFRS or both. They also confirm that there are issues which require further attention by companies, including disclosures regarding accounting policies and key judgements made by management, but that none of these issues are sufficiently major to undermine the level of compliance with IFRS-EU or IFRS.

Reports from the following national enforcement bodies are summarised and have also been used in our technical analysis:

- Finland: Financial Supervision Authority (FIN-FSA);
- France: Autorité des Marchés Financiers (AMF);
- Germany: Deutsche Prüfstelle für Rechnungslegung – Financial Reporting Enforcement Panel (DPR-FREP);
- Netherlands: Netherlands Authority for the Financial Markets (AFM);
- United Kingdom: Financial Reporting Review Panel (FRRP); and
- USA: Securities and Exchange Commission (SEC).

6. The reaction of securities markets

The voluntary adoption of IFRS in Europe from the late 1990s and the EU's decision to mandate IFRS from 2005 have led to a large number of research studies on IFRS. These find that larger companies that rely more on equity financing and have more foreign exposure perceive the benefits of IFRS as greater than other companies. They also find that there are economic consequences of both voluntary and mandatory IFRS adoption but that they are unevenly distributed. Research on mandatory IFRS is at an early stage and currently there is only limited and somewhat inconsistent evidence on the consequences.

The preliminary results of research undertaken for this report, however, suggest that IFRS do in some cases provide information that is value relevant to stock market participants:

- For companies previously reporting under UK, French or Italian GAAP, the IFRS earnings reconciliation adjustment helps to explain share prices as measured three months after the first year of mandatory application of IFRS. This is particularly significant for UK and French companies.
- For French and UK companies, the IFRS earnings reconciliation adjustment is also significant in explaining stock returns, that is year-on-year changes in share prices as measured three months after the end of the first year of mandatory IFRS reporting.

7. Costs of implementing IFRS

Based on the results of our on-line survey and application of the EU Common Methodology, insofar as this was practicable, a broad estimate of the typical cost of preparing the first IFRS consolidated financial statements of publicly traded companies is:

Companies with turnover below €500m	0.31% of turnover
Companies with turnover from €500m to €5,000m	0.05% of turnover
Companies with turnover above €5,000m	0.05% of turnover

Our survey also found that the broad estimate of the typical recurring costs of preparing IFRS consolidated financial statements in following financial years is:

Companies with turnover below €500m	0.06% of turnover
Companies with turnover from €500m to €5,000m	0.01% of turnover
Companies with turnover above €5,000m	0.008% of turnover

However, detailed examination of the figures suggests that at both extremes of the turnover size bands (below €100m and above €10,000m) the relationship between IFRS transition costs and turnover might be more variable than the percentages quoted above. We also think that even though we asked respondents for estimated incremental costs, some of the above costs might not be truly incremental.

These figures indicate that the smallest companies bore the proportionately greatest costs. There appear to be economies of scale, even among larger companies with more complex transactions requiring more sophisticated accounting policies. Small companies appear to have been unable or unwilling to utilise internal resources and relied upon external advice and support to a greater extent. The analysis also suggests that the largest companies were more prepared to embed accounting changes to reduce future costs.

The costs of auditing IFRS implementation were significant, ranking as the second highest cost for companies with turnover below €500m and the third highest for larger companies. Auditor responses to the on-line survey and the roundtables provided extra insight into the costs of IFRS implementation by bringing the importance of the relationship between companies and their auditors into focus.

8. IFRS consolidated financial statements of EU publicly traded companies

The 2005 or first mandatory IFRS consolidated financial statements of EU publicly traded companies appear generally to comply with IFRS across different industries, markets and member states. This assessment is based on an analysis of disclosures in Sample 1 and the associated audit opinions. We relied solely on publicly available information and did not make any inquiries of the companies or auditors concerned.

Of the 200 companies in Sample 1:

- 198 disclose full compliance with IFRS and 2 disclose partial compliance;
- 146 disclose compliance with IFRS-EU only, 31 with both IFRS-EU and IFRS and 23 with IFRS only; and
- none of the 23 financial statements which disclose compliance with IFRS-only indicate that the company is not complying with IFRS-EU.

Compliance with individual standards is separately considered at 11 to 24 below.

9. IFRS consolidated financial statements of EU non-publicly traded companies

Our review of the 2005 IFRS consolidated financial statements of a number of EU companies that were not publicly traded indicated that all complied with IFRS-EU. Some companies disclosed compliance with IFRS without reference to their adoption by the EU but there is no indication that any of the IFRS requirements adopted conflicted with IFRS-EU.

The high level review of the financial statements of the companies in Sample 2 did not identify any major issues not highlighted by our work in relation to the consolidated IFRS financial statements of publicly traded companies. However, a small number of financial statements were reviewed during this part of our study and therefore conclusions drawn should be treated with caution.

10. IFRS legal entity financial statements

Our review of 2005 legal entity financial statements indicated that, where full IFRS financial statements were presented, all complied with IFRS-EU. Some companies disclosed compliance with IFRS without reference to their adoption by the EU but there is no indication that there are any policies adopted which conflict with IFRS-EU.

High level reviews of financial statements of companies in Sample 3 did not identify any major issues not highlighted by our work in relation to the consolidated IFRS financial statements of publicly traded companies, except that the consolidated financial statements of a number of UK and Irish companies do not include an income statement and certain other information in their IFRS legal entity financial statements. They disclose that fact and, therefore, do not make explicit and unreserved statements of compliance with IFRS. They explain that the information has been omitted in accordance with exemptions in UK and Irish law.

A small number of financial statements were reviewed during this part of our study and therefore conclusions drawn should be treated with caution.

11. First-time adoption of IFRS

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS by an explicit and unreserved statement in those financial statements of compliance with IFRS. Such an entity must apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

We examined how many entities in Sample 1 had not previously presented financial statements under IFRS and how these first-time adopters applied some of the exemptions and exceptions in IFRS 1. A significant finding was that 151 companies had adopted IFRS for the first time as a result of the IAS Regulation and the remaining entities had previously presented their financial statements under IFRS. This suggests that companies will have faced varying challenges in their transition.

We found that first-time adopters used optional exemptions in IFRS 1 in different combinations with the result that the comparability of the financial statements both among first-time adopters and between first-time adopters and continuing IFRS reporters may be impeded. To some extent, the differences will have an effect on future periods.

This chapter includes a detailed analysis of the use of IFRS 1 exemptions by the 151 first-time adopters:

- 149 include the comparative information required by IFRS;
- 91 restated the prior period for IAS 32 *Financial Instruments: Disclosure and Presentation* and 84 restated the prior period for IAS 39 *Financial Instruments: Recognition and Measurement*;
- where applicable, all companies used the exemption for business combinations (IFRS 3);
- 31 used fair value or revaluations as the deemed cost of property, plant and equipment (IAS 16) or investment property (IAS 40), although practice varied over the amounts used as deemed cost and it is unclear whether some comply with IFRS 1;
- no first-time adopters used fair value or revaluations as the deemed cost of intangible assets (IAS 38);
- where applicable, all companies that opted to use the corridor approach for actuarial gains and losses on defined benefit plans recognised all such gains and losses at transition date (IAS 19); and
- where applicable, all companies used the exemptions for cumulative translation differences (IAS 21), compound financial instruments (IAS 32) and share-based payments (IFRS 2).

12. Fair presentation and accounting policies

IAS 1 *Presentation of Financial Statements* requires that IFRS financial statements present fairly an entity's financial position, financial performance and cash flows. The 198 companies from Sample 1 that disclose full compliance with IFRS-EU, IFRS or both state that their financial statements present fairly in accordance with IFRS-EU, IFRS or both. The audit reports express the same opinion.

IAS 1 requires an entity to depart from the requirements of an IFRS in extremely rare circumstances in which compliance with the requirement would be so misleading that it would conflict with the objective of financial statements set out in the IASB *Framework*. None of the companies in Sample 1 used this fair presentation override.

IAS 1 requires disclosure of the accounting policies used that are relevant to an understanding of the financial statements. All the companies in Sample 1 disclose their accounting policies, but there is too much standard wording or 'boilerplating' and little evidence of adaptation of accounting policies to suit companies' circumstances. More attention also needs to be paid to the disclosure of judgements made in applying accounting policies, the use of estimates and the impact of new and revised IFRS. Various securities regulators have identified the disclosure of accounting policies as an area of concern.

The IASB generally allows the early adoption of new or revised IFRS that are not mandatory for a period. It also requires an entity to make disclosures about the possible impact of new or revised IFRS that are not yet effective, but have been issued prior to approval of the entity's financial statements. These disclosures should include the possible impact of the new or revised IFRS. The following new or revised IFRS were early adopted:

- 6 companies adopted IFRS 7 *Financial Instruments: Disclosures*;
- 60 companies adopted the amendment to IAS 19 *Actuarial Gains and Losses, Group Plans and Disclosures*;
- 19 companies adopted the amendment to IAS 39 *Cashflow Hedge Accounting of Forecast Intragroup Transactions*;
- 36 companies adopted the amendment to IAS 39 *The Fair Value Option*;
- 5 companies adopted the amendment to IAS 39 *Financial Guarantee Contracts*;
- 8 companies adopted IFRIC 4 *Determining whether an Arrangement Contains a Lease*; and
- 3 companies adopted IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*.

13. Financial statements presentation

IAS 1 requires that a complete set of IFRS financial statements should consist of six specified components and lays down requirements for each of these component parts of the financial statements.

All 200 companies in Sample 1 presented consolidated financial statements that include the necessary components: a balance sheet, income statement, statement of changes in equity, cash flow statement, statement of accounting policies and notes. There were no instances of material non-compliance except for a number of companies which included actuarial gains and losses in equity but did not present a statement of recognised income and expenses as required by IAS 19 *Employee Benefits* as amended and the related amendment to IAS 1.

Many companies report operating profit, earnings before interest, tax, depreciation and amortisation (EBITDA) or some other measure that they appear to believe better portrays their performance. In many cases, these alternative measures are incorporated onto the face of the income statement. More often, they are presented outside the financial statements. This has attracted some attention from securities regulators who have expressed concern about such disclosure.

14. Fair value accounting

We found that use of fair value accounting under IFRS is much less extensive than is sometimes assumed to be the case, and is in fact very limited overall. In particular, where companies are given an option as to whether to use a cost or a fair value model, they typically choose a cost model.

Our analysis of the 200 Sample 1 companies found that:

- in addition to the mandatory use of fair value under IAS 39 for certain financial assets and liabilities, 36 companies used the fair value option in IAS 39 to measure at fair value some financial assets and/or financial liabilities that would otherwise have been measured at amortised cost. 21 were banks and 8 insurers. The option was used selectively: the vast majority of the companies' financial assets and financial liabilities were measured on a historical cost basis.

- 199 held own-use property, plant and equipment. 8 used the revaluation model (fair value) for property, but no companies used it for plant and equipment.

- 81 held investment properties. Of these, 23 used the fair value model.

- No companies used the revaluation model (fair value) for intangible assets.

- 9 companies held biological assets. Of these, 5 used the fair value model.

At the roundtables, concern was expressed at the subjectivity of fair values in the absence of active and liquid markets, at the volatility that fair value can introduce in reported income, and at possible moves towards much greater use of fair value. Recent reports from users and surveys of users' and preparers' views show a significant level of opposition to more extensive use of fair values in IFRS.

15. The use of other options in IFRS

This chapter analyses the use of optional accounting treatments, other than measurement options, in the IFRS consolidated financial statements of the companies in Sample 1. The areas examined include actuarial gains and losses, borrowing costs and joint venture entities.

When accounting for post-employment benefit plans, 73 out of 200 companies recognise all actuarial gains and losses immediately and in full. 54 of these 73 companies use the new option that allows them to include these items in equity rather than profit or loss; 8 of the 54 companies do not present the required statement of recognised income and expense.

The corridor approach is used by 88 out of 200 companies to account for actuarial gains and losses. All except 6 of the 88 defer and amortise the actuarial gains and losses that lie outside the corridor. All first-time adopters used the IFRS 1 option to recognise all actuarial gains and losses in the balance sheet and in equity at the transition date.

When utilising the options available in IAS 23 *Borrowing Costs* relating to borrowing costs on qualifying assets, 51 out of 200 companies capitalised these costs and 149 expensed them.

There were 101 companies with interests in joint ventures. 60 of these companies use the option in IAS 31 *Interests in Joint Ventures* to apply proportionate consolidation and 41 use the equity method.

16. Consolidated financial statements

We analysed the application of IFRS on the following technical issues:

- consolidated financial statements, including the concepts of de facto and legal control; and

- business combinations, goodwill and intangible asset impairment.

Sample 1 companies appeared to consolidate all material subsidiaries including those with dissimilar activities and special purpose entities. They also:

- used the purchase method to account for all business combinations except those which were common control transactions;

- allocated the cost of the business combination to the acquiree's identifiable assets, liabilities and contingent liabilities and sought to measure them at their fair values;
- recognised as goodwill any excess of the cost of the business combination over the aggregate fair values of the acquiree's identifiable assets, liabilities and contingent liabilities; and
- carried out annual impairment tests, rather than amortising, goodwill.

There may be diverse practices with respect to the detailed application of the purchase method and in applying the control definition, particularly when de facto control is involved or there are significant minority interests.

Findings from external studies and reviews by securities regulators on disclosures relating to business combinations, goodwill and asset impairment have been included in this chapter. The general view is that additional disclosures on business combinations and impairment testing of goodwill are needed to comply with IFRS 3.

17. Banks

Overall, the transition to IFRS by banks was carried out to a high standard. Whilst comparability was not assisted by the options available on first time application in IFRS 1, diversity of practice was reduced by the application of IAS 32 and IAS 39 to the 2005 financial statements.

Our work was directed at the disclosure of accounting policies; the use of the fair value option for financial assets and financial liabilities; hedge accounting; the EU carve-out; impairment of financial assets; and presentation and disclosure issues.

All 29 banks in Sample 1 disclosed their principal accounting policies, but some did not disclose policies for all relevant financial instrument issues, such as revenue recognition for interest income and fee and commission income.

Under IAS 39, an entity may use the fair value option only where: it eliminates, or significantly reduces, a measurement or recognition inconsistency (an 'accounting mismatch'); a group of financial assets, financial liabilities or both is managed and evaluated on a fair value basis; or a financial instrument contains one or more embedded derivatives. We found that 21 out of 29 banks in Sample 1 used the fair value option.

Hedge accounting is allowed for three types of hedging relationships. This chapter analyses the use of hedge accounting for each type of relationship by the 29 Sample 1 banks. We found that:

- 25 used hedge accounting for fair value hedges of the exposure to changes in the fair value of all or a portion of a recognised asset or liability or an unrecognised firm commitment;
- 24 used hedge accounting for cash flow hedges of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction; and
- 16 used hedge accounting for hedges of a net investment in a foreign operation in relation to the exposure to changes in the entity's share of the net assets of a foreign operation.

Our analysis of these banks also showed that eight used the EU carve-out with respect to hedge accounting in IAS 39. The EU carve-out allows banks to apply fair value hedge accounting for hedges of the interest rate risk of their portfolio of demand or core deposits and to ease the strict IAS 39 effectiveness requirements for some hedges.

IAS 39 requires an assessment at each balance sheet date of whether there is any objective evidence that individual financial assets or groups of assets are impaired. Where there is such evidence, the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) is discounted at the effective interest rate at the time of initial recognition and recognised as a loss. The carrying amount of the asset is reduced either directly or through an allowance account. With one exception, all banks in Sample 1 determined impairment losses based on both an individual and collective assessment. Some related disclosures are unclear in that it is not possible to determine the credit impairment charge separately from impairment of other assets because impairment is presented as one line in the income statement. Moreover, for those banks that disclosed an impairment allowance account, the income statement charge was not always apparent.

IAS 32 requires disclosure of the fair value of each class of financial asset and liability in a way that permits comparison with its carrying value. Most banks presented this information in tabular form but seven banks in Sample 1 appeared not to provide all the required fair value disclosures. IAS 32 also requires disclosure of risk management policies and various types of risk. Banks have always provided disclosures that are broadly consistent with these requirements and all Sample 1 banks provided risk disclosures. Three early adopted IFRS 7 which contains more demanding requirements in this area.

18. Insurance companies

In relation to the 13 specialist insurance companies in Sample 1, our analysis showed that overall the large multinational companies did a good job in complying with IFRS, in particular with IFRS 4 *Insurance Contracts*, including its disclosure requirements. By comparison, the disclosures of other insurance companies were of a lower standard.

Of the 13 companies in Sample 1, three were continuing IFRS reporters and had presented IFRS financial statements in prior periods and 10 were first-time adopters. Seven first-time adopters restated the comparative period to comply with IFRS 4 and three availed themselves of the exemption in IFRS 1 which allowed them to apply IFRS 4 from 1 January 2005 without restating the 2004 comparative information.

Appendix A of IFRS 4 contains a definition of an insurance contract which requires it to contain significant insurance risk. This led to the reclassification of many life assurance contracts as investment contracts under IAS 39 because they did not contain significant insurance risk. This definition issue led to the reclassification of some contracts by two out of three continuing IFRS reporters, as well as many of the first-time adopters.

We found that 8 of the 13 insurance companies in Sample 1 used the fair value option for some financial assets and financial liabilities.

All the insurance companies in Sample 1 appeared to carry out the liability adequacy test required by IFRS 4. This involves the company in assessing at each reporting date whether the insurance liabilities recognised are adequate using current estimates of future cash flows under its insurance contracts.

In relation to discounting, IFRS 4 allows insurers to continue using some existing practices. Among these, it allows an insurer to measure insurance liabilities on an undiscounted basis. However, an insurer may not adopt an undiscounted basis if it previously used a discounted basis although it may change from an undiscounted basis to a discounted basis. We noted that only one out of the 13 insurance companies in Sample 1 discounted non-life provisions.

IFRS 4 does not permit the recognition of catastrophe provisions and equalisation provisions and, as a result, seven of the Sample 1 insurance companies eliminated such provisions.

We noted that seven insurance companies in Sample 1 continued to use shadow accounting as permitted by IFRS 4. Shadow accounting arises where realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities, related deferred acquisition costs and related intangible assets. The insurer changes its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) is recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity.

19. Extractive industries

IFRS 6 *Exploration for and Evaluation of Mineral Resources* was mandatory only from 2006, but could be applied on a voluntary basis in 2005 by entities operating in the oil and gas and mining sectors. The standard introduces only limited improvements to accounting in this key sector, and allows the continuation of some existing national requirements that may conflict with usual IFRS principles.

Our work indicated that major companies involved in this sector made few changes when accounting for the costs of exploration for, and evaluation of, mineral resources on the transition from national GAAP to IFRS. We conclude tentatively that the adoption of IFRS is unlikely to have any significant effect on accounting by EU extractive industries before the implementation of new requirements. The absence of a comprehensive standard in this area was identified at our roundtables as a weakness in IFRS, albeit one of which the IASB is well aware.

There is some evidence relating to companies outside of Sample 1 of a shift from full cost to successful efforts accounting on adoption of IFRS 6. This observation might warrant further investigation as part of the IASB's long-term project now that IFRS 6 is fully in force.

20. Service concessions

Service concessions are arrangements between public sector bodies and private sector entities for the provision of public services. Such arrangements are now of major economic importance, but there has been wide diversity in how they have been accounted for.

IFRIC 12 *Service Concession Arrangements* was issued in November 2006 after all the relevant companies had issued the IFRS financial statements under our review. Assuming IFRIC 12 is endorsed for use in the EU, companies are likely to continue with their existing practices for the time being, and financial reports on an IFRIC 12 basis are unlikely to be common before 2009. It is therefore too early to draw any firm conclusions about the implementation of IFRS in this area. Indeed, out of the 200 Sample 1 companies, six of the seven companies that disclose the existence of service concessions apply IFRS without reference to the draft of IFRIC 12 rather than anticipate its requirements.

21. Intangible assets

IAS 38 *Intangible Assets* requires that intangible assets should be carried at cost or fair value less any amortisation and any impairment losses.

Among the 200 companies in Sample 1, our analysis indicates that the level of disclosure surrounding useful lives and amortisation rates was inconsistent, with some companies not providing full analysis of the useful lives selected where there was a range of different intangible assets.

Of the 200 companies, 20 were chosen for more detailed analysis in order to highlight any specific issues relating to the disclosures around impairment and business combinations. The majority of these companies disclosed sufficient information on impairment to comply with the requirements of IAS 36 *Impairment of Assets*. However, there is scope for improving disclosures that relate to allocation of goodwill to Cash Generating Units and sensitivity analysis.

One expectation for business combinations under IFRS is that more intangible assets will be recognised and reported and that additional information about the residual cost recognised as goodwill will be disclosed. However, it was noted that within 20 companies selected for more detailed analysis, examples were found where the additional disclosures required by IFRS 3 were not provided. Doubts were expressed at the roundtables about the value of the new information on intangibles required under IFRS 3.

22. Defined benefit pension plan disclosures

Accounting for pensions is recognised as complex, and the nature of the defined benefit plans falling within the scope of IAS 19 varies significantly from relatively straightforward provisions for severance pay to the complex plans of global groups.

IAS 19 has a number of specific disclosure requirements. It would appear from the sample of companies reviewed that some of these disclosures were not provided and, in the case of the actuarial assumptions used, disclosures were often poor.

IAS 19's general requirement to disclose information to enable users of the financial statements to evaluate the nature of the defined benefit plans and the financial impacts of changes in those plans is hindered by lack of consistency in the layout and location of the pension disclosures. Given the range of accounting options available, the lack of detail provided in the notes in some cases further inhibits the ability of users to evaluate the impact of the companies' defined benefit plans.

23. Share-based payments

IFRS 2 *Share-based Payment* requires companies to reflect in the income statement and balance sheet the effects of share-based payment transactions. The focus of reporting in this area is the amount charged as an expense as a result of awards to employees.

In reviewing the financial statements of companies within Sample 1 we noted that:

- it was sometimes difficult to locate the income statement charge information required by IFRS 2, particularly when this could only be done by adding together several numbers contained in the narrative of a note to the financial statements;
- the 'Black-Scholes model' was used most frequently to measure the fair value of equity-settled awards at the date of grant but, in the absence of a specific disclosure requirement in IFRS 2, the reasons for the model's suitability were not clear;
- whilst complex disclosures are unavoidable for companies with multiple schemes because IFRS 2 requires details of each scheme if they are different, greater use of tables would be helpful in improving transparency; and
- clearer reporting of the location of both the expense and the corresponding credit to equity would assist understanding of the effect of share-based payments on the financial statements.

24. Financial instruments

We reviewed the implementation of IAS 32 and IAS 39 by Sample 1 companies other than banks and insurance companies. Our work was directed at the reporting of financial assets and liabilities in the balance sheet; classification of certain financial instruments as liabilities and/or equity; hedge accounting; and disclosures relating to financial risk.

We noted in particular that:

- classification of financial assets and liabilities was mainly presented in notes to the balance sheet. The classification of investment financial assets varied in clarity. In some cases it was not possible to ascertain the type of available-for-sale assets;
- derivatives reporting was on the whole clear and it was apparent that companies had concentrated on providing comprehensive disclosures that distinguished between IAS 39 hedging derivatives and economic hedging derivatives;
- impairment of IAS 39 financial investments was not visible in most of the financial statements. This could account for the lack of accounting policy statements in this area. For non-bank entities the main reporting focus does not tend to be on financial instruments other than for risk management purposes; and
- financial risk disclosures were as comprehensive as required given the size of the reporting entity. The focus was on interest rate, foreign exchange and credit risk.

Appendix

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