Finishing touches

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Illustration: Ryan Snook

The IFRS deadline is finally here, and while there has been a great deal of preparation, it's not over yet

The long-awaited dawn of international financial reporting standards (IFRS) in Canada has finally arrived. IFRS became Canadian generally accepted accounting principles for most public companies on January 1. But experts advise adopters not to become complacent in the early days of this new era in financial reporting.

The changeover has involved a significant amount of preparatory work. “But adopters should not consider the project complete until they have sustainable processes in place and have communicated with the investment community,” says Gordon Beal, Toronto-based project leader for the CICA’s IFRS transition.

“When investors look at their first-quarter 2011 financial reports, they’re going to want to know, in terms of any differences between this period and last year’s, how much of that has arisen because of actual business issues, and how much has arisen because of changes in accounting language be-tween IFRS and old Canadian GAAP,” says Chris Hicks, a principal in CICA’s guidance and support group and publisher of The IFRS Changeover: A Guide for Users of Financial Reports.

“That’s why it’s important that the preparer community communicate to investors the impact of the changeover,” Hicks says, adding that failure to do so increases the level of uncertainty about an entity’s financial reporting, something investors do not appreciate.

There are a number of key external stakeholder groups, including investors, industry analysts, auditors, regulators, bankers and creditors, that need to be kept apprised of IFRS developments. Time is of the essence. Most firms reporting on a calendar-year basis will, for instance, need to prepare their first-quarter results under IFRS as of March 31, 2011, providing stakeholders with their first complete picture of reporting under the new regime. These first-quarter reports will be published just a few weeks after the annual 2010 reports that were prepared under old GAAP.

“The way we will report the business will be quite different under IFRS; therefore it’s important [stakeholders] understand those differences in order to understand our results,” says Eric Bouchard, director of financial reporting for Bombardier Inc. in Montreal, whose investor relations efforts began early on during its IFRS adoption process.

Stakeholders need to understand that the measurement and financial presentation of various assets, liabilities, revenues, expenses and cash flows might be impacted by IFRS.

For instance, says Hicks, “there could be circumstances where an entity needs to consolidate something under IFRS they didn’t consolidate under old GAAP, or there might be changes in a revenue recognition policy under IFRS, or changes in the way that an entity looks at the impairment of assets under IFRS.”

The extent of the impact of the changeover will vary from company to company. Says Hicks: “Say you have a real estate in-vestment trust that has, under old GAAP, recorded its investment properties at cost. Under IFRS it has the option of recording them at fair value. If it takes up that option then you’re going to see a very different picture in the Statement of Financial Position — likely with a big increase in the value of properties and a corresponding change to equity.”

Certain reporting changes could have unintended consequences if investors and other stakeholders do not understand them and therefore misinterpret the information. If, for example, the value of assets are written down by significant amounts as a result of the changeover to IFRS, it could, instead of a change of accounting method, be construed as a decline in financial performance and reduce the firm’s stock price.

“Even though there may not be a change in the financial environment of the enterprise, some investors may respond to the change in measurement, rather than the underlying environment,” says Peter Chant, partner in the national office of Deloitte & Touche LLP in Toronto.

Chant draws an analogy to Canada’s metric conversion in 1975. Switching from the Fahrenheit scale to Centigrade involved a relocation of scale, including resetting the freezing point from 32 degrees Fahrenheit to zero Celsius, with the result being that different numbers under the old and new scales meant the same thing — similar to what is occurring as a result of the IFRS transition.

“To prepare investors, it is wise to signal potential changes before financial statements are released, so they understand whether this reflects something that is going to have a substantial impact on the business or is just a different method of measuring and recording that doesn’t ultimately represent a change in the underlying cash flows,” Chant says.

Investors and stakeholders such as industry analysts also have a responsibility to educate themselves about the changeover, taking the initiative to learn about potential reporting changes arising from IFRS and understanding what questions they need to ask in order to be able to pinpoint the root cause of such changes.

Otherwise, investors might have a tendency to conclude “this corporation’s performance has deteriorated, when in fact it hasn’t gone down in economic terms,” says Chant. “It’s just been portrayed differently on the financial statements.”

Misinformation can be very costly to investors as well as the companies they invest in. “Investors who are unaware of the impact driven by business operations versus accounting choices could allow this misinterpretation to skew their investment decisions and therefore miss out on trading opportunities,” says ***Anthony Scilipoti***, executive vice-president of ***Veritas Investment Research Corp. in*** Toronto, and a member of Canada’s Accounting Standards Board.

So, where should investors look for information about the changeover?

Information concerning IFRS developments needs to be disclosed in the management’s discussion and analysis (MD&A) that accompanies a publicly accountable enterprise’s financial statements. This requirement, mandated by the Canadian Securities Administrators (CSA), demanded increasingly detailed information in the period leading up to the changeover. In 2010, the MD&A should disclose matters such as significant differences in accounting policy between IFRS and old GAAP including when available, the quantified impact on financial reporting. When the impact of the changeover is not yet reliably quantified, the CSA suggests companies report the direction for the impact of changes. In addition, the MD&A should discuss any material business issues created by the company’s adoption of IFRS.

“It’s very important that no matter what happens, we don’t have any covenant issues,” says Bouchard. “Even though we don’t have numbers yet, we want to be sure they’re ready, so there won’t be any issues.”

The first-quarter IFRS financial statements will help users understand the impact of the changeover by providing several reconciliations of comparative period information from IFRS to old GAAP. For calendar-year companies, the reconciliations will include equity at January 1, 2010, December 31, 2010 and March 31, 2010, comprehensive income for the year ended December 31, 2010 and the quarter ended March 31, 2010, and any material adjustments to cash flow.

While the first-quarter 2011 financial statements will provide information about the quantitative aspects of the changeover, they will likely not provide explanations for the change or the impact on reporting on an ongoing basis. Hopefully, companies will provide this sort of information in their 2011 MD&A, including discussions of any key performance indicators whose trends have been distorted as a result of the changeover. As well, both IFRS adopters and stakeholders should also seek more informal communication venues, such as webinars, phone calls and personal meetings, to supplement and solidify an ongoing dialogue.

It’s not just investors, potential investors and industry analysts who scrutinize financial results and are likely to notice IFRS-related changes. Financial statements can also be critically important for other parties. Take bankers, for instance. A firm’s lending arrangements might be tied to covenants that specify certain financial ratios need to be maintained. These could be placed at risk by restated numbers; therefore bankers need to be kept apprised of situations where ratios could potentially be affected by the IFRS changeover.

The Canadian Investor Relations Institute (CIRI) has been encouraging its members working in companies transitioning to IFRS to get involved with the adoption exercise. This puts them in a better position to “go out and start talking to the street about IFRS and the changes that are happening in their company or industry to help get them through that learning curve,” says Tom Enright, president of CIRI.

“Lots of decisions have been made along the way by a company transitioning to IFRS,” he says. “The investor relations person needs to understand what alternatives were available during the IFRS transition and why his or her firm made the decisions it did and then be able to explain all that to the street.” Sustainability is another priority area for adopters. Beal emphasizes that IFRS adopters who have implemented stop-gap measures in order to meet transition deadlines need to replace such measures with more sustainable long-term plans as soon as possible in order to avoid potentially negative consequences down the road.

One of the risks associated with instituting stop-gap measures is that investor relations professionals may not be adequately involved. “The accountants and other finance people of the organization are in a good position to advise investor relations professionals on where the need for additional communication will likely arise,” says Beal. “Just creating the financial statements and letting whoever is communicating to the markets deal with it afterwards is definitely the wrong way to go.”

Firms trying to put things together as quickly as possible during their IFRS transition process might also be prone to excessive use of spreadsheets to make manual adjustments, which increases the risk of error. Additional audit procedures would also then be required to minimize the risk of releasing incorrect information, thereby necessitating greater time and expense.

Furthermore, any time there’s the risk of manual errors occurring, there’s the possibility of restatement down the road. “No company is going to want to have to go back and explain to the market that an error was made. It really comes back to the reliability and credibility of information that’s being released to the markets,” says Beal, who believes it is better for IFRS adopters to incorporate changes directly into their accounting systems’ automated processes.

Adopters with noncalendar year-ends have the advantage of time, but Beal cautions against underestimating the amount of time these adopters need to make a smooth transition. “I advise them to take advantage of the added time to benefit from lessons learned by those companies that are already disclosing their IFRS information.”

The transition to IFRS has been a complex project requiring significant effort by all stakeholders. Hicks says once implemented, however, it should result in better comparability of financial reporting in an international environment with the anticipation that it will lead to increased international analyst coverage in the relatively small Canadian market.

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