PricewaterhouseCoopers

Europe and International Financial Reporting Standards 2005

Your questions answered

Focus on the change to IFRS

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PricewaterhouseCoopers (www.pwcglobal.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 125,000 people in 142 countries, we help our clients solve complex business problems and measurably enhance their ability to build value, manage risk and improve performance in an Internet-enabled world.

PricewaterhouseCoopers refers to the member firms of the worldwide PricewaterhouseCoopers organisation.

Other IFRS publications

The following publications on International Financial Reporting Standards and corporate practices have been published by PricewaterhouseCoopers and are available from your nearest PricewaterhouseCoopers office and at **www.pwcglobal.com/ifrs**.

Applying IFRS – Finding the right solution

Similarities and Differences – IAS, USGAAP and UKGAAP

International Accounting Standards - A Pocket Guide

Understanding IAS 39 – Financial Instruments

Illustrative Bank Financial Statements 2002

Illustrative Corporate Financial Statements 2002

Disclosure Checklist 2002

Understanding IAS 29 – Financial reporting in hyperinflationary economies

Audit Committees – Good practices for meeting market expectations

Reporting Progress – Good practices for meeting market expectations

2005 – Ready or not (IFRS survey 2002)

Making the change to IFRS - How will it impact your business?

World Watch – Governance and corporate reporting (newsletter)

IFRS News – Shedding light on the IASB's activities (newsletter)

See inside back cover for further details of IFRS products and services.

Contact us

Please contact your local PricewaterhouseCoopers office to discuss how we can help you make the change to International Financial Reporting Standards.

Alternatively, please send an email to: TransitionIFRS@pwcglobal.com

Europe and IFRS 2005

Your questions answered

Contents

Time to take action

The European Union has passed the regulation that requires listed European Companies to comply with International Financial Reporting Standards (IFRS)* in 2005 for their group financial statements. This is the biggest change to financial reporting in 25 years and makes the transition to IFRS an urgent issue for 7,000 companies in the EU that currently report under national GAAP.

This publication addresses some of the key issues that may arise as companies consider their strategies for conversion and for embedding the principles across their entire organisations.

The timing and requirements of the European legislation is now known. However, there remains uncertainty about the IFRS that will exist in 2005. These uncertainties will be reduced as the International Accounting Standards Board (IASB) publishes its standards on first time adoption of IFRS and other key areas such as business combinations and share based payments.

The EU regulation is an important step towards a single set of global accounting standards – a goal that PricewaterhouseCoopers strongly supports, whether by convergence of national standards with IFRS or worldwide adoption of IFRS.

Transparent corporate information is necessary now more than ever. Investors need clear, credible and internationally comparable financial and non-financial information on which to base their decisions. Without it, investor confidence in a company and its prospects can be quickly destroyed.

* New standards from the International Accounting Standards Board will be called International Financial Reporting Standards (IFRS) and not International Accounting Standards.

Which companies will be affected and when?

Q Which companies will be required to comply with IFRS?

A The EU regulation applies directly to companies incorporated in a member state and whose securities have been admitted to trading on a regulated market of any member state within the meaning of Article 1 (13) of Council Directive 93/22/EEC, or which have been offered to the public in accordance with Council Directive 89/298/EEC.

It requires all such companies to prepare their consolidated accounts in accordance with International Financial Reporting Standards as endorsed by an Accounting Regulatory Committee for financial years beginning during 2005. There is a limited exception for certain companies to delay implementation until 2007.

Regulated markets include any market established under the rules of specific stock exchanges in Europe and extends to markets such as the Nouveau Marche.

The regulation also provides member states with an option to extend the IFRS requirement to unlisted companies and to parent company accounts. However, to date there is no indication as to which countries, if any, will take advantage of this option. Some countries may organise to permit the use of IFRS or require compliance with IFRS in different ways before 2005. The following summarises the most recent developments by country:

- IFRS can be used at present for statutory financial statements (in some cases subject to certain tests or approvals): Austria, Belgium, Finland, Germany
- IFRS must be used in 2003: Greece
- IFRS can be used when existing legislation is enacted in full: France
- Legislation to allow IFRS is under development: Luxembourg, Netherlands
- Individual IFRS are expected to be introduced as national standards in the period to 2005: Denmark, Ireland, Sweden, UK
- IFRS cannot be used and there are no current plans for it to replace individual national standards: Italy, Portugal, Spain

Countries in the European Economic Area (EEA) have undertaken to introduce similar legislation. So companies incorporated and listed in Iceland and Norway will be expected to implement a similar regulation.

Q Which financial year will first have to comply with IFRS?

A The regulation applies to consolidated financial statements for accounting periods starting on or after 1 January 2005. Thus for those with 12 month accounting periods covering the calendar year, IFRS will first apply to periods ending on 31 December 2005. This means that companies will first publish IFRS financial information as at 31 March 2005 (if they report quarterly) or as at 30 June 2005 (if they report semi-annually).

Q Will IFRS financial information need to be provided in advance of 2005?

A Many companies are likely to provide additional IFRS financial information in advance of 2005 to manage the expectations of shareholders, market analysts, regulators and other stakeholders. Preparing such data, even for internal use, will be crucial in advance of 2005 if there is to be an orderly transition.

Euronext (Amsterdam, Brussels, Paris) has introduced rules to require companies included in the NextEconomy and NextPrime segments to comply in full with IFRS or provide a reconciliation to IFRS for interim and annual financial information commencing 1 January 2004. Other exchanges may follow suit.

The Commission has also identified that additional requirements may be necessary for those that are seeking a new listing in the period before IFRS becomes mandatory. Detailed proposals have not yet been made and may be left to the individual exchanges. However, it would be impractical to list a company during 2005 on the basis of national accounting standards if the first annual results will be significantly different.

See also page 9, ‘Can IFRS be adopted early?’

Q When will IFRS data need to be collected?

A To comply with IFRS, companies must apply the standards to the earliest comparative year presented in their statutory (audited) financial statements. Most companies will therefore have to obtain IFRS-compliant data going back to 1 January 2004. Those companies that show two years of comparatives will need to collect IFRS data from 1 January 2003.

Q Which companies can defer implementation until 2007?

A This dispensation is restricted to:

- European companies that have issued debt, but not equity, securities on a regulated market of a member state
- European companies that already use other international standards at the date of the regulation for the purpose of a listing outside a regulated market in the EU. For example, those that already use US GAAP for their primary financial statements.

Neither of these can be used unless the appropriate options are adopted by the relevant individual member state. To date no indication has been given of which countries will take up these options.

Q What issues should be considered if there is the option to adopt IFRS for consolidated statements before 2005?

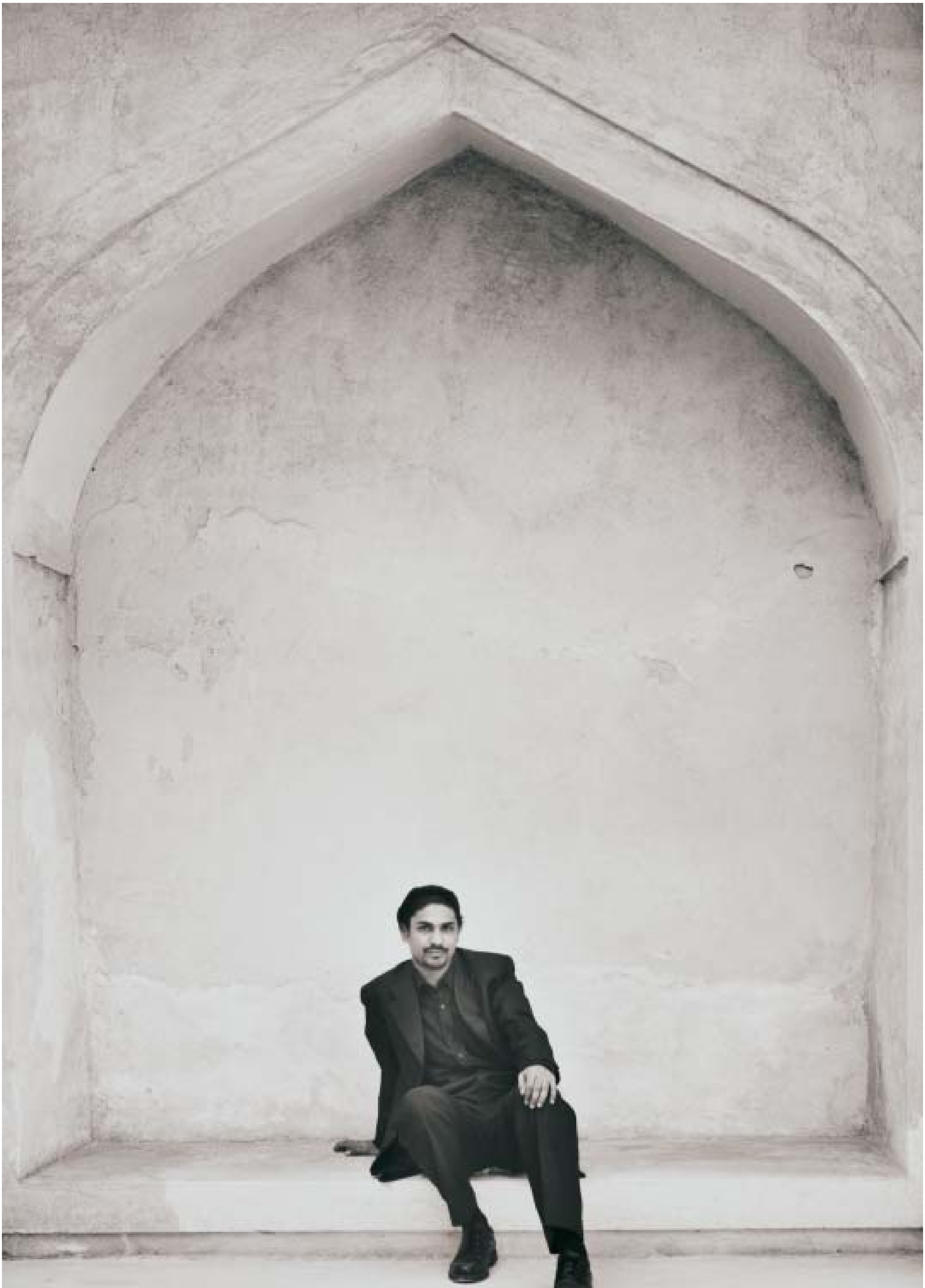
A The option to adopt IFRS for consolidated statements in advance of 2005 depends upon the necessary legislation being in place in the relevant member state. Provided that this is available, a decision on when to first adopt IFRS will depend upon whether:

- Adopting IFRS will reduce the current cost of capital
- There is a significant acquisition, disposal or share issue into a market that has knowledge of IFRS, but not of local GAAP
- The internal cost of adopting IFRS earlier will be less than waiting until 2005
- The IFRS track record will give a clearer view of the underlying economics and the company's expected future value, than national GAAP

See also page 9, 'Should IFRS be adopted early?'

Q Who uses IAS at present?

A IAS is widely used in various parts of the world. Many large listed companies from Switzerland and Germany have already adopted these standards, as have a significant number of the largest companies from Eastern Europe. Elsewhere, IAS are being adopted as national standards or are being used as the basis for national standards in locations such as the Caribbean, Russia (mandatory in 2004), Australia (mandatory in 2005), Malaysia and Singapore. More details on the differences between IAS and individual national standards can be obtained from GAAP 2001, the publication produced by PricewaterhouseCoopers in conjunction with other major firms (available from www.pwcglobal.com/ias).



Which version of IFRS will be applied in 2005?

Q What will be the requirements for first time adoption of IFRS in 2005?

A The International Accounting Standards Board has issued an exposure draft – *First Time Adoption of IFRS* – intended to simplify how companies apply IFRS for the first time and achieve some comparability between these entities. In outline, the existing and proposed options are as follows:

Existing requirement (SIC 8): each IFRS in force in the relevant historical accounting period is applied to each historical transaction depending upon when it originally took place. The transitional provisions in each new or revised standard are then applied to arrive at the opening balance.

Companies are given the option to continue with this approach or use the new alternative below.

Proposed option: each IFRS in force at the date of the closing balance sheet in the first IFRS financial statements will be applied for the whole of the period covered by those financial statements, i.e. including all comparative years. These are applied to restate all transactions and balances. No account is taken of standards that were in force in earlier periods.

The effect of the new option on accounting periods can be illustrated as follows: the date of first application for those that produce audited financial statements containing one year of comparatives with a 31 December 2005 year end will be 1 January 2004. Thus the same standards will be applied throughout 2004 and 2005. Some companies, such as US registrants, who provide two years of comparative data will need to start collecting IFRS information from 1 January 2003.

The proposed option is intended to relieve the extensive burden that can arise from restating old business combination transactions and recovering old records of the historical costs of fixed assets in particular.

Companies must now make the critical decision whether to take advantage of the exemptions proposed (in their entirety) or stick to SIC 8 and go for comparability with existing preparers. After that, planning for the preparation of the opening IFRS balance sheet will be a priority issue.

The new standard is expected to be published in 2003 (first half).

Q How does a summary table affect the date of adoption?

A Many companies provide a summary table of three or five years of history within their annual report. However, this historical information generally does not form part of the audited financial statements. The proposed standard does not require the restatement of earlier periods presented in the track record, but companies may wish to do so on a voluntary basis.

This is separate from the comparative data in the audited financial statements, which will dictate how many years of data will have to be restated under IFRS (see preceding question).

Should IFRS be adopted early if possible?

Q Can IFRS be adopted early?

A The PricewaterhouseCoopers survey, *2005 – Ready or not*, showed that CFOs strongly support having the ability to adopt IFRS early. However, the ability to use IFRS instead of national standards for their consolidated financial statements is regulated by national legislation. Companies are not prohibited from producing supplementary IFRS financial statements, but this is costly and may lead to confusion when two sets of data are presented to the market.

See also page 5, 'Will IFRS financial information need to be provided in advance of 2005?'

Q Should IFRS be adopted early?

A IFRS should be adopted early if this will reduce the cost of capital, or enable a transaction that is being contemplated, or improve the ability to resist a hostile takeover.

A company that produces accounts using a national GAAP that is significantly different to IFRS or US GAAP is likely to enjoy a positive re-rating by the market and rating agencies if it adopts IFRS. This is because of the increased confidence in the information provided which comes from greater transparency of reporting and an increased understanding of IFRS and US GAAP by analysts.
A re-rating will be particularly beneficial if a share-based transaction is being contemplated such as a proposed acquisition, or when trying to resist an offer from an acquirer.

If such opportunities or threats are not present, early adoption of IFRS may be beneficial to smooth the transition to IFRS which is becoming increasingly complex. However, some of the proposed changes to IFRS could encourage a short delay. In particular, the proposal to reduce the burden of revisiting old transactions on first time adoption of IFRS and some improvements to IFRS 39 (final standards expected in the first half 2003) may make transition less of a challenge in the future.

See also page 6, 'What issues should be considered..?'

81% of CFOs want the freedom to adopt IFRS before 2005

PwC IFRS survey result

'Start! Transition is going to take time'

PwC IFRS survey respondent

How big is the difference between IFRS and national GAAP?

Q How different will existing IFRS be by 31 December 2005?

A The new IASB has set out a very demanding agenda for the next few years. Its plan is to make significant improvements to the existing standards and to introduce new standards in time for widespread application throughout Europe. Thus we can expect significant differences, and in some areas these will be fundamental.

Accounting topics that are expected to be the subject of new standards include: business combinations, insurance contracts and share-based payments (including employee share options). There will be changes of detail in many other areas such as: associates, joint ventures, financial instruments, extraordinary items, and changes in accounting policy.

Q How different will these standards be to national GAAP by 31 December 2005?

A It depends on how different national GAAP is today to IFRS and how much progress is achieved by national standard setters in the interval. However, time is tight and unless the national standard setter has an active agenda it is likely that the impact of the differences will increase significantly rather than decrease over the next few years.

IFRS has been developed for communicating with the world's capital markets, while around Europe many national standards were developed to support tax and other regulatory purposes. As a result the underlying principles can be very different, with IFRS focused on transparency through disclosures and through the increasing use of fair value measurement for assets and liabilities. This contrasts starkly with some national standards that require only limited disclosures and measurement that is often dictated by historical costs and prudence.

The survey, *GAAP 2001*, benchmarked national GAAP against IFRS. It showed that there were major differences in the GAAP of many European countries in the areas of: business combinations, financial instruments (including derecognition and embedded and other derivatives, in particular), special purpose entities, pensions, provisions and impairment, to name a few.

A reduction of these differences can be achieved by national standard setters adopting the full text of IFRS as their own. Some countries such as Denmark are well advanced in this process, while others, such as the UK, have some standards that are already identical and have proposed to adopt some revised IFRS as they are issued. However, in some European countries there has been little or no progress towards conforming national GAAP with IFRS.

Generalisation is always dangerous. However, the most significant effects of adoption of IFRS in some countries will be: financial instruments, making provision for pensions and certain other employee benefits and the effect of more stringent impairment tests using market discount rates that will reduce the value of some assets. PricewaterhouseCoopers has issued a series of publications that identify the major differences, see *Similarities and Differences* at www.pwcglobal.com/ifrs

For many, IFRS will have a more significant impact on the amount of information that companies disclose as IFRS tend to have many more disclosure requirements than national standards.

Q What will be the effect of adopting IFRS on reported net income?

A The effect of adoption will depend upon the difference in the relevant accounting policies between IFRS and national GAAP. However, a common effect in practice in some countries is to charge expenses earlier and to defer the recognition of revenue, while in others it is to release provisions and require longer depreciation periods. The effect of the requirement to use more fair values, particularly in relation to derivatives and some other financial instruments will, for many, lead to a significant increase in the volatility of items in the income statement. Other areas identified as creating differences include larger provisions for deferred tax and pensions.

Each company has individual circumstances that need to be analysed in full to determine the effect (see *Making the Change to IFRS* at www.pwcglobal.com/ifrs).

Q How can the potential changes to IFRS be influenced?

A Becoming involved in the consultation process can influence the development of new standards as well as changes to existing standards.

The IASB publishes all of its proposals for comment in the form of discussion papers and exposure drafts in advance of them being introduced as new standards. Comment letters received are always analysed in detail and taken into account in finalising proposals.

The IASB consults extensively during the development of new standards and on the amendment of existing standards. Formal discussions are held with national standard setters and with members of the Standards Advisory Council (SAC) to the IASB. Thus companies and others involved in the preparation and use of financial statements should be active in meeting their own national standard setter and members of the SAC. IASB members also make themselves available should individuals wish to meet them to discuss issues.

The European regulation provides that IFRS must be endorsed for use in Europe before they can be implemented in European Law. The IFRS 2005 regulation establishes a new committee, the Accounting Regulatory Committee (ARC), with representation from each member state. The Fédération des Experts Comptables Européens and a number of other European trade associations, such as UNICE, have also formed a technical advisory group to provide input to the endorsement of IFRS by the ARC. Known as the European Financial Reporting Advisory Group (EFRAG), it comprises a supervisory board and a technical expert group. The technical expert group will be seeking views from companies, analysts and other users, and from regulators, as it considers the issues that will face Europe when new proposals are being discussed. It has recommended that the ARC initially adopts all of the existing IFRS standards, interpretation and guidance.

These mechanisms all provide for views to be given and heard. However, to be effective, comments need to be timely (if possible during the development of proposals) and to be founded on a consistent set of conceptual principles. To achieve this requires monitoring proposals as they are being developed and the preparation of detailed comment letters to send to national standard setters, EFRAG and the IASB. Those that do not participate in this way will not be heard.

Q Will IFRS be different in Europe from elsewhere in the world?

A The endorsement mechanism has the power to reject an IFRS for use in Europe. This could lead to the creation of European standards. Financial statements prepared to comply with a European version of IFRS would not be IFRS compliant and would have to be called something different or receive qualified audit opinions. But the European Commission has stated that it has no intention of seeking to change to IFRS.

A majority of Europe's chief financial officers do not want the endorsement mechanism to create 'European IFRS', according to the PricewaterhouseCoopers survey *2005 - Ready or not* (copies can be downloaded from www.pwcglobal.com/ifrs). A European version of IFRS would work against the goal of comparable financial information across the globe. As EFRAG plays an increasingly pro-active role in the development of IFRS, it should ensure that there are no grounds for rejecting IFRS once they have been finalised by the IASB.

57% of CFOs favour a pan-european or global enforcement mechanism over national enforcement alternatives

PwC IFRS survey result

71% of those using IFRS are very positive about the benefits of IFRS transition for their company

PwC IFRS survey result

What is the impact of IFRS on US registrants?

Q Will European companies still have to produce a US GAAP reconciliation as US registrants?

A The US SEC consulted a few years ago on what change it should make to its registration requirements in relation to IFRS. No indication has been given of any proposed relief from the reconciliation and with the recent arrival of a new chairman and chief accountant it is likely to be some time before any specific policy proposals will appear. However, recent speeches from the chairman are more hopeful and it is expected that the issue will be reviewed again in 2005. It is expected that the reconciliation requirement will be removed as soon as possible, but this will depend upon progress made on the further development of accounting standards and the development of an effective enforcement system in Europe, and elsewhere.

Q How different is IFRS to US GAAP?

A The PricewaterhouseCoopers *Similarities and Differences* publication (see www.pwcglobal.com/ifrs) identifies that there are significant differences between IFRS and US GAAP at present. This is particularly in the areas of: impairment, discounting of provisions, and some business combination issues such as the recognition of in-process research and development and other intangibles. The IASB and the FASB have both set out to reduce these differences where possible, consistent with improving the quality of financial statements. Thus the differences will become less significant over the next few years.

Q What will be the date of adoption for a company that produces full US GAAP consolidated financial statements?

A It depends whether a member state uses the option to defer certain companies until 2007. For a company that uses US GAAP as its primary statements and provides two years of comparatives, the date of adoption would be 1 January 2005 for a 31 December 2007 year end, if the 2007 option is available to it. Otherwise it will be 1 January 2003 for a 31 December 2005 year-end.

Financial instruments and deferred tax are expected to be the biggest change for companies adopting IFRS in the EU

PwC IFRS survey result

How does IFRS affect relationships with the markets?

Q How aware are market analysts and others of the change to IFRS and the effect that it could have?

A At present there are only a limited number of companies that report using IFRS. Thus the level of awareness of the detailed IFRS accounting requirements is somewhat restricted. However, many analysts have a working knowledge of US GAAP or UK GAAP and most are familiar with accounting principles that are designed for communicating with the capital markets, so the effects should not be too much of a surprise.

Q To what extent will IFRS implementation change relationships with investors and financial analysts?

A Companies will need to minimise the effects where possible. This can be achieved by early communication of conversion plans together with providing an impact assessment well in advance of 2005. The increase in volatility and changes to the recognition of income and expenses has no effect on cash flows and key non-financial metrics. PricewaterhouseCoopers has promoted the benefits of increased transparency of such metrics and information on our Valuereporting strategy can be found at www.pwcglobal.com/valuereporting.

In general, the greater comparability of financial information under IFRS is likely to lead to more probing questions from analysts and other investors, because the differences between companies will be more obvious. Management will need to make sure that they have well-considered explanations for significant variations between their information and their industry peers if they want to maintain good relationships with investors and financial analysts.

Management may be punished or rewarded more quickly for its decisions when reporting under IFRS because in many cases stakeholders will be able to analyse their effectiveness more quickly than before.

For example, under IFRS investors and analysts will tend to have more information on segment performance, so under-performing segments will not be hidden by the good results of other sectors. This will put pressure on management to allocate resources to the most profitable segments or improve the less profitable ones quickly.

This improved transparency should provide key benefits. It should reduce the cost of raising capital for companies because it will improve investor confidence in their reported information, thereby reducing the risk premium. It will help companies to access virtually all capital markets worldwide (apart from the US where reconciliations will still be required in the short-term) without going to the trouble and expense of producing separate sets of financial data.

Q Will the share price of individual companies be affected by IFRS?

A Hopefully, share prices should improve. A company’s value is in the market estimate of the future cash flows that it is capable of generating and so should not depend on the accounting principles on which its financial statements are prepared. Changes in the measurement and reporting basis should have no impact. However, if IFRS leads to more detailed and transparent reporting, it should result in analysts having more confidence in their ability to predict the company’s future performance and cash flows.

IFRS products and services

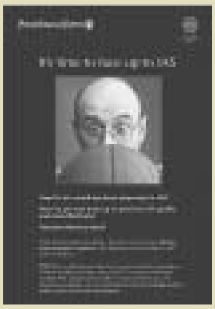
PricewaterhouseCoopers has a range of tools to help companies make the change to IFRS and apply the standards in practice. These include:

TransitionIFRS

TransitionIFRS is PricewaterhouseCoopers' proven methodology for conversion to IFRS that addresses all issues a company needs to consider in making the change to IFRS. It is suitable for any size of company, in every country and industry.

Designed to guide you through the operational, process, organisational and reporting issues associated with transition, the service brings you the expertise of our technical, training and communication specialists as well as our project management resources.

For further information please contact your usual PricewaterhouseCoopers representative or your local office.



P2P IAS *– from principle to practice*

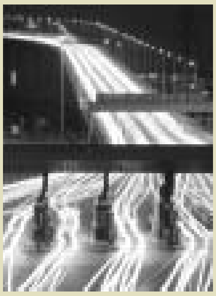
P2P IAS is a self-directed, electronic learning tool that helps to get you and your team up to speed on IFRS quickly and cost-effectively. It provides a solid grounding in all key areas of IFRS in a practical business context. This unique solution, which is co-branded with the IASB, provides 21 hours of learning in 34 interactive modules, so that you can build up your knowledge quickly, easily, and at your own convenience. P2P IAS can be used on its own as an introduction to IFRS or as part of an integrated programme with our specialist workshops.

For further information, prices or demonstrations, please contact Nabarun Hazarika on +44 (0) 20 7804 1970 or email: nabarun.k.hazarika@uk.pwcglobal.com.

IFRS website

PricewaterhouseCoopers' Corporate Reporting website is dedicated to helping businesses improve the quality of their financial reporting. It provides the latest news, discussion and reference material on IFRS, international audit and corporate governance. A range of publications, newsletters and surveys are available for free download.

Visit www.pwcglobal.com/ifrs to discover what's out there for you.



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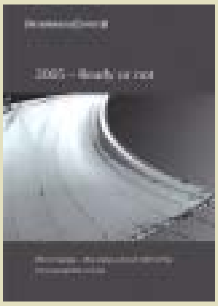
Comperio IAS is a comprehensive online library of financial reporting and assurance literature, designed specifically for companies already using IFRS and for those planning to make the change.

It provides a fast and effective solution to finding answers by simply browsing a standard, pronouncement or topic, or by searching the entire database for key words, topics or terms.

To order Comperio IAS, please visit the website www.pwcglobal.com/ifrs



IFRS survey: *2005 – ready or not*

The findings of this comprehensive PricewaterhouseCoopers survey of over 650 CFOs across the 15 EU member states carries a clear message: start preparing now for IFRS – or put your business at risk. The results speak for themselves:

- 85% of Europe's listed companies have yet to convert to IFRS
- More than 60% of companies have yet to start transition planning
- Only 3% of UK companies (19% across the EU) believe they are fully prepared
- 43% of companies (64% of financial services companies) that have converted found the process took longer than expected
- Training staff is one of the main obstacles to IFRS conversion

Electronic copies of the full survey, including PwC comment, are available free from www.pwcglobal.com/ifrs. For hard copies and further information please email Sarah Grey (sarah.grey@uk.pwcglobal.com)

Your worlds Our people