



IFRS and Transparency

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A brief overview of the institutional setting:

The 1934 securities act created

The Securities and Exchange Commission
(SEC)

- The SEC delegated the establishment of accounting standards to the private sector.
- The early efforts have evolved to give that task to the Financial Accounting Standards Board (FASB).

The FASB became responsible for Generally Accepted Accounting Principles (GAAP)



Accounting standard setting around the world was dominated by various domestic systems

- The SEC required foreign registrants to reconcile their filings to US GAAP.

- There are securities commissions in many countries
- Although none has the same power and influence as the SEC in the USA.
- Formation of *IOSCO*

(International Organization of Securities Commissions)

- Accountancy organizations plus IOSCO endorsed the creation of a committee to set accounting standards for the world.
- The organization started in 1973 and evolved to become the IASB

(International Accounting Board)

• IASB  IFRS

(International Financial Reporting Standards).

- In 1995, IOSCO proposed to the European Union Commission using IFRS for all EU nations.
- In 2001, the EUC issued a Directive to use accounting standards that are IFRS – with some adjustments

- Up to that time in 2001, the strong accounting standards were those of

(A) the UK

& (B) the USA

- As an EU nation, the UK adopted IFRS in 2005 according to the Directive.



In the meantime, the NYSE kept losing funds to London and the American competitiveness was questioned.

The pressure intensified on the US to adopt IFRS.

& the US Treasury, the SEC and the FASB began to reconsider their positions regarding IFRS.

- However, the SEC moved slowly.

First, it allowed foreign registrants to file with the SEC without reconciliation from IFRS to the US GAAP.

Second, it charted a plan (Roadmap) to gradually converge, then convert from GAAP to IFRS.

- In the transition period, 2007, foreign registered companies had to report comparative financial statements for 2006 under both, the **IFRS** and **US GAAP**.
- **Question: How different are the resulting numbers?**

IFRS Income much higher than GAAP

	IFRS	GAAP	% Diff.
OCE NV	72.9	7.9	826.4
Bayer AG	1695.0	269.0	530.1
Rhodia	66.0	15.0	340.0
Fiat SPA	1519.0	719.0	111.3
Abbey National PLC	313.0	173.0	80.9
Telecom Italia	3003.0	1862.0	61.3
Reed Elsevier PLC	625.0	399.0	56.6
Lloyds TSB Group	2803.0	1815.0	54.4
Lihir Gold	53.8	36.3	48.4
Credicorp	247.3	175.0	41.3
Astrazeneca	6043.0	4392.0	37.6

IFRS Income much lower than GAAP

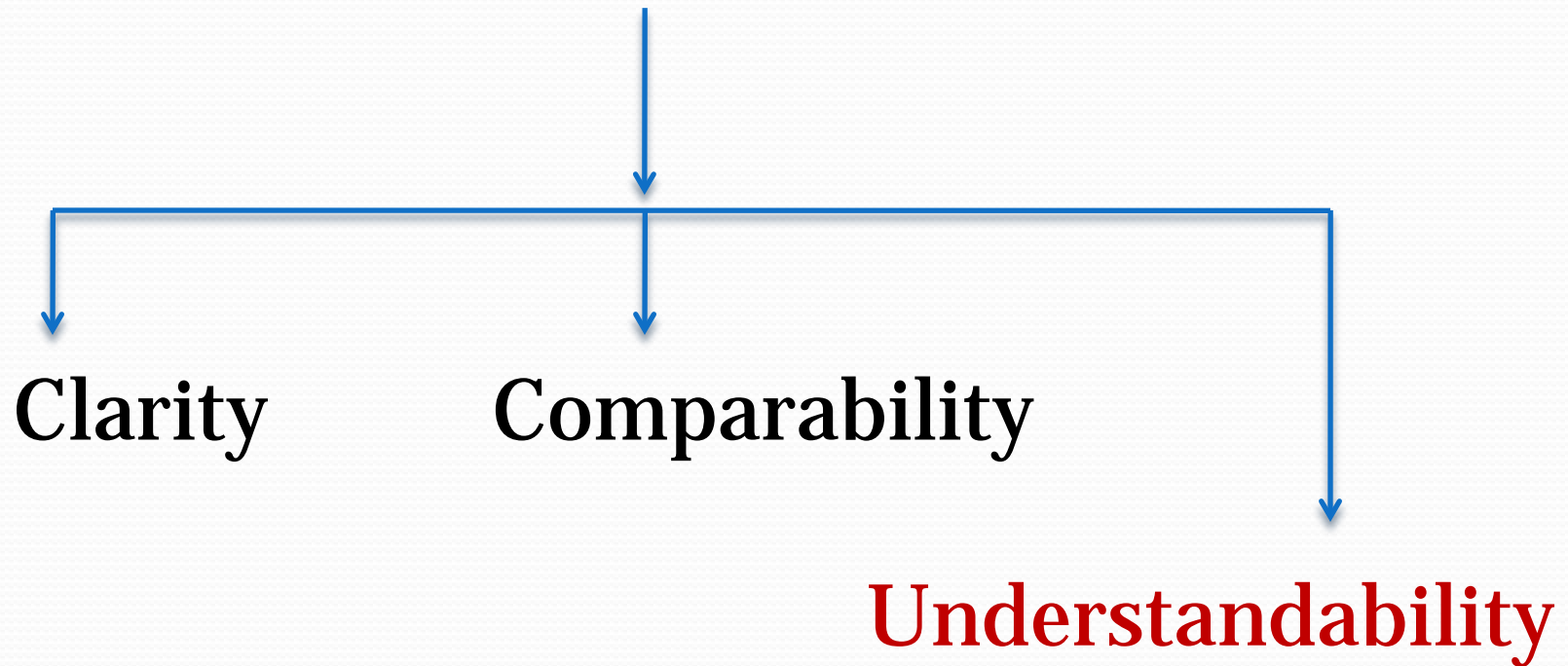
	IFRS	GAAP	% Diff.
Intercontinental Hotels	405.0	486.0	-16.7
Turkcell Iletisim	4007.0	4907.0	-18.3
UPM Kymmene Corp	168.9	230.7	-26.8
Crucell NV	126.0	216.0	-41.7
China Southern Airlines	(176.0)	(590.0)	-70.2
Alcatel Lucent	(3.4)	(20.3)	-83.5
Protherics PLC	(4.0)	(116.0)	-96.6
Sappi Ltd	55.0	(199.0)	-127.6
Thomson	3.3	(1.9)	-268.3

- Why then replace GAAP with IFRS?
- The reasons cited most often are:
 1. Relevance
 2. Transparency &
 3. IFRS is based more on principles.

What is transparency?

- For **abstract** as compared to **tangible** objects

Transparency



How different is transparency across nations?



S & P Transparency Index

(In 2002 based on 1500 companies)

United Kingdom	81
Continental Europe	69
USA <i>Annual Report</i>	66
<i>All financial filings</i>	77
Japan	76
Asia/Pacific	60
Latin America	58
Emerging Asia	54



The critical question:

Will converting to IFRS enhance transparency?

This question may be viewed in terms of specific issues.



- Question 1.

Will IFRS reduce accounting by
“management intent?”

Answer: Not likely

Examples

Accounting for marketable securities

- Held to maturity – Cost
- Available for sale – FV → OCI
- Trading – FV → Income P&L



The choice of classification is
based on **management intent!**

But, does it really matter?

- Yes,

Ask Fannie Mae

Classified at the end of the month
of acquisition to opportunistically
manage income

- Page 111 in the OFHEO report on Fannie Mae



- Question 2

Will IFRS enhance comparability?

Answer: Not likely

Why?

Giving management choice of

1. Using fair value option for financial assets and liabilities.
2. Choice of reappraisal or cost basis for property, plant and equipment.

- Giving management choice of
 1. Using **fair value option for financial assets** and liabilities.
 2. One time choice of reappraisal or cost basis for property, plant and equipment.



Question 3:

Will IFRS reduce management manipulation?

Answer:

To the contrary,

it might even increase it.



Why?

- Two reasons (at least):
- Management must use the “substance” of the transaction to decide on the accounting measurement.
- Much more judgment and discretion is allowed.

Question 5:

Will all countries apply IFRS on equal footing?

Answer: No.

It is naïve

- (a) To think of foreign governments in the same light as that of the US.
- (b) To believe that self serving activities will be neutralized.
- (c) To expect cultural and legal differences to be washed away.

Question 6

How about the debate on
“principles” vs. “rules?”

Answer:

The differences are overplayed.

First: No one can point out the domain of differences.

- Second:

GAAP has

1. Evolved over many decades;
2. Always began with principles;
3. Codified into rules due to practices, pressures from users; accounting and litigation.

Best examples:

(a) *Accounting for leases by lessees.*

Early GAAP standards used control and transfer of risk as criteria for considering a lease a “purchase in substance.”



Eventually, the FASB was pressured to have bright lines 75%, 90%, etc.

Surprisingly IFS is not much different.

(b) Accounting for Derivatives

The FASB grouped derivatives into four categories.

1. Speculative – undesignated
2. Fair value hedge
3. Cash flow hedge
4. Hedging net foreign investment

- IASB used the US standard to base their own accounting IAS 39.
- Differences are not in the concepts or in the principles.
- Instead differences are in having a **different set of rules!**



➤ Why does it matter?

➤ Once again, we look Fannie Mae and Freddie Mac

➤ By switching hedge classifications, Fannie Mae manipulated the recognition of **\$10.4 Billion** over a five-year span!

Question 7:

Will IFRS help users to disaggregate the **realizable** and **unrealizable** components of income?

Answer: No


- There is nothing in IFRS to cover this issue or compensate users for the lack of details.

Question 8:

- Will IFRS provide information to avoid the likes of Enron, WorldCom and Tyco?

- *Answer: No*

- No accounting system will change management greed or fraud.

- 
- The question once again,
 - Will IFRS enhance transparency in financial reporting?


- Based on the issues raised by these questions,

I DO NOT SEE HOW!

I see it as changing one set of rules for another set of rule.



However, some people point to the
OPACITY IINDEX to suggest
improvement in transparency over
the past few years

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- **Transparency is often studied in terms of opacity of financial statements.**
 - **That is, the degree to which financial statements are opaque or vague.**

PwC Opacity Index

- In early 2000 Pricewaterhouse Coopers developed (to my knowledge) an index to measure opacity (anti transparency) across many countries as the average of five variables, each was rated on a 100 points scale

These variables are:

1. Corrupt practices.
2. Legal environment.
3. Ambiguity of economic policy.
4. Accounting reporting and corporate governance.
5. Regulatory opacity.

- The *Milkin Institute* has subsequently continued the measurement and disclosure of the index.
- Let us have some comparison

Country	Opacity in 2000	Opacity in 2005/6	Opacity in 2007/8
Greece	57	40	32
Italy	48	44	38
Hong Kong	45	19	12
Singapore	29	28	14
South Africa	60	32	26
UK	38	14	17
USA	36	21	23

- Of relevance, however, are the indexes of Accounting and Reporting.
- In the Milkin Institute's report, each of Finland, Hong Kong, Australia, Sweden, Ireland, France and South Africa has a score of "1" for least opacity (highest transparency), while the USA has a score of 20 (relatively more opaque).

- Even my own native country, Egypt, has a score of “4”, much better than that of the USA.
- At first glance, one might doubt the reliability of the instrument used in the measurement.

- There is a reason to believe in the reliability of the measures, however.
- It is simple. Many of these countries do not have much of hedge accounting, derivatives, securitization or postretirement benefits. The information environment is much simpler than that of the USA.



- It is indeed the complexity and volume of financial innovations create a much more complex environment for accounting identification, measurement and reporting. I believe that the USA rates high, perhaps the top, in the complexity indicator and opacity follows complexity.

- In conclusion, transparency must be viewed in terms of the objectives leading to the establishment of the SEC, namely
 1. to reduce information asymmetry between managers and investors.
 2. to allow small investors equal access to information as those who could buy it.

- GAAP does both well

&

- It is not clear what IFRS buy us



Thank you for listening!