

Investor perspectives on IFRS implementation



*Fédération
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Contents

Foreword by Alain Leclair and Gérard de La Martinière	p.3
Introduction by Nicolas Véron	p.5
▪ Bertrand Allard and Jacques de Greling , co-Chairs of the Accounting and Financial Analysis Committee (Jacques Mériaux's Committee), <i>Société Française des Analystes Financiers</i> (French Financial Research Association)	p.11
▪ Philippe Chaumel , Director of Unit Trust Asset Management, and Natacha Rousset , Rothschild Gestion	p.15
▪ Philippe Danjou , Chief Accountant, and Sophie Baranger , Deputy Chief Accountant, <i>Autorité des Marchés Financiers</i> (the French financial markets regulatory authority)	p.19
▪ Richard Deville , consulting actuary specialising in employee benefits	p.23
▪ Catherine Guttmann , Partner, Deloitte	p.25
▪ Michèle Jardin , Head of the STARS division (Strategy, Trading, financial Analysis, Research & Systems), and Stéphane Taillepied , Equity Research Director, Crédit Agricole Asset Management	p.29
▪ Denis Kessler , Chief Executive Officer of SCOR	p.33
▪ Yann Le Pallec , Head of European Insurance, Standard & Poor's	p.37
▪ Xavier Paper , Founding Partner, Paper Audit & Conseil	p.41
▪ Marie-Pierre Peillon , Head of Equity & Credit Research, Groupama Asset Management	p.45
▪ Julien Vannier , Buy-Side Analyst, Société Générale Asset Management	p.47
▪ Pierre Vaquier , Managing Director, and Laurent Liot , Director of Finance and Administration, AXA Real Estate Investment Managers France	p.51
▪ Thibaud de Vitry , Director of Investment Affairs responsible for liaison with AXA insurance entities, AXA Investment Managers	p.53
▪ Adam Ward , Senior Research Analyst, AXA Rosenberg	p.57
Glossary of Acronyms	p.59

Foreword

By Alain Leclair, Chairman, Association Française de la Gestion financière / French Asset Management Association (AFG)

and Gérard de La Martinière, Chairman, Fédération Française des Sociétés d'Assurances / French Insurers' Association (FFSA)

The debate over accounting standards is no abstract polemic. It has as its focus one of the chief tools at the disposal of actors in the economy for their day to day analysis of business performance and for defining their investment options.

The members of our two associations represent the preponderant part of French investment in listed securities and we naturally wish, for that reason, to contribute to the debate. Accounting standards, and more particularly International Financial Reporting Standards or IFRS, are intended first and foremost to serve the needs of investors – such at least is the objective proclaimed by their conceptual framework. But is this the case in practice?

We believe that the best means of responding to this question is to ask for the views of investors in the field. Their reactions comprise the major part of the present study which is complementary to the survey of opinion that was jointly published by our two associations in December 2004. We express our thanks to Nicola Véron for having agreed to coordinate the work involved, in close collaboration with Carlos Pardo of the AFG and Philippe Trainar, followed by Bertrand Labilloy, of the FFSA.

There is great diversity in the points of view expressed but the investing community clearly discloses a form of consensus in respect of certain key issues. On the one hand the transition to IFRS is perceived as an definite source of progress, compared to the previous situation, and one that has been professionally managed by the French business community. But these positive aspects should not mask the sources of dissatisfaction and disquiet. The standard-setting process continues to be regularly criticised in particular for its failure to pay due attention to the point of view of investors. IFRS implementation remains lacking in consistency and the anticipated comparability of financial statements has not yet materialised. Several contributors have suggested that direct public intervention on the part of the European Union will be required if use of the standards is to become more effective and more robust.

The interviews comprising this collection were performed before the credit crisis which broke out during the summer of 2007. IFRS no doubt contributed to avoiding a still graver crisis, thanks in particular to the inclusion in the balance sheet of information relating to certain commitments, such as those associated with derivative financial instruments, which were previously treated as of a purely contingent nature. But by emphasising market values they ignore the phenomenon of long economic cycles such as, in particular, those engendered by investment in infrastructure and by pension financing requirements. They also cope badly with market illiquidity. The recent developments have underlined how important to the proper functioning of the economy the provision of financial information has become. They also raise issues of identification of risks, and of transparency, to which accounting standards should be able to provide a certain response for the benefit of the investing community. Our two organisations have the intention of participating actively in the future debate from this perspective.

The ongoing debate is clearly in essence an international one and this is why we have chosen to publish the present study simultaneously in French and in English. We hope you will enjoy reading it.

Introduction

Nicolas Véron, Research Fellow at Bruegel and Principal, ECIF

Users of financial statements – first and foremost investors, but equally analysts, credit rating agencies as well as the whole range of consultants and advisors who assist investors in optimising their choices – are logically the first rank of “clients” of the accounting standard-setting process. Indeed, the IASB’s conceptual framework states explicitly that the information needs of investors should be at the forefront of the standard-setter’s preoccupations. Yet financial statement users are often conspicuously absent from the debate over accounting issues albeit that debate has become significantly more vigorous since the European Union’s decision, in 2002, to adopt IFRS as the framework for the publication of the consolidated financial statements of quoted companies.

The current period is particularly propitious for taking stock. After two years of European implementation, the first lessons from experience of the new standards are emerging. At the same time, numerous decisions remain to be taken before implementation will have been stabilised and it would be a mistake to imagine that the market has already reached cruising speed as far as IFRS application is concerned.

From this point of view, the present selection of interviews is intended to complement other sources of research into the first-time adoption of IFRS, which has often taken the form of surveys, such as those performed by the big auditing firms, or of European-wide analyses of the published financial statements of quoted entities, for example the review performed by the Institute of Chartered Accountants in England and Wales (ICAEW) on behalf of the European Commission and published in October 2007.

The method employed by this collection – free-ranging interviews with market participants – whilst lacking in quantitative elements provides a focus on qualitative aspects of first-time adoption, as experienced by the community of users of financial statements, as well as on their spontaneous preoccupations. The method thus provides a contribution to the public debate by highlighting the issues that users perceive as priorities, revealing matters of both convergence and divergence with the points of view of the other communities of players in the market and in particular, of quoted companies (“preparers of financial statements” to use the jargon of the profession), often much more negative than users in their assessment to date; auditors, sometimes reluctant to depart from a purely technical viewpoint given the sensitive nature of their role; and regulatory and standard-setting bodies whose perspective is generally limited to that of a single national territory. The users questioned for the purposes of this review in no sense comprise a scientifically prepared “representative sample”, but their points of view underline the diversity of the perspectives that together make up the investment community and put the spotlight on a certain number of questions that have not yet always been adequately debated. The views of a limited number of preparers of financial statements, auditors, and public authorities have also been sought in order to complete the field of observation.

This introduction can be no substitute for a detailed perusal of the interviews which follow it, the content of which is often dense and provides numerous assessments which can hardly be summarised in a few paragraphs. Certain broad tendencies, both of consensus and of contestation, may nevertheless be distinguished.

1. The primary assessment is that of the **quality of the standards** and in this respect, the interviews conducted provide several conclusions:

- The introduction of IFRS has provided increased **transparency** in several areas: derivative instruments, off-balance sheet items more generally, securitisation, pension obligations, stock options, segment reporting. In all these respects, the richness of the information provided under IFRS is generally very positively appreciated, even if certain users deplore the sometimes cumbersome nature of the resulting financial statement developments.
- The **relevance** of the information provided is, on the other hand, disputed and also gives rise to conflicting perceptions (cf. Danjou and Baranger). Many users remain attached to the analysis of operating flows, an approach that is not necessarily facilitated under IFRS in comparison with the standards previously applicable. The financial instrument categories defined by IAS 39 are criticised for their rigidity (Chaumel and Rousset, Vannier, de Vitry). Several interviewees remain sceptical as to the prescribed bases for testing goodwill for impairment. The rules applying to capitalisation of research and development expenditure are also criticised. Several observers feel that the IASB's approach is too often one of abstract formalism far removed from economic reality (Vannier). Others express misgivings in respect of the temptation of certain entities to focus their communication on pro forma data, not subject to the requirements of IFRS, as a means of countering the perceived deficiencies in terms of relevance of the IFRS framework (Chaumel and Rousset, Vannier).
- The **reliability** of IFRS financial statements is more or less unanimously recognised as superior to that of the prior configuration and the potential for "earnings management", particularly in the area of financial services, has been considerably reduced (Danjou and Baranger, Le Pallec). On the other hand, users remain extremely prudent on the subject of impairment testing of goodwill which is considered to be very dependent on market conditions.
- The **understandability** of financial data is sometimes considered to have suffered since the adoption of IFRS. Certain users consider that this is the necessary corollary of transparency, but others feel that the standards have been made unnecessarily complex. Insurance companies are perceived as a special case in the absence of a final standard governing their liabilities (Kessler, Le Pallec).
- Finally, certain recent standards raise specific misgivings which may often be attributed to the process of convergence with US GAAP. This is particularly the case of IFRS 8 dealing with operating segments (Guttmann, Peillon).

2. The second major category of conclusions relates to IFRS **implementation** during the first two years following adoption.

- The **preparation of the transition** by major French and foreign issuers is generally recognised to have been of high quality (Allard and de Greling, Peillon). The complexity of the exercise was properly anticipated and significant resources were committed both internally, to preparing the new financial statements, and externally in terms of alerting and "educating" the market to the impacts of the new rules, even though certain observers remain of the opinion that the transitional information provided has been insufficient.
- The **quality of audit** generally gives rise to a prudent assessment as the users interviewed do not always feel qualified to express an informed opinion. However most believe that

the audit mechanism alone is not sufficient to ensure coherent application of IFRS and that financial reporting of quality also implies the active participation of users and regulators. Certain observers (Delville, Vannier) go so far as to underscore the challenge faced by the audit networks in training and adapting their staff skills in this area.

- The key issue in assessing IFRS implementation remains that of the **comparability** of financial statements, in particular between different European Union countries for a given business segment. The universal adoption of the international standards clearly does improve comparability, but application of the standards remains subject to significant disparities (Jardin and Taillepied, Kessler, Vannier) which are sometimes described as “local flavour” (Allard and de Greling) and even as “nostalgic accounting” (Ward). All the observers recognise that comparability was not achievable as early as first-time adoption (given in particular the facilitating options provided for by IFRS 1), but there are diverging views as to the capacity of the existing mechanisms – pressure from the market, auditors and regulators as well as peer benchmarking by issuers of financial statements – gradually to eliminate the differences observed so as to achieve satisfactory comparability ultimately. Certain observers (Allard and de Greling, Jardin and Taillepied) are prepared to wager that the market will succeed in spontaneously eliminating the current inconsistencies, whilst others (Danjou and Baranger, Peillon, Vannier) are not so sure.
- A question that follows on from this is that of the capacity of IFRS to remain principles-based, with as its corollary that of the need to introduce more detailed **implementation guidance**. It is striking to note the convergence of opinion as to the fact that more precise guidance or rules will gradually be required if consistency of application is to be ensured (Allard and de Greling, Ward), a user consensus which appears to contradict the position of other participants in the public debate over IFRS who remain, on the contrary, firm believers in the principles-based approach.

3. **Governance** of the standard-setting process, and control over related matters of implementation, are also commented on.

- The **governance process of the IASB**, and more generally of the overall structure of international standard setting including the IASC Foundation and IFRIC, is often criticised for the scant attention paid to the viewpoints of users of financial statements (Chaumel and Rousset, Le Pallec, Ward).
- The **European dimension** raises a certain number of interrogations. Several observers stress the political responsibility assumed by the European Union in imposing IFRS on its corporate entities, and the resulting political necessity of ensuring a successful outcome for implementation. The interaction with the American authorities, and in particular with the SEC, is generally scored positively if it is mentioned albeit some reservations are also expressed as to the cultural differences which subsist on both sides of the Atlantic (Le Pallec).

4. The global **impact** of the adoption of IFRS is the final issue and no doubt the most important one.

- The **overall cost/benefit effect** is judged severely by certain users (Vaquier and Liot) but more favourably by others (Vannier, Ward). Several interviewees insist on the fact that no definitive assessment will be possible before several years have elapsed and IFRS

implementation has left the transitional phase behind and entered a more permanent regime.

- The **volatility** in accounting balances induced by the adoption of IFRS is not judged to have had any serious harmful consequences (Jardin and Taillepied), but certain observers regret that due weight is not given to the long economic cycles existing in particular in the area of insurance and reinsurance (Kessler, de Vitry). Further, as the market had been well prepared for this issue the anticipated accounting volatility did not translate into stock market volatility – on the contrary, the period of first-time adoption of IFRS was one of greatly reduced volatility when compared with the peak observed in 2001-2.
- The impact of IFRS on companies' **management decisions** is generally considered to have been limited. The users interviewed are rarely convinced by the idea that the new standards encourage entities to have a more short-term approach to their management and certain observers (Paper) even believe that the opposite impact has been the case.
- Finally, many users noted the importance the **economic climate** has had during the adoption phase (Jardin and Taillepied, Paper, Vannier). The favourable market conditions in force since 2003-4 have facilitated the transition to IFRS and the robustness of this framework – which is much more responsive to market changes than the standards it replaces, particularly in France – cannot be properly assessed until a complete market cycle has taken place. Albeit the interviews were all performed prior to the summer of 2007, many interviewees expressed a preoccupation with this dimension which has been fully borne out by the market turbulence of August.

The overall conclusions are in phase with the results of the collection of essays published in 2004 by the AFG and FFSA: adoption of IFRS is good news for investors assuming that consistent practices emerge in terms of implementation – a condition which, two years after first-time adoption, has still not really been met. There is thus a challenge ahead for all market participants, including investors themselves who are perhaps the best placed to reward best practices and sanction bad ones. Auditors and market regulators should also play a key role in fostering convergence in implementation of the new standards and must devote adequate resources to that end if IFRS are to live up to their initial promise.

The following interviews took place at the end of 2006 and during the first half of 2007. The views transcribed are those of the individuals interviewed and do not in any way engage, as such, the institutions employing the interviewees.

Collection of essays

Bertrand Allard and **Jacques de Greling**, co-Chairs of the Accounting and Financial Analysis Committee (Jacques Mériaux's Committee)

Société Française des Analystes Financiers (French Financial Research Association)

Has the community of financial analysts taken IFRS on board?

Collectively we are still at the stage of discovery, like a child who has just been given its first bicycle. We need time to adjust and take a long view. The job of an analyst is to put figures in perspective and for the time being we do not yet have that perspective: the change is still too close.

Do you have any fears as regards financial statement comparability?

We must first of all recognise the great progress that has been achieved in matters such as off-balance sheet items, securitisation, pension obligations, stock options and the initial approach to segment reporting (IAS 14) which is essential for the work of analysts, all of which has provided a leap in quality. In addition, the transition was well prepared. The main financial statement issuers devoted significant resources to the changeover and organised specific presentations for their analysts whenever desirable.

That said, IFRS have been adopted in all countries with a certain "local flavour", a feature which no doubt translates both the weight of previous habits and a general desire to achieve a presentation as close as possible to whatever was previously provided under local standards. In any case, given the considerable flexibility available under IFRS 1 and certain other standards this situation was entirely to be expected. In addition, certain cultural factors, such as the different approaches to presentation of the Latin and Anglo-Saxon countries, continue to play their part.

Has financial reporting been improved?

Certain useful information, for example in respect of revenue, has disappeared. But one may hope that the increasing competition between groups in financial reporting matters will result in an overall improvement in the quality of financial information. In particular, the notes to financial statements are increasingly packed with information much of which is genuinely useful.

The wealth of new information available has perhaps not yet been fully understood and analysts have equally perhaps not yet fully apprehended fair value accounting. The distinction between recurring and non-recurring items also raises questions of interpretation. But many open windows have been closed and in this respect, to have put a lot of (especially financial) items back on the balance sheet, that had otherwise become invisible there, has been a particularly positive move. But progress is still needed in matters of presentation. IAS 1 is not, from this point of view, an entirely adequate response to users' needs and it must be said as well that in certain areas, such as the capitalisation of research and development expenditure, not all financial statement issuers have demonstrated the degree of transparency that is desirable.

What risks have materialised or are liable to materialise in the near future?

Debate began sufficiently early for the market to have understood and absorbed the volatility factor, so the accounting volatility engendered by IFRS has not had any negative consequences. What was important was to avoid surprise and given this was achieved the

change of standards has not had any impact on market volatility. As the IASB Chairman, Sir David Tweedie, has said, profit and loss volatility is the natural consequence of a business's exposure to risks. But we should not, even so, assume for example that the debate over hedge accounting is over.

As for the risk of financial statement distortion, it remains a little early to judge. We analysts are gradually going to learn which items, in this respect, we need to scrutinise most closely and we are going to have to renew our approach to detection.

Goodwill impairment testing is a source of preoccupation. IFRS have opened a Pandora's Box. The conceptual foundation is no improvement on what we had before but certain testing methods are liable to prove impossible to implement. Aside from the risk that enterprises will want to present themselves under the most favourable light, this example also underlines the limits of the IASB's balance sheet approach. Rightly or wrongly, financial statement users continue to prefer giving priority to revenues and costs.

Do you feel that IFRS implementation has been sufficiently coherent?

There were no very precise expectations. There have been real divergences but that is not surprising, even though one may be disappointed at certain developments such as, for example, the discount rates adopted for impairment testing purposes.

We expect the regulators to eliminate at least part of the present inconsistencies. Competition between financial statement issuers can also be expected to encourage them to reinforce their credibility. Particular industries will cooperate in order to develop common practices, as is already happening in the area of IT service providers. Finally, the big audit networks can also be expected to play a role in unifying accounting approaches. Naturally that will not all happen overnight, but there still will not necessarily be any need for any specific mechanism for coordination.

It is still difficult to be certain of anything given the lack of any prior experience of this type. For example, three transactions in the mobile telephone industry gave rise to three different accounting treatments of the goodwill arising and to three different concepts of intangible assets. Intangible assets other than goodwill also give rise to significant differences in accounting treatment since they are sometimes subject to amortisation, sometimes not. It is impossible to guess whether market pressure will suffice to impose harmonisation of practices in this area. The business combinations standard will in any case have to be revised. Intangible assets are a very difficult subject and will continue to raise strong objections.

Whatever happens, convergence will be a very long process and will no doubt only ever be partially achieved. Significant differences will subsist and the authorities will simply have to assume the reasonableness of the choices they will have approved.

But the room for manoeuvre that exists should not be too negatively perceived. It is a useful means of enabling analysts to ask the right questions. For example, when the available accounting options are systematically used to enable the enterprise to maximise equity and minimise debt, there is a useful signal for the analyst to respond to, in the same way as when the amortisation of research and development expenditure is adjusted as a means of improving operating profit.

Is the choice of a principles-based approach sustainable?

Principles are important but there are also concrete problems to be resolved and for that reason there will be more and more rules as time goes by. The American standards were also originally intended to be principles-based but time has decided otherwise. It will be important,

in this respect, to ensure that the authorities do not opt for any disordered proliferation of rules.

The question is above all applicable to the European Union which has, in a sense, chosen a new steed without knowing if it might one day want to hold the reins? If so, the change would be a radical one and would not be without cost. Nor is it certain that the national accounting standard-setters would have the capacity to unite their forces albeit they possess the necessary technical ability to do so.

There is a risk that the markets may not have unlimited patience. There is a gap to be filled and a form of European accounting authority will no doubt be required, the price of which may well be the creation of a certain number of differences in comparison with the non-European countries also applying IFRS.

The option for IFRS in 2000-2002 was a political one. Will Europe have a different approach to ensuring proper implementation of the standards? For the accounting standard-setter to be independent is a good thing in principle, but the question of ultimate political responsibility still needs to be addressed.

What is the role of auditors in ensuring proper implementation of IFRS?

We are perhaps not the best placed to judge. The audit networks clearly have a role to play but they should no doubt not have sole responsibility. It would be a mistake to overestimate their capacity to impose consistent practices of the highest quality. Accounting practices will not be harmonised without some form, however mild, of political intervention. Europe will need at least to play a coordinating role.

Does the economic cycle play a role?

Of course. Impairment tests will need to be scrutinised closely once interest rates start to rise again. We have not yet seen the more painful aspects of the transition to IFRS. Let's not forget that as the applicable accounting practices gain in precision they will also become less favourable for certain issuers of financial statements.

Philippe Chaumel, Director of Unit Trust Asset Management, and **Natacha Rousset Rothschild Gestion**

What has been your experience of the first stages of the transition to IFRS?

Within the financial sector the community of analysts has somewhat mixed feelings. On the one hand, the adoption of IFRS has harmonised the accounting treatment of assets, with a large proportion of assets henceforth measured in the balance sheet at market value, and has contributed overall to ensuring international accounting convergence. On the other hand, adoption has not really improved the comparability of financial statements, given the large scope for interpretation left to issuers, and has also introduced a specific dose of IFRS volatility.

More specifically within the insurance sector, accounting practices have been harmonised to a certain extent and general use is now made of segment reporting, but the insurance companies have for example retained their individual approaches to analysis of the income statement with the result that it is not really possible to make meaningful comparison of profit and loss ratios.

Equally, IAS 39 dealing with the accounting treatment of financial assets provides a choice of classification of assets between various categories (trading, held-to-maturity, available-for-sale), but the constraints imposed on the held-to-maturity category have led certain entities to treat a large part of their assets intended to be held to maturity (bonds) as available-for-sale, thus greatly increasing equity volatility given that changes in the market value of available-for-sale assets are taken directly to equity.

In addition, we remain in a transitional phase in which only assets are measured at fair value. The ensuing dissymmetry between the asset and liability sides of the balance sheet is intended to be partly compensated for by the “shadow accounting” approach which in practice is very difficult to implement. In point of fact, therefore, entities’ reserves always reflect the application of their local accounting standards.

So implementation of the new standards has really resulted in the insurance industry’s tending more and more to explain its performance outside the confines of the IFRS framework, by communicating in respect of operating results not reflecting IFRS adjustments to assets rather than on IFRS profit or loss. The community of analysts has gradually adapted to this new form of financial reporting, albeit there is still some way to go before one will be able to talk in terms of any general consensus.

On the other hand, it is important and also reassuring to note that the change in the accounting definition of insurance revenues does not appear to have had any direct impacts.

Do you nevertheless perceive any positive impacts?

Yes, in particular the convergence of valuation ratios (PER, share price/share of net assets) as a result of the harmonisation achieved in the calculation of profit or loss (via the discontinuance of amortisation of goodwill and of transfers to “hidden” reserves) and of equity (via the measurement of financial assets at fair value). Harmonisation is now underway and will continue as we are still collectively only at the beginning of our learning curve.

Is the situation different within the banking sector?

Comprehension of financial statement is not better assured under IFRS than previously. As for the insurance sector, financial statement interpretation is perturbed by the volatility factor. If we take the example of the treatment of impairment of PEL and CEL savings accounts [*Plan Epargne Logement, Compte Epargne Logement*], 2006 saw a significant increase in revenue growth for the French retail banks simply attributable to reversals of previous impairment losses due to the so-called Fourgous legislation or to the tax treatment of previous generations of PEL accounts.

The treatment of revenue arising from trading operations is another source of confusion, since such revenue is henceforth allocated over several captions of net banking income. In the same way certain hedging derivatives designed to protect interest spreads are now classified as trading instruments, all of which makes it more difficult to interpret financial statements and understand the underlying economic models.

And outside the financial sector?

Opinions are less negative in the other sectors. There have not been too many surprises. Transparency in the description of hedging transactions has been improved, a change which was expected but is no less welcome. There is greater comparability of profit and loss than before, due partly to the new accounting treatment of goodwill. The consensus data we employ for market positioning purposes reflects more coherent definitions than previously. Concepts such as revenue and operating profit now respond to unified definitions, all of which is positive.

We nevertheless expected greater availability of information. Not all enterprises have been as transparent as we would have liked in explaining the impacts of the transition to the new standards. But IFRS are merely part of a longstanding trend towards greater transparency in matters of profitability and economic models, greater homogeneity of financial information and a brake on the potential for obtaining insider information: a trend which has been underway for at least fifteen years and within which IFRS will ultimately have played a fairly moderate role, essentially contributing to greater consensus and adding a little more information.

Above all, no proper appraisal of the new standards will be possible before we have experienced a downward cycle in the markets. Only then will we be able to assess entities' approaches to goodwill impairment, or alternatively when other changes take place in the economic environment, for example if a reform of the Raffarin law were to have a negative impact on the value of retail distributors' goodwill. So far, the occasional goodwill impairment losses that we have observed have been largely painless.

Has the accounting volatility engendered by IFRS encouraged company directors to adopt a short-term focus?

We never expected any such effect – and it never materialised. Of course market pressure exists but the market is concerned with observing and identifying economic results. Yes, IFRS have made accounting results more volatile but the market is capable of the necessary interpretation.

Overall, IFRS do not appear to have had any visible impact on corporate strategy, at least as regards companies not suffering from any particular equity problem. As for the issue of depreciating intangible assets, it existed long before the transition to IFRS.

Is international consistency in the application of IFRS a cause for concern?

In the past there were so many differences from one country to the next that one must first of all salute the progress accomplished! In Europe, the situation we have reached is satisfactory. The harmonisation of accounting rules that has taken place was both absolutely necessary and has been considerable.

The essential factor, which extends well beyond the sole issue of application of IFRS, remains the pressure of the market for improved and more consistent accounting practices. Very strong pressure is exerted by investors in particular. The development of continuous benchmarking has already played a key role in raising standards and will continue to do so.

If the regulators intervene to impose best practices, businesses will have less room to manoeuvre. The financial sector is characterised by great complexity given the large number of regulatory and supervisory bodies and so it will be a long time before completely consistent shared approaches may be expected to emerge.

Are you satisfied with the degree of involvement of investors in the standard-setting process?

It must be recognised that investors remain too little consulted and too little involved, as a result of which accounting standards do not entirely reflect their needs. If the purpose of the exercise were solely to obtain a true and fair view, standards would be notably different – even though, once again, one must salute the progress achieved in companies' financial reporting.

There remain areas for further progress, for example the impact of foreign exchange rates on profit or loss. It is true as well that, particularly within the financial sector, financial statements continue to provide an insufficiently economic vision of their issuers' operations.

Finally, let us remember that standards are only one element within the whole range of market practices. For example, segment information (whether for business or geographical segments) provided in the United Kingdom tends to be less detailed than elsewhere. The role of auditors, and more generally of the entire market environment, in forming accounting practices remains essential.

Philippe Danjou, Chief Accountant, and **Sophie Baranger**, Deputy Chief Accountant
Autorité des Marchés Financiers (the French financial markets regulatory authority)

What is your current assessment of IFRS implementation?

Overall, investors have not been very forthcoming. If they had been dissatisfied with the transition to IFRS they would no doubt have protested. But as yet it is impossible to make any precise cost/benefit assessment. Have investors made use of all the new possibilities opened up by financial statements established in accordance with IFRS? It is not easy to make any honest assessment of the extent to which the change in standards was a response to any real need.

There is no doubt that the change in standards has brought improvements in certain specific areas, such as the more rational methods now employed for impairment testing. Great progress has also been made in avoiding unjustified deconsolidation, which provides the investor with greater security. And segment reporting has improved as well, albeit a few nuts and bolts need tightening in terms of effective application of the [IAS 14] standard.

Application of IAS 39 has its positive and its less positive side. The standard has contributed to improving the supporting documentation and no doubt the administrative management associated with hedging transactions, but has also raised significant problems of comprehension given the very technical nature of the text. In the case of IFRS 2 (dealing with share-based payment) it is equally too early to express a judgement as to the validity of the valuation models used.

Have the objectives of comparability, transparency and relevance been attained?

The market has been promised a great deal, including perhaps a few illusions. The achievement of certain objectives, notably as regards the possibility of direct comparison of entities, will take longer than expected. In 2002 it was not yet clear that the framework available for first-time adoption would be incomplete and that IFRS 1 would provide for so many options. These aspects were not sufficiently scrutinised at the time and as a result, comparability is still only partial. Many options are still available, as for example in the areas of accounting for investment property or the fair value treatment of financial instruments, and there are also grey areas when it comes to accounting for certain business combinations.

In terms of transparency, there has not been any real loss of financial information, quite the contrary. At the same time IFRS leave a great deal of freedom for organising the presentation of the income statement and from this point of view, the new standards are less restrictive than the combined requirements of the French national chart of accounts and the texts published by the AMF.

This is indeed an illustration of the dialectic, in terms of implementation, between the role of accounting standards and that of the market regulators. For example, the description of the entity's policies for managing capital, now a requirement of IAS 1, strikes me as not strictly comprising accounting information but representing more general information about the entity that until now was provided in the directors' report. Is it part of the vocation of IFRS to regulate matters of management commentary as well? The intention was no doubt present when, in 2001, the standards' name was changed from IAS (International Accounting Standards) to IFRS (International Financial Reporting Standards), but even so the debate as to the limits of financial reporting is not yet closed.

As for the relevance of financial statements, the conclusion is positive overall but work remains to be done. Undoubted progress has been made in areas such as off-balance sheet items, post-employment benefit obligations, consolidation and segment reporting, but in other areas, such as the comparability of the income statement geographically and over time, not all is rosy. Relevance is a concept which varies from observer to observer and depending on whether the shareholder is an active or a passive one. To dispose of a completely relevant vision of a business, an investor often needs additional financial information which is imposed by the stock market regulators as a complement to the requirements of purely accounting standards. I am thinking in particular of the pro forma information intended to provide financial statement comparability over several years and of the information provided about share capital ownership or about directors' remuneration.

What can be said about the risks that the market associated with the transitional period?

Some observers feared a problem of volatility, and of pressure towards a short-term management focus, but none of these risks has materialised in France. Share price volatility is linked to decisions of the US Federal Reserve and to the price of oil, but not to IFRS. Retrospectively, these debates have a whiff of armchair strategy brandished to draw reactions from political leaders possessing little knowledge of market mechanisms and accounting principles. The introduction of IFRS has not had any major impact on businesses' management methods and the "short-term focus" strikes me as something of a myth.

Has the scope for financial statement manipulation been affected by the change of accounting standards?

The only obvious scope for flexibility in terms of accounting options was that available during the transitional period with the options for first-time adoption made available by IFRS 1. Some groups took advantage, in particular in order to reinforce their equity or compensate for having to recognise certain liabilities by revaluing their assets. But by definition that was a one-off phenomenon. It seems to me that IFRS leave very little scope for earnings management, or for cookie-jar accounting as the ex-SEC Chairman Arthur Levitt used to say. There remains a little subjectivity in fixing the basis of depreciation of tangible and intangible assets, or the level of discount rates, but any scope for manipulation is limited over time. In contrast the constraints posed by the standards in areas such as provisions, the temptation to materialise capital gains as required and many other matters are far more restrictive than before.

Did implementation provide you with any surprises?

Implementation still leaves a little to be desired in some areas, in particular in terms of the absence of detailed guidance for certain specific transactions. Put options for minority interests, the consolidation method to be used in situations of de facto control, greenhouse gas emission quotas, the frontier between equity and debt in the case of certain hybrid derivatives, are all well-known examples.

The inherent complexity of the IFRS standards also faces users of financial statements with problems of comprehension which are complicated, given the historically different cultural approaches to accounting from one country to another, by the need for translation from the English. There is also a problem of friction between standards that were drafted at different moments of the existence of the IASC which then became the IASB, as for example between IFRS 5, dealing with non-current assets held for sale and discontinued operations, and IAS 27 which prescribes the accounting treatment for investments in subsidiaries. A lot of maintenance will be required in the coming years.

However this judgement must be nuanced: things are not worse than before! The French accounting framework was still less complete even if certain areas, such as consolidation, were *prima facie* better provided for in terms of the applicable rules.

Will the market impose convergence of accounting practices?

I have no idea because market reactions are not easy to forecast. For example, within Lagardère Group's financial statements, minority interests' put options have been treated differently by Airbus and by the group's media business. But there has been no market protest since the approach adopted was perfectly explained and justified in the notes.

It is too early to know where problems of implementation may arise. Precise application rules generally emerge as a result of positions taken by the regulators in the event of disputes over matters of interpretation, and as yet not so many IFRS disputes have been observed. The stock market regulators have only recently started taking position and it is too early to extrapolate.

There is little doubt that sooner or later regulators or the competent courts will be required to clarify certain positions. It is perhaps a little idealistic to imagine that the standards will remain principles-based indefinitely. There will always be complicated situations for which the market will require arbitration that will then take on status as jurisprudence, i.e. rules.

In Europe, the multiplicity of jurisdictions is naturally a source of additional complexity. CESR (the Committee of European Securities Regulators) is an adequate forum for coordinating the work of national regulators but the same cannot be said in the case of jurisdictions, or at least not below the level of the European Court of Justice. The European Commission itself may need to take the initiative of instituting a more demanding coordination mechanism.

As for the national accounting standard-setters, there is a risk that they will exaggerate the specific nature of the issues they examine for the purpose of defining their accounting treatment under IFRS. Here too there will be a need for both coordination within Europe and rigorous quality control over individual interpretations of IFRS. Such is the role devolved to IFRIC, which will however be confronted both with a problem of resources and with the risk of conflict with the principles-based approach.

Can we expect this multiplicity of the sources of authority to engender conflicts that will be difficult to manage?

It would not be a good solution to centralise all decisions at the level of the IASB and IFRIC, which would be contrary to the principle of subsidiarity. We need to distinguish between what is a matter for accounting standards and what is more a matter of best practices – the compatibility of which with the accounting standards will of course have to be verified. As an example one might imagine that, encouraged by the recognition of best practices, there will be a certain convergence in the application of IFRS 2 to stock option plans.

CESR and IOSCO will also play a role but will be confronted with the difficulty of their decisions having to be taken by consensus. Let us not forget that the stock market regulators are not accounting standard-setters and do not wish to become so. I think there are no preconceived ideas. It is true that the *Commission des Opérations de Bourse* [predecessor body to the AMF] used to have a habit of drafting accounting pronouncements but the context has changed. The real job of the regulator is to ensure market transparency, not to complement accounting standards.

What can be said about the role of auditors?

The first issue is one of avoiding contradictions both within any single audit network and between networks. Each audit network has instituted mechanisms for international arbitration and that of course naturally creates client tensions. Beyond, arbitration can be performed according to the circumstances by IFRIC, the IASB or some other body. The round table instituted by the European Commission to coordinate positions has existed since May 2006 but we should not expect any miracles. The arrangement is a cumbersome one and does not have power of decision, serving more simply as a relay between the Commission and IFRIC.

What will be the next hurdles to overcome?

To begin with, the new standard-setting projects. The IASB will need to show discernment in its choice of subjects. The market is probably not prepared to go too far in certain directions such as full goodwill or “full fair value”. It will also be necessary to determine the point beyond which too much information becomes bad information. That point is perhaps not so far off!

Then, of course, there is the risk of a change in the market climate. So far, market fundamentals seem reasonably healthy but what will happen to accounting practices in the event of a major crisis? The regulators will have to do their job to ensure that the quality of financial reporting is not the first victim sacrificed. Competition between regulators can play a positive role from this point of view, as we have seen in the case of the SEC which has succeeded in stimulating the Europeans to greater rigour.

Richard Deville, consulting actuary specialising in employee benefits

How has the IAS 19 standard on employee benefits been applied?

Certain enterprises have been proactive where others have tended to wait and see. In general the most proactive have been the most international groups with the largest levels of employee obligations whether for pensions or for other post-employment benefits.

For groups listed both in Europe and in the United States, which were already accustomed to implementing US GAAP and in particular FAS 87, the adoption of IFRS has brought extra constraints and increased volatility. For example, FAS 87 allows for use of a rolling five year (maximum) average of the value of assets invested in shares, as a means of attenuating fluctuations in the financial markets. From this point of view IFRS are a great deal less flexible since they require quoted investments to be measured at market value.

There are perceptible differences between entities as regards the choice of actuarial assumptions. Inflation, salary increase and staff turnover rates vary from country to country. There may be differences within a single group, between subsidiaries, particularly if the group is active in distinct market sectors. The differences one observes also reflect entities' specific culture and traditions. For example, French groups tended to leave more freedom to their local entities, in determining their actuarial hypotheses, than American groups. As a result, the post-employment benefit obligations for identical populations in two different countries, or even in the same country, may be disclosed at different amounts simply because, for example, the two local entities have not used the same life tables. There has nonetheless been a very significant increase in comparability as a result of the adoption of IFRS.

What has been the role of auditors in this adaptation?

In a context of continuing pressure on fees, their expertise and above all their availability for the purposes of reviewing employment benefit obligations have not always been adequate to requirements. But auditors' understanding of the valuation mechanisms is certainly improving, albeit it remains an area in which progress still needs to be made both by auditors and actuaries.

How do you assess the impact of the stock market environment?

When the markets started falling in 2001, practices that had developed during the period of financial market euphoria (contributions holidays, i.e. temporary interruption of pension fund contributions, optimistic assumptions as to the long-term returns on plan assets, over-exposure of certain pension funds to investment in shares when compared with the demographics of plan beneficiaries) revealed themselves as bad practices which served to accentuate the market problem. And as bad luck would have it, the downturn in the financial markets took place just as new accounting standards reducing the scope for earnings management appeared (most notably, FRS 17 in the United Kingdom and IAS 19).

As businesses operating in continental Europe are generally more prudent than their Anglo-Saxon counterparts, their pension funds are generally less exposed to the risk of fluctuation in the markets for equity securities. In contrast, during the period 2001-2003 the major French groups with a worldwide presence sometimes became painfully aware of the nature and extent of their deferred benefit obligations. That has created volatility in the level of plan assets given the application of the new accounting standards reducing the scope for managing earnings and deferring recognition of actuarial gains and losses.

Catherine Guttman, Partner

Deloitte

Have the expected benefits from adoption of IFRS been harvested?

So far, not really. The regulators have not yet expressed an opinion, or at least not publicly. The SEC has reviewed some financial statements, the European regulator members of CESR have too, and have no doubt made some remarks and requests to issuers, but we do not yet have much information.

There has been a promising beginning to dialogue between Europeans and Americans. CESR is attempting to communicate with the SEC. Nothing is really operational yet but everyone is taking precautions. But we are still at the stage of exchanging information rather than participating in decisions.

There are numerous examples of diverging practices when it comes to implementing the standards, such as the classification of insurance contracts between financial and insurance liabilities: very similar contracts are treated as financial liabilities by the Northern countries and as insurance liabilities in the Latin countries. The major differences observed are between different countries, whilst accounting practices are more consistent within any given country.

France had mechanisms for unifying accounting practices via the action of the AMF [securities regulator] and CNC [national accounting standard-setter], whence a fairly similar approach from one company to another. In contrast, a Spanish public service concession is different from a French one and the French one is not identical to a British one. Cooperation remains above all a national habit. The CNC has looked at a lot of topics and set up working parties, with the issuers involved, to review the accounting treatment of matters such as employee savings accounts or public service concessions.

The list of the questions submitted to IFRIC gives a good idea of the divergences that exist: quotas for greenhouse gas emissions, mining activities, or the definition of operating profit which differs from one entity to another... As things are, comparability will necessarily remain limited in extent.

Do IFRS provide investors with relevant information?

IFRS are hybrid standards which combine accrual accounting and value analysis. So long as a performance reporting standard has not been finalised, we shall continue to accumulate disparate elements. And the more hybrid the system, the less likely it is to propose relevant information.

To date, that has enabled financial groups to report excellent results because the market is rising. But matters of classification (pertaining to investments, the fair value option, pension obligations etc.) are very difficult to grasp. Relevance has suffered because the reporting format is inadequate.

To be coherent we need to cease perceiving net income as the be all and end all of performance. Instead we need a performance summary with a sufficient number of lines and columns. This is a necessity if we are to enable investors, analysts and management to calculate their own meaningful sub-totals for a given context and in particular, for the purposes of segment analysis for which the importance and usefulness of the information provided tend to be underestimated.

What is your opinion on the new IFRS 8 dealing with operating segments?

I am in favour of the choice of a presentation based on management's own vision of the business. But the segment information reported needs to be reconciled to the financial statements, a reconciliation which IFRS 8 does not provide for. More generally, there is a balance to be found between the economic basis of the information provided and the objective of comparability, and for that purpose accounting standards need to be neither too severe nor too lax.

In any event I feel that a reconciliation of the segment information is the minimum that should be asked for by any board of directors, audit committee or analyst. Subject to this reservation, I believe that presentation of the segment information on a management basis certainly should enable the accounting regulators and financial analysts to express an opinion as to its relevance. Indeed, it is often when different choices can be made that it becomes possible to focus on the important issues, but this only underpins my conviction as to the importance of reconciling segment information to a group's financial statements as a whole and to date this is unfortunately not a requirement.

More generally, has IFRS implementation increased the amount of information available to investors?

At present, most financial statement notes simply copy captions listed in the standards, which is not what is required. Relevant information is smothered instead of being highlighted. To me the situation is unacceptable but there are unfortunately very few exceptions to this attitude.

Of course a certain amount of new information has been provided, but not as much as might have been expected. There have been some exciting instances of best practices, such as the financial statements of JC Decaux, very much in the spirit of IFRS, but they are rare. From this point of view France has not really done better than the other countries of continental Europe.

Volatility does not appear to have had any observable impact and everyone seems very satisfied in that respect. In the short term there have been a lot of opportunistic accounting options retained for first-time adoption, but their effects are non-recurring and the real consequences of IFRS will only become apparent little by little.

Has the promise of financial statement comparability been kept?

Ultimately, yes, and the institution of a database of the decisions of members of CESR, together with the exchanges in progress between CESR members and the SEC, will contribute to the trend. CESR is likely to acquire a power of arbitration between its members and this too will be an important step even though it will not strictly amount to a power of interpretation of the standards. The SEC is also going to scrutinise a lot of accounting practices (they have a staff of 250 accountants!), and when the time comes for them to issue an opinion on the consistency of IFRS implementation in Europe, that will have its effect. All this might even happen very quickly.

There is of course another scenario. If implementation does not satisfy anyone, the very principle of IFRS adoption might be placed in question. Many of the projects and amendments currently under review by the IASB (business combinations phase II, amendment of IAS 37 dealing with non-financial liabilities) have so far been very badly received in Europe. The violence of the recent reactions to IAS 37 is not without significance in this respect. The same is true of the measurement of business combinations at their fair value and of recognition of the full amount of goodwill even in the presence of minority interests. The latter point is merely a technical response to an anomaly of the previous

standard but it raises other questions: how should minority interests be measured and how should one account for successive investments in the same business?

Is the IASB right to insist on the principles-based nature of IFRS?

Yes, it is very important, because it means that all the persons involved must exercise their judgement, in particular when it comes to differentiating between what is certain and what is only probable or possible, which gives rise to different levels of responsibility and status in terms of both financial statement presentation and the associated audit opinion. Once concepts of valuation and uncertainty have been recognised, not all accounting information can be deemed to have the same degree of reliability. Nor must one ever forget that accounting information makes no predictions.

Is it realistic to have such great expectations of all actors in the process?

It is true that there is a precondition in terms of extensive education. What is important is not the accounting convention itself but the way in which it is applied. In France, it is preoccupying that the university syllabuses for accounting professionals have not yet been adapted to this new development. From this point of view the market is badly prepared for the challenge to be met, whether in terms of methods of analysis or of responsibilities.

The audit report, for example, has not evolved sufficiently to reflect the dimension of uncertainty which is inherent in accounting under IFRS. We could also learn a lot from actuaries with their approach to their reports on embedded value.

In addition, the definition of financial performance and the importance attached to it continue to evolve. The IASB is currently at a crossroad. One direction it could take would be to require increased disclosure of entities' future cash flows, which would probably imply more extensive use of discounted cash flow techniques for balance sheet measurement. The other direction, reflecting a certain distrust of cash flow data originating within the entity, would imply systematic measurement by reference to hypothetical market data.

I believe that to date the Board has not really analysed the question. Its last discussion papers, such as the ones on fair value measurement or insurance, escaped the debate by treating all markets and contracts as though the economic environment was always entirely transparent and efficient. I believe that this is a significant flaw in reasoning. It may even result in a presentation of entities' financial performance with no relationship to their actual performance. The models currently under review run the risk of resulting in disclosure of up-front losses when an entity is more efficient than the market, and profits only subsequently, or vice versa. If such a direction were followed it would seriously compromise the content of financial information.

Michèle Jardin, Head of the STARS division (Strategy, Trading, financial Analysis, Research & Systems), and **Stéphane Taillepied**, Equity Research Director

Crédit Agricole Asset Management

What are your first conclusions following the adoption of IFRS?

In terms of the stock market, adoption of the new standards has not had any major consequences at all, which in part is surprising. One might have expected greater market volatility and bigger changes in balance sheets. The impression which predominates is that the market was well prepared for the transition which therefore went through without any jolts. There has been an evolution, not a revolution.

Significant national disparities subsist even so. They are due, depending on the circumstances, either to intervention of the regulators or to differences in issuers' economic assumptions, for example in the context of fair value measurement. So comparison remains difficult even within the same business sector.

For harmonisation to be complete a third stage will be required, following preparation of the transition and first-time application, which would involve the emergence of standards dealing with the economic assumptions to be retained, such as discount rates or hypotheses in respect of market volatility. We can expect that the market will play a significant harmonising role in this respect.

A somewhat negative factor has been the great increase in the complexity of the information provided following implementation of IFRS. Annual reports have become much thicker and there do not seem to be many future simplifications to look forward to.

Has the introduction of a shared set of accounting standards provided financial statement comparability?

It's too early to say, for that we'll need to wait at least until we have accounts for 2007. For example, in the area of employee benefit obligations first-time adoption is not an adequate basis for the expression of an opinion.

In respect of the income statement, one would have to recognise that the change of standards has not had any immense impact. Almost all the major changes appeared below the level of current income, which is the level that the market pays most attention to, so overall those changes had little effect.

In respect of the balance sheet the changes have been more substantial; there has been an increase in liabilities, but investors had been well prepared to take that on board.

As a whole the market, for the time being, remains aloof but that may change. If the macroeconomic environment deteriorates, or if the market starts to decline, or if aversion to risk increases, then a stronger reaction is possible. We shouldn't forget that we haven't experienced any market downturn since 2003.

Is the available information more complete as a result of the new standards?

The underlying assumptions for the calculation of employee benefit obligations, such as the discount rates applied, are now more fully described and indeed, that is how we now note disparities of up to 2% or 3% even within the same business sector. But that sort of data is lost in the mass of information provided: there is an advantage for the professional investor

but the small investors probably lose out compared with the more direct communication available to them before.

In terms of relevance, cash items are much more visible than before and that is real progress. There is also greater balance sheet transparency, which is what the market wanted.

All this echoes the market's own evolution towards the use of present value calculations in preference to less sophisticated measures of value such as PER multiples. The market reasons more and more in detail, at the level of operating segments, and for that purpose makes appropriate allocations of equity or overheads. The trend is one which also creates new opportunities for debatable practices because if two operating units of the same group are valued differently, it may be that transfer pricing has had an impact but even under IFRS, the available data is insufficient to analyse that impact. There's a risk there to which we shall need to remain attentive.

What risks arose at the time of transition?

The introduction of fair value has not brought a revolution in financial analysis. The change has been fairly well received but there hasn't been a great deal of debate.

Short-term strategies are a long-term tendency, illustrated by the increasing presence of hedge funds and more generally by a shortening of the market horizon, but those trends are in no sense a specific consequence of IFRS. Fundamental analysis remains a profitable approach over the long term, from three to five years, but is less and less relevant on a quarterly basis. As for the accounting volatility induced by the international standards, it was explained in detail by issuers and has been well comprehended by the market.

Have all the accounting options chosen at the time of transition to IFRS been taken into account by the marketplace?

Issuers want more and more convergence between the economic and accounting visions of their businesses. The effect can only be a positive one by limiting implicit risks and speculative behaviour.

The hardest issue remains the accounting treatment of retirement benefits. The market has understood the changes wrought by IFRS application and now has a better grasp of the underlying assumptions. Overall, the risks that exist are more clearly expressed than before. Alcatel Lucent is a good example.

Are you satisfied with the consistency of implementation of the standards?

Take the case of Spain, where the government has facilitated certain developments by, for example, granting tax deductibility for goodwill. We shall see further examples, nothing perhaps to do with the international standard-setter, but national policymakers will continue to take initiatives, as often as not to promote or protect their "champions", and they are clearly in the best position! In the real estate sector, the use of fair value has boosted the economic cycle with a blossoming of share for share purchase offerings: to some extent, the standards have encouraged the emergence of new stock market tendencies. It will be interesting to observe the evolution of this market.

The French banks are another example. Their asset and liability management has sheltered them from any significant interest rate fluctuation. IAS 39, as adopted within the European Union, has not required them to modify their accounts and from this point of view the sector's lobbying has had a payback. In contrast the British banking sector, which manages its assets and liabilities over a two to three year horizon rather than the four to five year horizon typical in France, has taken a heavier knock.

National governments will always exercise influence, and the banking sector is an illustration of the degree to which economic models can vary from one country to another. Asset and liability management is more sophisticated in France than elsewhere because the banks' balance sheets include long-term commitments such as 25 year fixed rate property loans. This is also an example of the role of cultural factors: French customers have a preference for fixed rate loans. These differences in behaviour will persist.

Will such disparities self-correct?

Yes. The market will impose standards within the range of existing options. It will take time, perhaps three to five years, but there is no doubt that it will happen.

The principles-based nature of IFRS will not be a problem because the market will impose comparability and any issuers that don't comply with the market's standards will be sanctioned.

How is the role of the audit firms evolving?

Their role has been amplified by the adoption of IFRS. They're on their learning curve. They will no doubt perform better within a few years but for the time being one observes a certain lack of training.

Meanwhile the situation will be a contrasted one, naturally with an advantage for the biggest audit firms which are better placed to audit IFRS financial statements and at the same time resist any pressure exerted by their clients. There's a certain tension because on the one hand IFRS have complicated financial statement preparation whilst on the other hand the market is imposing ever tighter deadlines for publication. Ten years ago a couple of months was considered normal but more and more companies are now publishing their results within a couple of weeks. That poses problems for the smaller firms.

What view do you take of the next stages in the standard-setting debate?

It's surprising to note the relatively low volume of US mergers and acquisitions, at least within certain sectors such as banking. European issuers are preparing themselves for globalisation of their markets by attempting to gain critical mass, and there is clearly a link between IFRS and the vitality of this process of consolidation in Europe: both factors are a response to the same desire to prepare the future. In this respect, it is to be hoped that the United States will be prepared in turn to recognise the IFRS framework.

As for the market focus on the short term, I think it is here to stay, albeit it's not ideal and half-yearly rather than quarterly reporting would be desirable as a means of lengthening the vision of decision-takers. But it is a debate to which accounting standards are not central.

Denis Kessler, Chief Executive Officer

SCOR

At the head of the Federation of French Insurance Companies (FFSA) for more than ten years, from 1990 to 2002, you were in the front rank of the debate over the adoption of IFRS. What is your current assessment?

The previous sense of a war of religion has almost completely vanished. The often virulent opponents of IFRS have become more realistic, or perhaps defeatist, in any event they seem less motivated to lead a rearguard action. A stage has been accomplished, though that is not to say that the business community has become enthusiastic as a whole.

Personally I have never thought that the adoption of IFRS was going to amount to an irreversible ideological turning-point. It's more a matter of seeking practical solutions to practical problems. The real issue is one of providing an economic, rather than strictly an accounting, measure of business performance and IFRS do provide a contribution in that direction.

Have the financial statements of listed European groups become comparable?

In that respect we're disappointed. I defended IFRS personally on the grounds of comparability, of their promise of enabling a direct check of the financial statements of, say, Axa against those of Allianz. We haven't got there yet. Comparability remains a valid goal but it is a goal that is a long way from being scored.

Take the example of the financial sector. Certain British banks are carrying several billion euros in their balance sheets in respect of their brand names, which is not at all the case of other European players.

These differences are also linked to the circumstances of IFRS implementation which were fairly chaotic. There has been a great deal of trial and error and a lot of waiting for guidance on matters of principle that then had to be applied at breakneck pace.

I'm also preoccupied by the multiplication of the sets of standards with which issuers have to comply: different sets of financial statements are required by shareholders, regulators, credit rating agencies and the taxman. The French insurance regulator has developed its own accounting framework which I believe should now be aligned on IFRS. There is the same risk with the discussions in progress over the Solvency II insurance framework which is also liable to be substantially different from IFRS. It's not a good trend.

Are financial statements – for insurance companies in particular – more comprehensible following adoption of IFRS?

The situation remains unsatisfactory with the persistence of the mismatch between insurance liabilities and financial assets accounted for in accordance with IAS 39. As a result, balance sheets are not easy to understand.

When SCOR adopted IFRS there was a change in the classification of reinsurance contracts, with recognition limited to the applicable margin, and the effect for us was a loss of about €300m of revenue. One can always explain, but the fact is that the analysts just don't understand this type of development. Series of historical data lose their coherence and there is a part of the market which simply does not know how to adjust the figures.

Further, IFRS often rely on the exercise of judgement – necessarily a somewhat subjective concept – for example when, in the area of insurance, the standard employs the concept of “significant” risk. That can lead to long discussions with the auditors, but it is also apparent that significant differences of perception can exist between the audit firms themselves: the Big Four clearly do not yet share the same interpretation of IFRS.

But let us not underestimate the positive side. Employee benefit obligations, for example, are now much better accounted for by all entities. Certain changes have also been less radical than what was announced in 2003-2004. Certain observers expected there to be more fair value items in balance sheets than has proved to be the case. For many entities, the changes wrought by IFRS have been fairly marginal.

Can one envisage measuring insurance liabilities at fair value?

At the very least it would be very difficult. Non-life insurance risks, and particularly extreme risks, are very difficult to quantify. Reinsurers cannot necessarily reason in terms of mathematical models because our risks fall outside the scope of normal standard distributions. If you take the World Trade Center, the annual premium amounted to \$500,000 but the final exposure hit \$710m.

Economic models are a practicable basis for measurement when the associated risks are homogenous in nature, not the Dirac peaks which populate the world of reinsurance. Some risks simply cannot be provided for, they can only be charged to profit and loss if and when they materialise.

What has been the consequence of the new standards in terms of earnings management practices?

IFRS undoubtedly make earnings management more difficult. Is it a good thing? Reinsurance cycles last for eight years and managing them is part of the reinsurer’s business. Is it a good thing that IFRS deny their existence in accounting terms despite the fact that their recurring nature is one of the basics of the profession? One may give an affirmative response of principle, if the market is capable of integrating the parameter precisely, but personally I have my reservations. Strictly speaking it would make sense for reinsurance balance sheets to be compared with the same period of the previous cycle, i.e. on an eight year basis rather than every year or every quarter.

Let us not forget that on average, nine tenths of a reinsurer’s liabilities are calculated amounts unrelated to specific transactions. Many reinsurance liabilities are “incurred but not reported” since the reinsurer may not be informed until long after a reinsured event has occurred. The concept of a market value updated every quarter does not fit in with this reality. The analysts do not always grasp the very real difference between insurance and reinsurance, and nor does the IASB which tends to be overly confident in the market’s capacity for discernment. A clearer distinction should be made in the balance sheet between documented liabilities and estimated ones.

Estimated liabilities are on a greater scale in the world of insurance than in any other business sector, including the banking sector whose provisions for risks never exceed a few percentage points of their balance sheets. The only really extreme banking risk is systemic risk and in particular, country risk – and those risks aren’t on their balance sheets at all.

There are fewer difficulties with assets. The complexity of accounting for derivatives seems to have been fairly well absorbed. Property remains a real problem because professional valuations do not always prove to have been particularly useful as a reference. One of our

own properties was sold for 40% more than its carrying amount just a couple of weeks after the valuation had been performed.

What judgement do you express as to the current governance of the IASB?

IASB governance remains a matter for some surprise. Standard-setting is a prerogative in which government should retain its part of responsibility. The divergence between accounts prepared for tax purposes, for regulatory purposes and for publication is preoccupying and requires corrective action which can only come from the state.

The community regulation adopting IFRS in 2002 opted for all or nothing: Europe adopts a standard or rejects it but is powerless to change it. This is not a good thing. The current system is a profitable one for auditors but not for other interested parties. The IASB's governance does not provide a convincing response to the risk of standard-setting becoming the hostage of the accounting profession. This conflict has not yet been resolved. Finally, and despite the recent progress in this area, the lack of convergence with US GAAP remains an essential weakness.

Yann Le Pallec, Head of European Insurance

Standard & Poor's

What has been the impact of the adoption of IFRS within the insurance sector?

Let us not forget that IFRS 4, which deals with insurance contracts, is a transitional standard that will ultimately disappear. The debate over insurance liabilities began quite late, around 2001-2002, but was a keen one. The very idea of reconciling the concept of insurance with the IASB's own conceptual framework is a very ambitious one. At the end of 2003 the standard-setter reached a compromise the aim of which was to attenuate the balance sheet and income statement impact of the changeover to fair value.

The debate is now back to its starting-point for the purpose of preparing the definitive standard dealing with insurance liabilities, which will probably not be published before 2010. The aim remains one of retaining an economic focus but it won't be simple, for two main reasons.

The first problem is that insurance liabilities are intrinsically difficult to measure at fair value given in particular their long-term, and sometimes very long-term, nature. No other business sector is confronted with comparable issues. Fair value is in essence a transaction value. In the insurance industry transactions exist, but on a specific basis between insurers and reinsurers, and in any event they are limited in number.

The second problem is that in the insurance industry, liabilities and the investments which underpin them are pooled. In contrast, the philosophy of IFRS is to prohibit symmetrical measurement of assets and liabilities other than in the context of very strict relationships which in formal terms are only met by contracts expressed in units of account. The IASB's great reluctance to recognise the particular relationship existing between insurance assets and liabilities is a major obstacle to the development of a standard achieving the true and fair view objective.

Has application of the new standards had positive effects?

First of all, in France the mutual insurance companies have generally not yet adopted IFRS, which for the time being restricts the scope of any judgement.

In terms of transparency, the volume of information provided in the financial statement notes has made a large leap forward, even though the information supplied by the different groups remains very heterogeneous and would gain from harmonisation particularly in terms of indications as to their exposure to the different types of risk. The listed French insurers (AXA, AGF, CNP, Euler-Hermes, April) had already made significant efforts in this respect in particular during the difficult period for them following 11 September 2001. In response to market pressure, and despite the lack of precision of the French standards of the time applicable to consolidated accounts in the insurance sector, they supplied significant information in particular in respect of their embedded value for those groups with a material life insurance exposure.

The mutual insurance companies are also working towards transition, but without any public communication with the exception of Groupama which is also working towards a future public listing. La Mondiale Vie and MACIF issue negotiable debt securities and so will apply IFRS with effect from their financial statements for 2007. The other mutual institutions have not yet set any formal date for adoption of IFRS.

Little progress has been made in terms of comparability. In France, application of the European directive on insurance accounts produced a significant change in the middle of the 1990s albeit the change was limited to the income statement and more specifically, to introducing the possibility of analysis of expenses based on their function within the entity. It must be recognised that the market's alignment on what is now a standard practice took several years and that convergence was only achieved after a period of wide disparity in application of the new standard. Indeed, differences still subsist albeit they have become essentially marginal in nature. So it would be illusory now to believe that accounts produced since the middle of 2005 can have embodied any real progress in terms of comparability. Practices will only converge in the fullness of time.

And if the volume of information provided has effectively grown, which in principle can be considered an improvement, that fact does not necessarily mean that the objective of comparability has been attained. For example, reconciling the various descriptions of the actuarial assumptions underlying the calculation of embedded value is like looking for a needle in a haystack! The CFO Forum, which brings together the twenty biggest European insurers, has been promoting the concept of European embedded value since early 2004 and the concept of market-consistent embedded value is also gaining ground. But even if these initiatives have the laudable aim of encouraging the market to implement a more standardised approach, any attempt at comparison remains difficult, if not impossible, given the disparity in the underlying assumptions.

As for information relevance, it is up to investors to say what they need, which is certainly the *sine qua non* for progressive alignment on best practices. At present there is probably too much information, which poses a problem in terms of transparency but is no doubt an inevitable stage through which we need to pass.

What risks are posed by the adoption of IFRS?

In the case of Phase 1, virtually none at all. Certain insurers had predicted disastrous effects from the volatility expected to arise as a result of the standards and declared that new policies written would require redrafting, but there was no real need to cry wolf as shadow accounting has worked well as a shock absorber and greatly attenuated any volatility there might otherwise have been.

Nor have asset allocation practices been visibly impacted by the change in standards, not even as regards the investment horizon since the shortening of that horizon by certain players has above all been a tactical reaction reflecting anticipated changes in interest rates. There will, on the other hand, be a risk in the case of Phase 2, i.e. when the definitive standard on insurance liabilities appears.

As for recourse to accounting artifice, IFRS have brought a slight improvement. IFRS 4 has done away with equalisation provisions, whilst the extension of the principle of substance over form has attenuated the risk of financial reinsurance contracts being used for cosmetic purposes – assuming, at least, that the customer is also subject to IFRS which is however far from always the case. But even so it is noticeable that certain providers such as Hanover Re now report far fewer such contracts. This remark naturally only applies to part of the financial reinsurance business.

Is application of the standards sufficiently consistent from one country to another?

In the realm of insurance there are clearly differences from one company to another but not especially from one country to another given the extreme variety in the insurance products offered, particularly in the field of life insurance. As IFRS 4 allows for technical provisions to continue to be recognised on the basis of local accounting standards, the national dimension

naturally retains considerable influence – but that was the standard-setter's decision. As an example, one may quote the differences in application of shadow accounting, and in the treatment of discretionary participation features, both between countries (the United Kingdom compared to France and Germany) and between types of entity (traditional groups compared to bank insurers).

Financial conglomerates, which combine the provision of insurance and other financial services, raise specific issues that will take on particular importance at the time of Phase 2. Creating consistency between the new standard and IAS 39 will be a major challenge for the IASB.

What judgement do you express as to the standard-setting process?

Lenders and, by extension, the credit rating agencies should be more involved. At present the IASB sees the shareholder as the dominant perspective, but it must be recognised that the problem arises from both sides. The IASB is not very open to other parties' points of view but at the same time it is true that lenders, and in particular investors in bonds, have not devoted as much time and resources to questions of accounting standard-setting as they might have. Standard & Poor's, on the other hand, has chosen to be active in the debate and is thus a contributor to the IASB's Insurance Working Group.

Financial statements have multiple users whose variety extends well beyond the duality between shareholders and lenders. Certain insurers do not issue bonds but nevertheless submit themselves to the credit rating process for commercial reasons. This is for example the case of reinsurers, major risk insurers and mutual life insurers and it means that the main interested parties that we really represent whenever we issue a credit rating for an insurer are its policyholders – well before the entity's bondholders and other lenders even assuming they exist.

Does convergence of the international and American standards raise any specific questions within the insurance sector?

Without any doubt. The recent indication of the SEC to the effect that it was prepared to recognise IFRS augurs for a clash of accounting cultures on many subjects beginning in particular with the question of discounting of provisions for non-life insurance claims payable. As for life insurance, let's not forget that the Americans have no time at all for the concept of embedded value and are fiercely opposed to full recognition of future margins. All of that gives us scope for keen debate.

How have auditors played their role in adopting IFRS?

The credit rating agencies are second level users and very much dependent on auditors, whose role is vital to the overall functioning of the system. They must in particular ensure that there is not excessive divergence in the accounting options retained by different entities. Businesses cannot perform all the accounting compliance made necessary by the transition to IFRS on a stand-alone basis.

Xavier Paper, Founding Partner

Paper Audit & Conseil

What is your general assessment of the beginnings of IFRS application?

We do not yet have a great deal of experience. First-time adoption is the beginning of a very long process. Quoted issuers, whatever their size, have made a considerable effort. The audit profession has risen to the challenge of providing awareness and (for once) has acted as a motor for change, not hesitating to depart for that purpose from its habitually reserved attitude.

More generally, for the first time financial reporting has become a subject of broad public debate, with renewed dialogue between accountants and non-accountants which was particularly visible at board and audit committee meetings many sessions of which were devoted to the transition. All that was very positive.

What benefits have been harvested from the transition?

The objective of comparability and of standardisation of practices has not yet been achieved. It will come about progressively, by mutual comparison, within each business sector of course but also from one sector to another. But full comparability will be an elusive goal given that IFRS leave too much scope for individual interpretation. The international standards are difficult to read and lacking in illustration and detail. In comparison, the American standards are very sector-specific – but also very comprehensible. Their content is lengthy and detailed, but clear.

In terms of transparency there have been some very positive aspects. The information provided is richer and more detailed overall, in particular in respect of financial and hedging instruments as well as off-balance sheet items, albeit this final point would have evolved even had IFRS not been adopted. The data in respect of impairment testing and sensitivity analysis is very useful and a feature which might profitably be extended to other aspects of financial reporting. It would have been beneficial to have had such information for groups like Vivendi Universal and France Telecom in 2001-2002.

That being said, this additional information is only usable by specialists. In contrast, adoption of IFRS has not facilitated the understanding of financial statements by the non-initiated and certain users find themselves suffocated. Inevitably, financial reporting is tending more and more to be aimed solely at specialists.

Finally, in terms of relevancy, certain options may seem debatable from the point of view of the investor, as for example in the case of IFRS 2 and its application to stock options. I remain doubtful as to the principle of recognising an expense for a transaction which doesn't involve any outflow of cash either immediately or on a deferred basis.

As another example, the accounting treatment of convertible bonds has not particularly been contested by investors but certainly has been by directors. The concept of implicit borrowing costs is complex and difficult to understand. The widening divorce of accounting principles from both transactions' contractual terms and any related cash flows is liable to give rise to doubt. There is a tendency, in debating substance over form, to forget that use of the legal viewpoint does have the merit of simplicity.

What risks do you perceive?

I don't feel competent to measure any impact of accounting volatility, for which there is certainly a specific dimension applying to the financial services sector. In other sectors the impact of IAS 39 dealing with financial instruments has been fairly limited.

IFRS have not fostered any short-term vision, on the contrary. For example, the requirement for goodwill impairment testing obliges directors to look towards the future and typically, with a five year horizon. The debate over quarterly reporting is not an issue of accounting standards. The investor needs first and foremost to be informed, via the market, of new and important events as and when they occur.

As for risk in the area of information reliability, it must be recognised that the IFRS framework is very conceptual, global and non-specific and as such, leaves a vast margin for interpretation, perhaps too vast a margin. For example, the reference in the definition of control to the "risks and rewards of ownership" is too imprecise. IFRS have increased issuers' scope for retaining different options from one business to another and the Big Four's initiatives are unlikely to be sufficient to standardise practices.

My remark about accounting options is not aimed at earnings management practices such as those employed by Xerox. Companies that want to manage their earnings can do so with or without IFRS which have had, I believe, little impact from this point of view.

Has financial reporting become more consistent from one entity to another?

On the contrary, IFRS have accentuated the lack of consistency both within each country and internationally. The authorities try to coordinate themselves within the Committee of European Securities Regulators (CESR) but their decisions will remain without effect for so long as they are not made public.

Segment reporting is a good example. Each issuer applies IAS 14 in its own way and companies specialising in providing financial databases find it impossible to process the information provided in order to enable any meaningful comparison. I am indeed sceptical as to the capacity of the XBRL (eXtended Business Reporting Language) project to provide comparability. There are too many differences between groups' charts of accounts.

In France, the 2004 recommendation on income statement presentation of the *Conseil national de la Comptabilité* is not uniformly applied, which is a pity because with the exception of the very biggest enterprises the basis of comparison most often remains a national one.

This absence of convergence, consistency and homogeneity is not surprising and was entirely foreseeable. Day to day practice will progressively eliminate a large number of the current inconsistencies, and enable refocusing of the standards that prove badly adapted, but it will be a long process.

What is your assessment of the process of convergence with US GAAP?

Convergence between IFRS and US GAAP will necessarily have implications but it's too early to be specific as to which. For my part I'm a keen partisan of more specific, less general, standards. Sector-specific accounting standards, on the model of those that exist in the United States, are often desirable. A good example would be that of oil reserves the treatment of which requires both accounting and non-accounting elements. At present US GAAP are always the standards of recourse whenever sector-specific considerations come into play.

There are a few instances where, on the contrary, the IASB has taken a position in respect of a sector-specific issue, such as the IFRIC interpretation dealing with members' shares in

cooperative entities, but even this text is not sufficiently adapted to the differences between agricultural and banking or insurance cooperatives. Sector-specific standards are indispensable yet remain cruelly absent. For entities subject to concessionaire arrangements, for example, the current uncertainty is very damaging. The regulators' decisions may help to fill the vacuum but only if they are prepared to devote significant funds to creating a public and practicable database.

What is the role of the audit firms?

Their role is to ensure proper application of the standards. The large networks often impose a point of view, generally following consultation between the Big Four, and their clients do not retain much scope for discussion. The regulators have been overtaken and often rally to the points of view of the audit networks. The standard-setter is simply absent from the debate and apparently not competent to intervene in the relationship between preparation of standards and their application. This is a real problem, with a real risk of a dichotomy between standards and practices which is anything but desirable.

The auditors themselves are often poorly trained and poorly organised. The technical functions each network has created are far removed from the field and the signatory partner acts as a screen between those functions and the client, which is not good for dialogue. The technical functions should have direct lines of communication with their audited entities.

What will have been the impact of the market conditions prevailing at the time of the changeover?

The valuation of goodwill and of other assets is going to raise some serious questions in the future. Impairment testing will prove a cruel sport, which is why directors are beginning to take this dimension into account when engaging in acquisitions. IAS 36 is an imperfect standard from this point of view because control premiums (reflecting for example the benefit procured by eliminating a competitor) do not perform well under the valuation microscope of a discounted cash flow approach. In such instances it is preferable to reason in terms of the market value of the target entity and to try to answer the question of the price at which it might be resold.

Marie-Pierre Peillon, Head of Equity & Credit Research
Groupama Asset Management

What is your overall assessment of the introduction of IFRS?

Some observers expected a potentially destabilising revolution but nothing of the sort has happened. The transition to the new standards has gone smoothly. The groups involved worked hard to prepare the transition and, particularly in France, were prepared to spend a lot of money for that purpose.

One of the reasons for the fluidity of the transition has been the intensity of the attendant negotiations between entities and their statutory auditors. The changeover was a novel situation for which no-one had any experience. For example, certain major groups such as Accor or LVMH have concluded large numbers of leases, for their hotels or stores, which have rarely been brought onto the balance sheet as finance leases. Arrangements have been arrived at which have limited the impact of the changeover. And analysts have had trouble in understanding the opening balance sheets. The impacts of the new standards will take time to work through.

Certain benefits in terms of depth of information and comparability are already visible. For example, pension fund information is now much more standardised where previously the subject was a very difficult one to analyse. The cash flow statement has also been improved, for example in the case of Spanish companies which were lagging behind in this respect.

Having said that, there remains unresolved comparability issues such as, for example, the income statement distinction between recurring and non-recurring items, which distinction is differently interpreted from one entity to another. For their part, the analysts have not yet finalised their own indicators but they will gradually adapt. In the banking sector, provisioning policies are very variable from one country to another: the Spanish are very prudent but the Italians very much less so.

Segment reporting is another major topic. Within the telecoms industry, for example, the unending changes in the definition of segments pose a problem. Different groups make different choices both for their operating and geographical segments. Yet the onset of globalisation means that geographical analysis has become an essential component of assessing income statement risk. From this point of view the new IFRS 8 dealing with operating segments is a dangerous development because there is a risk that it will provide poorer comprehension of entities' economic models.

Another difficulty relates to the distinction between equity and debt. The analysts have a real problem of understanding in this respect. Hybrid instruments are becoming more common. And both the credit-rating agencies and banking and insurance regulatory authorities are in process of developing their own methods of analysis. There is a real risk of confusion.

Have the standards had an influence on corporate behaviour?

In general this type of effect has not been observed. IFRS have not led to short-term management focus. On the contrary, there is a gradual movement towards adopting the criteria of socially responsible investment which imply a less exclusive short-term focus. IFRS do not have much impact in relation to major market trends of this type.

Within the financial sector, and more particularly in the case of the banks, issuers have taken pains to minimise the accounting volatility induced by the application of IAS 39. As a result, the change of standards has hardly been noticeable but has involved the development of a technical infrastructure the complexity of which is a problem in itself.

As for the potential for manipulation, it is simply as present as ever. People adapt to situations, whatever accounting standards are in force.

Will market pressure gradually impose comparability?

I am not sure that market pressure will suffice to ensure consistency in implementing IFRS. Issuers' financial communication has been very focused on the technical issues linked to the IFRS changeover in 2005 but by now the pace has definitely slackened.

The pressure for standardising practices is above all exerted by auditors. Whatever one may say, auditors are averse to ad hoc accounting and their negotiating position will no doubt gradually improve as uncertainties are lifted and the complexity of the standards begins to be generally assimilated. Experience will prove a lever for standardising practices.

Auditors have gone through some difficult moments during the past couple of years but have learned from their experience. They possess considerable technical skills and have the will to do the best job possible. The increasing concentration of the audit sector also provides them with bargaining power.

As to the potential role of the public regulators, one may have one's doubts. Certain prospectuses are quite baffling. The regulators are submerged by their workload and in general are cruelly short of resources.

Will the market climate play a role?

In principle no, but one must equally recognise that a crisis in the market may highlight unforeseen problems. No-one, today, can affirm that any and all risks associated with IFRS have been fully integrated by the market.

Julien Vannier, Buy-Side Analyst
Société Générale Asset Management

What is your overall assessment of the adoption of IFRS?

Globally positive given the trend towards comparability. My area of focus as a financial analyst is the banking sector, which has strong special characteristics, and the adoption of IFRS has brought a clear improvement within this sector albeit accompanied by disappointment as to the practices of certain issuers.

One of the difficulties is that IFRS are still a long way from being universally applied. When groups have subsidiaries that are also listed, but publish their financial statements in accordance with other standards than IFRS, comparison remains a real problem. This often remains the case for the Central European subsidiaries of European banks, which continue to publish their financial statements in accordance with local standards, e.g. Komerční Banka (Société Générale Group) in the Czech Republic or BPH (UniCredit Group) in Poland.

The scope for interpretation also remains colossal. In this respect, the regulatory authorities play a leading role because they retain the capacity to influence the options chosen by the banks for purposes of application of the standards. So in Spain, the banks continue to recognise general provisions despite the fact that such provisions have been banished in most of the other countries that have adopted IFRS. Until the end of 2007 Spanish issuers will also continue to amortise their goodwill. In the United Kingdom, dividends paid during the previous year are added back for Tier 1 ratio purposes. In principle, accounting and prudential divergences of this sort are supposed to be resolved by European cooperation but in practice harmonisation is only ever partial.

The banks and their regulators are moving towards harmonisation but one sometimes has the impression that it's one step forward and two back. Overall we must expect that progress will only be gradual. For example, the Bank of Spain has stated that the Spanish banks' faculty to recognise general provisions in their IFRS accounts should be discontinued in 2009. The criteria in respect of which the authorities have made their own choices have not been favourable to any real adhesion to the philosophy of IFRS.

There has also been some disappointment in terms of the international consistency of accounting policies. We did not think that so much local variation would be possible, and some of that variation will subsist into the medium term because it is very much linked to the structure of local entities, to their culture and to the relationship with their local regulators. I'm thinking in particular of the United Kingdom.

Has the relevance of financial statements been improved?

Overall, yes, but there remain numerous instances of IFRS accounting entries which do not equate with economic reality and which therefore hamper users' understanding of the accounts. For example, in the area of corporate and investment banking the day one P&L provision changes from one quarter to the next despite the fact that the change disclosed is hardly useful to the market, so that sort of information is perceived as artificial and difficult to comprehend.

The same goes for the treatment of certain provisions associated with PEL and CEL [*Plan Epargne Logement / Compte Epargne Logement*] savings accounts in French banks' balance sheets: the provisions reported are devoid of economic value because the net balances of the

related accounts are not separately disclosed from one year to the next. To provide the market with a better understanding, the banks then publish pro forma statements which discount the impact of these provisions. No-one gains from this kind of complexity.

Certain banks, such as Lloyds TSB, go so far as to publish three sets of financial statements: IFRS, IFRS but without exceptional items, and IFRS without exceptional items and after re-weighting. That strikes me as reflecting a problem of quality with the standards.

Another example, investment portfolios that under IAS 39 have to be classified as trading, available-for-sale or held-to-maturity: the associated differences in accounting treatment pose a problem. The previous vision, which simply distinguished in principle between strategic investments and purely financial investments, was preferable and provided a better understanding of the underlying economic reality. Despite the praiseworthy intention of increasing financial statement reliability, IAS 39 thus paradoxically gives precedence to rules over principles i.e. achieves exactly the opposite of what the IASB proclaims to be its philosophy.

What is your view of financial reporting transparency?

More information is undoubtedly available but it is not necessarily of better quality than before. It is indeed not to be excluded that the strategy of certain issuers may consist in drowning the financial analyst under the quantity of information provided. For the purposes of goodwill impairment testing, the definition of the applicable cash-generating units is sometimes rather fictitious mainly as a result of the somewhat literal vision of the auditors.

The problem is an inevitable one whenever new rules are introduced: to begin with, application tends to focus on the letter rather than the spirit of the law. This dimension may gradually improve but there are not yet very many indications to that effect.

The reality is that accountants are still focused on the previous accounting standards. They do not yet “think IFRS”. Children born in the 1940s count in francs, those born in the 1960s and 1970s count in francs or in euros depending on the size of the amount, those born in the 1990s count everything in euros. It’s the same thing for accounting standards.

It will take a generation for IFRS to be fully assimilated because the issue is above all one of training. That’s also the reason for which harmonising practices is so difficult, and the problem is the same but worse with the local regulators who are even longer in changing their modes of reasoning.

To return to the quality of the information provided, the rupture introduced by IFRS naturally creates a problem in respect of historical data. For example in the area of banks’ commissions and interest margins, the available series of data reflect accounting policies which have changed from one year to the next and in some cases, subsequently to first-time adoption of IFRS. That raises doubts as to the quality both of the information and of the audit.

What has been the impact of IFRS in terms of volatility?

The banks publish pro forma data whenever IFRS create “artificial”, non-economic accounting volatility, as in the case of the French PEL and CEL provisions that I have already mentioned. This does not amount to earnings management, which in the banking sector has greatly diminished as a result of the adoption of IFRS mainly as a result of the suppression of any provisions for general banking risks. The phenomenon has not completely disappeared – in certain areas of corporate and investment banking it can still be clearly perceived by comparing the final quarter accounts to the three previous ones – but there is definitely less scope for manipulating the accounts than previously.

IFRS have not modified the banks' strategies or their management practices – in contrast with Basel II which did have a real impact. But on the other hand the new standards are no doubt going to change the perception of risk exposures in particular as regards systemic risk.

Does the process of convergence between IFRS and US GAAP provide anything positive?

I have the impression that the ambition for convergence is rather lukewarm on the American side. The IASB is keener than the FASB because the latter body remains largely driven by internal US considerations.

What is needed for comparability to be more effective?

There is a need to educate certain national regulators! Beyond that, perhaps more centralised control of implementation of the standards will be required. At present, only the Scandinavian countries have really taken on board the philosophy of IFRS. Market pressure alone will not suffice because investors are not accounting specialists so no conclusive peer pressure can be expected on their part.

So there will be no spontaneous convergence of practices. There is nothing to prove that stock market performance can be correlated with the quality of accounting policies so any alignment on best practices is likely to be limited, as is any direct pressure by investors for improvements in the quality of accounting given that very few analysts possess the necessary accounting skills. Nor must one overestimate the intensity of the market's interest for financial statements. A few lines of the income statement concentrate the essential part of their attention and the balance sheet often tends to be somewhat neglected.

As a result, if practices are to converge the mesh of rules will necessarily have to be tightened. In the absence of any such movement towards rules-based standards, more and more companies are liable to invent their own standards by publishing pro forma financial statements. Alternatively, if IFRS do not provide for sufficient comparability, US GAAP might regain popularity because they at least impose the same rules on all issuers! In the long term, the risk for IFRS is therefore to end up by being perceived as irrelevant if expectations in terms of comparability are not addressed. For the moment, of course, the question is not formulated in such bald terms but I think that the longer-term issue for the IASB is a very important one.

What has been the role of auditors during the transition?

The auditing profession has taken a long time to develop proficiency in respect of IFRS and issuers have sometimes had the impression that it has been to their cost. It is more worrying to note that the profession has not exercised the intellectual leadership that might have been expected.

As a result, it cannot be ruled out that they have sometimes been a little manipulated. In 2003-2004 a certain number of banks seemed to be focusing their financial communication more on the audit profession than on the market: their intention was clearly to persuade the profession to adopt and relay their own views as a means of imposing them on the other players in the market.

I think that this relative absence of leadership is a consequence of the structure of audit firms in which the most experienced partners focus essentially on client relationships. The technical functions are intended to provide a common language but they are far from the field and their role thus sometimes remains rather theoretical. The real impact of the audit is therefore not always as great as one would expect.

Nor do the credit rating agencies play a very positive role because they tend essentially to retain their previous formats of analysis, simply making more numerous adjustments than before to the data they receive. They do not therefore contribute to accelerating the transition towards the new framework.

What has been the impact of the market environment?

The favourable market environment has not had any direct impact on IFRS implementation. In contrast, a downturn would have consequences in terms both of amplifying the impact of the cycle (because general provisions have vanished) and possibly accentuating system risk (via the shortfall in revenue if large losses had to be recognised on prior transactions). In sum, the question of liquidity risk might arise.

From this point of view, one must not underestimate the dimension of irrationality. If there were to be a significant change in market conditions, its corollary might be a sudden shift in the market's perception of risk and relationship to that risk.

Naturally that would not compromise the existence of IFRS but it might finally lead the market to change its basis of reference, which is not yet the case. A crisis might also revive the belief that the financial sector is subject to multi-annual trends to which the concept of fair value is only very imperfectly adapted. The debate on the integration of long-term cycles within the accounts of financial institutions is not, in my view, entirely over.

Pierre Vaquier, Managing Director, and **Laurent Liot**, Director of Finance and Administration

AXA Real Estate Investment Managers France

What is your assessment of the passage to IFRS in your business, property investment?

It's still too early to express a judgement. The technical complexity of the transition is now evident but the consequences in terms of investor behaviour are not yet apparent.

With the passage to IFRS and the simultaneous implementation of the Sarbanes-Oxley Act, the accounting profession has implemented an extremely complex framework. There is a sentiment of lack of mastery of the new processes which engenders a certain perplexity. In the past, debates with the auditors were tinged by a combination of strict application of principles and common sense. At present one sometimes has the impression that principles are disappearing behind a mass of very technical texts, piloted from London or New York, subject to response times, in the event of a request for interpretation, of as much as six to nine months. And these difficulties are not all linked to the transitional period, so some of them may prove to be persistent.

From the investor's perspective, the cost of the new framework is more visible than its added value. And there are real problems of consistency in the standards' implementation by different businesses. But we are adapting. Despite IFRS, we shall continue to use a lot of non-accounting data to assess projects' economic performance.

The component approach, which is one of the main changes, poses particular problems. The fact is that in the case of real estate, obsolescence is more of an art than a science. A skyscraper in La Défense can be thirty years old but not in the least obsolete, whereas certain more recent buildings are already in need of renovation. From this point of view the systematic component approach is a form of set piece without any firm economic basis because, contrary to what one might believe, real estate involves a lot of intangibles.

As for the concept of control for purposes of consolidation, its consequences are logical but its implementation is costly and complex in terms of administration.

In a word, there is disappointment at the absence of economic vision. Balance sheets will now fluctuate in line with the markets, as a consequence of fair value, but we won't have gained in terms of hard assessment of performance.

Are there nevertheless some positive aspects?

We do not really see any at present but perhaps it is still too early. Comparability will not be achieved either for so long as the Unites States remain subject to US GAAP.

It's true that the scope for interpretation has if anything diminished, for example in terms of the distinction between capital expenditure and expense of the period, which is the positive side of the component approach.

Is there now greater risk of accounting manipulation?

The options retained by different entities do not always strike us as particularly coherent, and we sometimes have the impression that technicality now takes precedence over reasoning, but the resulting difficulties of comprehension do not amount to manipulation and we don't have the impression that the risk of manipulation has increased as such.

In the property business, application of the concept of fair value requires professional valuations which, in the same way as for private equity, cannot be reduced to a mechanical approach or exact science. Historically the result has been a certain smoothing or lag compared to the reality of the market. At present the market has become more liquid and transparent but even so, mark to market still does not apply literally to property.

In the specific context of insurance groups there is also the question of the long-term nature of balance sheets which is not taken into account by IFRS albeit that dimension of resilience is at the heart of the insurance concept. During the 1990s the banks were obliged to sell off a lot of their depreciated property assets but the insurers generally managed to weather the storm.

Another as yet unresolved question is that of the optional recognition of fair value adjustments either in profit or loss or directly in equity. Property companies tend to opt for the former approach.

In retrospect, the Sarbanes-Oxley Act was initially viewed with apprehension, and it is true that its implementation proved onerous, but the development has ultimately proved a manageable one and even a source of added value. The component approach introduced by IFRS so far has much less to say for it. A certain number of professionals, no doubt for reasons both of technical satisfaction and commercial advantage, will always be tempted to rigidify and complicate the application of the standards. It will be many years before we shall really be able to assess the impact of the adoption of IFRS.

Thibaud de Vitry, Director of Investment Affairs responsible for liaison with AXA insurance entities

AXA Investment Managers

What is your point of view as to application of IFRS by the insurance industry and the associated challenges for AXA?

In the same way as for other businesses, the preoccupation of insurers is to maximise their profits whilst at the same time minimising volatility in their income statements and, to a lesser extent, in their balance sheets. From this point of view, IFRS have made it necessary to rethink asset management so as to maintain economically optimal asset allocations compared with the liabilities they are designed to cover. Pending phase 2 of the insurance IFRS, the IASB has authorised the use of methods such as shadow accounting, hedge accounting or the fair value option. These methods are sometimes difficult to handle, and are very demanding in operating terms, but, combined with a judicious choice of asset categories, they do help minimise profit and loss volatility.

Compared with the French standards previously applicable, IFRS have extended the scope of consolidation and brought the content of mutual funds onto the balance sheet. That can have an impact on the management profile of these funds, in particular when they include investments in shares or corporate bonds, because under IFRS the classification of assets is linked not to their nature but to the manner in which they are managed in order to create wealth. The difficulty in holding shares is made all the greater by the numerous uncertainties which subsist at this stage for the Solvency II project, more particularly as regards the compatibility of the criteria defined by CEIOPS and the horizon, not of ownership, but of management of the share portfolio. Let us remember that the longer the horizon, the greater the return on shares compared to other asset categories (including after adjustment for risk) and so the greater the protection against inflation.

The classification of assets under IAS 39 reflects asset management profiles and their structure in such a way as to conserve the same asset allocations and sources of added value for both alpha and beta purposes. In this way AXA entities have preserved their potential for creating long-term investment performance whilst at the same time reducing the short-term volatility of their accounting result. To simplify, assets managed with a view to long-term capital gains are classified as available-for-sale, whilst assets acquired in the context of short-term performance strategies (e.g. based on momentum analysis) are classified as held for trading. We had to take care to perform this classification without changing our allocations between classes of asset but by reinforcing the weighting of the management profiles contributing to long-term value creation.

As part of AXA's "Ambition 2012" performance improvement project, we are aiming to improve long-term asset returns via both improved product mix and improved performance of each product. That implies modifying our long-term allocation whilst avoiding any aggravation of income statement risk, i.e. achieving improved economic and accounting returns without increasing accounting volatility. This amounts in a sense to optimising an accounting Sharpe ratio at the same time as the economic one.

Has the adoption of IFRS provided the market with information of better quality?

The information provided in respect of asset management is new and different. In order to maintain optimal asset allocations from an economic point of view it may be necessary to have greater recourse to derivatives and other techniques of balance sheet structuring. But it will be more and more difficult to summarise the complexity of the strategies engaged in within a set of consolidated financial statements, and in terms of communication complexity has never been synonymous with quality.

IFRS are merely a new language for communication between the different players in the market, players who must continue to learn the language so as to improve their mutual understanding. It is simply regrettable that this language, and more particularly the fair value rule, is not naturally compatible with the dual objective of value creation to meet long-term liabilities, and low exposure to volatility in the income statement.

In terms of comparability, different entities have made some different choices of category but there are common trends even so. Almost no-one has used the held-to-maturity category and only limited use has been made of the held for trading category. The complexity involved in consolidating mutual funds has limited recourse to their use. Hedge accounting is employed to some extent. Management profiles have evolved but the underlying choices are not explained in detail.

In general, the choice of categories has also been influenced by management of the transition from the old to the new accounting framework including the impact on reserves of latent gains. Overall, comparability is neither better nor worse than before. There has not yet been a great deal of standardisation.

Have IFRS resulted in any short-term management focus?

The fair value rule introduced by IFRS focuses valuation on the short term despite the fact that the real value created by holding an asset depends on its purchase price and resale price and not on the change in its price during any given accounting period. For the long-term management horizons which are those applicable to insurance liabilities, the premium offered by shares or corporate bonds is an excellent complement of remuneration compared to the income provided by government bonds. The risk associated with this premium diminishes over time so it's a win-win situation for both shareholders and customers.

Since IFRS were implemented the economic environment, particularly as regards the market for shares, has remained favourable and there has been no crisis. Many entities are going to discover the volatility of their income statement in the future because volatility will inevitably arise as a result of their choices of the categories defined by IAS 39. Entities with experience of American accounting standards already know all about accounting volatility and its perception by investors. The markets impose focused accounting treatments which to some extent are at odds with the economic logic of long-term optimisation. There is no doubt that investors sanction accounting volatility.

It is to be feared in this respect that the Solvency II reform, by introducing annual value testing, will make things worse rather than better. It will also be necessary to ensure that Solvency II does not result in a system of dual standards, particularly in terms of information structure, i.e. that IFRS, including the future new standard on insurance liabilities, and Solvency II remain mutually compatible. But this compatibility is far from being certain as regards, for example, the calculation of technical provisions.

Will implementation of the standards become more coherent as time goes by?

The IASB's objectives are structurally irreconcilable with the economic constraints of long-term financial protection. The specific characteristics of this sector, and in particular the necessity of taking position as a long-term investor in the markets, are not fully recognised. If an optimal solution exists it will impose itself as a point of convergence for all the market players but we don't yet have one in view. We shall only gain in visibility assuming a market crisis and that is hardly what we want. The audit firms are playing a very positive role in providing accounting guidance and thus improving the overall consistency of implementation of the new standards.

Adam Ward, Senior Research Analyst

AXA Rosenberg

AXA Rosenberg's investment approach is based on quantitative analysis of large amounts of corporate financial data. How did the shift to IFRS impact your activity?

Generally speaking, IFRS has been a step in the right direction. Cross border comparability of financial data has improved. There has been significant effort on the part of companies (issuers), and it has been beneficial for users of financial information. Aside from comparability, there is greater transparency and more detailed and consistent information. This applies, for example, to cash flows or segment information.

That said, I don't think practices have become completely uniform, as one can still see a lot of what I call 'nostalgic accounting', where companies do their best to keep similar accounting policies to before in spite of the change of standards, because they are used to a certain approach.

Fair value accounting is controversial, because as the information becomes more relevant it also becomes more volatile. However, I believe that most investors would agree they prefer information to be 'approximately correct rather than precisely wrong.'

From a technical standpoint, we had to make some very minor adjustments to ensure data was consistent on transition. Like many managers, we needed to manage the changes in earnings estimates where goodwill amortization was removed. However, generally speaking very few adjustments have been necessary to adapt our investment process.

You make heavy use of financial information databases. Has there been a problem of broken time series?

Most of our processes are based on static data. We build our own pro forma financial statements taking differences between national sets of standards into account: for example, on inventories and R&D. From this perspective, IFRS has made our job simpler. Furthermore, many companies (e.g. South African companies), already used IFRS before 2005, so we already had a reference point.

Is IFRS-induced accounting volatility a problem? Did it lead companies to focus on the short term?

We use the most up to date information once it has passed various detailed checks as to its reasonableness. Today this accounting information is provided by various financial database vendors. In the future, with XBRL or other comparable standards, the same information might be provided directly by issuers. But for us, it would change little apart from the method of the integration of the data.

As to short-termism, there is no doubt that accounting rules have an impact on corporate behaviour. We saw this with corporate pension plans in the way some types of software were marketed for example, and in stock options, and insurance investments. But I generally hope that corporate managers don't allow IFRS or fair value accounting to force them to make more short-termist decisions.

Do IFRS favour earnings management?

Earnings management is always possible, but in principle IFRS's are designed to reduce the scope for it, e.g. the rules on provisions. There is risk of earnings management in fair value estimations, but as time goes by, fair value valuation practices should become more consistent.

Are you satisfied of the level of comparability that has been reached with IFRS?

It is still all very new. CFOs' reactions are still determined by their old national standards to some extent. Old habits die hard, but fortunately, accountants are rapidly amassing experience and the impact of first-time application options will gradually disappear.

I think that investors assume that issuers and auditors accept the trend towards convergence. But they have understood how difficult these accounting issues can be, and are ready to show some patience as long as the trend remains in the right direction.

What is your assessment of the 'principles-based' nature of IFRS?

I personally am in favour of a principles-based approach, over a rules based approach for the reason that it allows the true substance of the accounting standard to reign. Interpretation issues should reduce over time.

How is the role of auditors evolving?

I think that investors make the general assumption that auditors do their job correctly, but of course, as soon as there is a transition towards something new, there are also new risks. I believe investors paid close attention to the audit opinions of companies at the time of transition!

What will be the next difficult steps?

Convergence with US GAAP, and 'comprehensive income'. In both cases, there will be difficulties and risks, but also possible benefits! Convergence of course is essentially an opportunity, but its implementation is likely to take a long time. There is also the risk it does not happen at all. Comprehensive income influences the old market practice of focusing on earnings per share.

Of course, there are many other important standards being developed, such as insurance contracts, for example.

Are you concerned with the new IFRS8 standard on operating segments?

The risk is that the new standard leads to less consistent data. I would be interested to see how the new standard, once endorsed, results in different disclosures.

Glossary of Acronyms

AFG	Association Française de la Gestion financière
AMF	Autorité des Marchés Financiers
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEL	Compte Epargne Logement
CESR	Committee of European Securities Regulators
FAS	Financial Accounting Standard (in US GAAP)
FASB	Financial Accounting Standards Board of the US
FFSA	Fédération Française des Sociétés d'Assurances
FRS	Financial Reporting Standard (in the UK)
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board (since 2001)
IAS	International Accounting Standards
IASC	International Accounting Standards Committee (1973-2001). The acronym remains in use by the IASC Foundation, created in 2001
ICAEW	Institute of Chartered Accountants of England and Wales
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IOSCO	International Organisation of Securities COMmissions
IT	Information Technology
PEL	Plan Epargne Logement
PER	Price-Earnings Ratio
SEC	US Securities and Exchange Commission
XBRL	eXtensible Business Reporting Language

