DECIPHERING IFRS

What Analysts Need to Know About IFRS Transition

Introduction

The transition from Canadian generally accepted accounting principles to International Financial Reporting Standards (IFRS) for public companies in Canada is imminent.

Similar to the CFA Institute, the Ontario Securities Commission's mandate is to foster fair and efficient capital markets and to enhance investors' confidence in the market place. Having all market participants ready for the transition to IFRS is important to achieve this objective.

The analyst community plays an important role in our capital markets. It is essential to both analysts and the greater investing public for companies to disclose significant IFRS related information prior to the first IFRS interim filing.

To assist analysts in preparing for the type of IFRS information they will require, we have included the following questions for analysts to consider:

Question: Is the company ready for the transition?

Most public companies[1] are required to adopt IFRS for fiscal years beginning on or after January 1, 2011. In other words, the first quarter financial reports filed in 2011 for these companies will be in IFRS. Time is becoming critical, especially for calendar year-end companies, as the first IFRS filing date nears.

Companies are required under securities legislation to discuss their IFRS changeover plan in their 2010 year end management's discussion and analysis (MD&A). To date, we have observed that some companies have done a better job than others at providing entity-specific and comprehensive transition disclosure. So some companies' disclosure may not contain all the information an analyst needs to know about the company's preparedness. For example, it is important for an analyst to know:

- What is the status of the company's transition? Is it on schedule or behind?
- Have any issues come up, and if so, how does the company plan to address them?
- What remaining steps are left in the transition process (for example, completing the quantification of the impact of IFRS adoption)?

Analysts should note that a 30-day extension to the filing deadline of a company's first IFRS interim report has been granted under securities rules.

Ultimately, it is critical that an analyst knows whether the company will be able to file its 2011 first quarter report on time. There are serious regulatory consequences if a company misses its filing deadlines, one of which is that we may respond with a cease trade order.

[1] The adoption of IFRS by rate regulated entities and investment funds is deferred. Canadian public companies that are also SEC issuers may prepare their financial statements in accordance with U.S. generally accepted accounting principles.

Question: What impact will the IFRS transition have on the company's financial results?

The adoption of IFRS will likely cause recognition, measurement and presentation differences in a company's financial statements. It is important for analysts to understand the various financial impacts of IFRS adoption in order to isolate any business issues that cause changes in a company's financial results.

Knowing how the transition to IFRS may affect a company's key performance indicators is important. For example, the debt-equity ratio may be a key performance indicator for a company that has significant debt financing. How will the transition to IFRS affect the values of these financial metrics and the way they are calculated? As key performance indicators differ from one industry sector to another, and even from one company to another, analysts should look for explanations from companies that are specific to the company's own circumstances.

Analysts are already aware that IFRS allows more accounting policy choices than Canadian generally accepted accounting principles. Accounting alternatives available under IFRS may make it more difficult to compare a company against its industry peers. Therefore, accounting policies selected by a company and the reasons behind the selection will be important information for an analyst, especially if the selection made by the company is different from that made by its peers.

In doing their financial analysis of a company, analysts often use financial modelling techniques that require various items reported in the financial statements as inputs. It is therefore important to look for answers to questions such as:

- How will the adoption of IFRS affect a company's revenues and net earnings?
- Will the adoption result in significant changes to a company's assets and/or liabilities? Will it have an adverse impact on equity?
- How will IFRS adoption affect a company's cash flows?
- How will the adoption affect a company's taxes payable?
- What are the ongoing impacts of specific IFRS accounting policy choices?

In order for these types of questions to be answered, it is important that companies provide specific information in sufficient granularity. For example, analysts will find it helpful to have the quantitative impact of the transition by major financial statement line items. In their 2010 year end MD&A, companies will have to discuss the expected effect of the changeover to IFRS on the issuer's financial statements, or a statement that the company cannot reasonably estimate the effect. If a company indicates in their 2010 year end MD&A that it cannot reasonably estimate the quantitative effect, an analyst will need to understand why that is the case, given that the filing of the first quarter IFRS report is right around the corner from year end reporting.

Potential increase in earnings volatility is often cited as one of the effects of IFRS adoption. In order to gauge the extent of this effect on a company, an analyst's financial analysis would not only need to include information that pertains to historical impact. Information that enables the analyst to assess trends and to come up with financial outlooks for the company, such as changes in the nature of a company's accounting estimates resulting from the adoption, will also be essential.

Question: What impact will the transition have on a company's business activities?

The adoption of IFRS is not just an accounting exercise. It may also change a company's business activities. For example:

- Accounting policy choices available under IFRS may affect a company's philosophy for managing its assets or business.
- The executive compensation structure may be amended to accommodate any changes in the financial metrics used to evaluate an executive's performance.
- Financial covenants in banking or other agreements may be affected by changes in a company's financial results due to IFRS, which may lead to amendments to such agreements or possible covenant breaches and defaults.
- A company may also change its dividend distribution policies in light of the company's changed financial results that could emerge from applying IFRS.

In general, any area that relies on the use of financial information should be carefully reviewed for possible management modifications in practices as a result of the transition. It is important to understand what business activities have been impacted by the adoption of IFRS since these changes may have financial implications.

Conclusion

Our research of IFRS transition in other countries shows that companies that provided a greater level of proactive IFRS disclosure benefitted from more accurate analyst forecasts. Canadian public companies that provide sufficient information about their conversion process and its effects prior to the changeover date will reduce the level of investor uncertainty about IFRS readiness and inform investors and other stakeholders about the potential for volatility in future reported results. This disclosure should lead to a more stable and less disruptive transition to IFRS, which will be beneficial to all market participants.

It is important for analysts to anticipate the type of information they will require in advance of the IFRS transition, and look for that information from a company's public disclosures. The information should be clear and entity-specific rather than boiler-plate. This information should assist analysts in their review of financial information in a company's first IFRS interim financial report. Investors and the capital market as a whole will ultimately benefit from high-quality advice from analysts as companies enter the new era of reporting in IFRS.

Reference Resources:

Some of the IFRS reference resources available on public websites are included below for your convenience:

Ontario Securities Commission website:

http://www.osc.gov.on.ca/IFRSGuide

Canadian Institute of Chartered Accountants website:

http://www.cica.ca/ifrs

http://www.acsbcanada.org/international-activities

Financial Executives International Canada website:

http://www.feicanada.org/pdfs/CFERF%20IFRS%20Readiness%20in%20Canada%202010.pdf

Ontario Securities Commission Contact Information:

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