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THE IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS): EVIDENCE FROM CANADA

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Abstract:

The Canadian transition to IFRS provides a valuable IFRS learning opportunity. The Canadian transition and implementation of IFRS provides a unique opportunity to examine the conversion of financial reporting from a similar set of financial reporting rules as U.S. GAAP in a similar economic and business environment. The implementation and adoption of IFRS is not a monolithic event. Our ability to comprehensively understand and assess IFRS requires transparent disclosures such as those mandated by IFRS 1 and disaggregation of the equity components to observe and measure the impact of IFRS as it pertains to discretionary management implementation choices, material reclassifications, and GAAP-to-GAAP differences. Comprehensive knowledge of IFRS 1, First Time Adoption of International Financial Reporting Standards is crucial to our ability to assess the transitory and future impact of IFRS. IFRS 1 sets the precedent for financial reporting under IFRS, overrides transitional provisions included in other IFRS, and prescribes detailed disclosures. This detailed "rules-based" standard permits discretionary management policy choices which have material impact on transitory reporting as well as future financial results.

Key words: *IFRS 1, disclosures, management discretionary choices.*

1. Introduction

In 2011, Canada mandated International Financial Reporting Standards (IFRS) for financial reporting. The adoption of IFRS in Canada is of particular importance to U.S. financial reporting constituents. Both jurisdictions share many similarities such as high-quality reporting and accounting standards with strong enforcement, market-oriented economies, and common-law legal systems. Whereas Canada moved forward with IFRS, the U.S. initiative toward global accounting standards stalled due to concerns about cost, implementation, and the effect on smaller companies. In 2014, Christopher Cox, former U.S. Securities and Exchange Commission Chairman, once an advocate for the U.S. adoption of IFRS for financial reporting declared, “the moment has passed for broad IFRS adoption by U.S. domestic companies.” However, Mary Jo White, current U.S. Securities and Exchange Commission Chairman, reaffirmed that IFRS will continue to be a top priority to the SEC. Further progression was made in December 2014, when current SEC Chief Accountant James Schnurr introduced a proposal allowing voluntary filing of supplemental IFRS material in financial statements by U.S. public companies.

However, Paul Beswick, former Chief Accountant, Office of the Chief Accountant U.S. Securities and Exchange Commission at the 32nd Annual SEC and Financial Reporting Institute Conference summed up the most important reason why IFRS is relevant to U.S. constituents, “Put simply, the reason that IFRS matters to the U.S. is that the U.S. is heavily invested in companies that prepare their financial statements using IFRS.” This statement holds true when it comes to the Canadian transition to IFRS. Canada is the #1 trading partner with the U.S. for imports and exports representing 16.5% of all U.S. Trade for 2013.

Leading up to 2006, Canadian accounting standards (CA GAAP) paralleled U.S. GAAP. In fact, CA GAAP and U.S. GAAP were so closely aligned that Canadian and U.S. regulators determined that CA GAAP and U.S. GAAP were allowable alternatives for cross-listed companies under the Multi-jurisdictional Disclosure System (MJDS). Canadian regulators accepted U.S. GAAP for domestic reporting and the SEC accepted CA GAAP without requiring a reconciliation to U.S. GAAP. Motivated by the desire to expand access to global capital markets and reduce the cost of capital, the Canadian Accounting Standards Board (AcSB) changed the course of the Canadian financial reporting system by announcing its intention to adopt IFRS in January 2006 with mandatory application date of January 2011. Canada provides the first opportunity for the U.S. to observe the application of IFRS in a country context similar to the U.S.

For many CPAs, our ability to assess financial reporting under IFRS has been confined to the concept of IFRS rather than the application of IFRS. The Canadian transition and implementation of IFRS provides a unique opportunity to examine the conversion of financial reporting from a similar set of financial reporting rules as U.S. GAAP in a similar economic and business environment. The objective of this article is to present evidence and observations from the implementation of IFRS for a sample of Canadian publicly accountable enterprises (i.e. publicly-traded) by examining their required equity reconciliation disclosures.

2. Canadian early adopters

Prior to the mandated January 2011 adoption date, Canada permitted early adoption of IFRS subject to Provincial approval. Although the sample of companies examined in this article are early or voluntary adopters of IFRS, the implementation process and reporting requirements are the same for early adopters as for mandatory adopters. 69 publicly accountable enterprises opted for early adoption of IFRS.

As presented in Exhibit 1, the Canadian early adopters were primarily dominated by the mining industry. The primary stock exchanges in which the companies traded were fairly evenly split between the large-cap, Toronto Stock Exchange and the smaller-cap, Toronto Venture Exchange. Both markets are dominated by commodity stocks due to the concentration of natural resource businesses in Canada. As measured by market capitalization, these entities ranged in size from $103 billion to $3.2 million. As measured by total assets, these companies ranged in size from $61 billion IFRS ($57 billion CA GAAP) to $1.4 million IFRS ($1.9 million CA GAAP).

Exhibit 1

PROFILE OF CANADIAN EARLY ADOPTERS

Industry Breakdown	
Extractive Industries	72%
Manufacturing	16%
Utilities	5%
Real estate, Rental, and Leasing	5%
Professional, Scientific, and Technical Services	2%
By the Market	
Toronto Stock Exchange	51%
Toronto Venture Exchange	49%

IFRS 1

IFRS 1, *First Time Adoption of International Financial Reporting Standards* sets the precedent for financial reporting under IFRS, overrides transitional provisions included in other IFRS, and prescribes detailed disclosures. IFRS 1.39 requires the first IFRS financial statements to include a reconciliation of the equity reported under national GAAP to the equity under IFRS at the date of transition to IFRS and at the end of the latest period for comparative information presented in the first IFRS financial statements. The reconciliation of equity is of particular interest as it presents the same cumulative economic activity as measured under two sets of standards – CA GAAP and IFRS. According to IFRS 1.40, the reconciliations have to be sufficiently detailed in order to enable users to understand the material adjustments to the balance sheet and income statement. These reconciliations also report management choices permitted under in IFRS 1, material reclassifications of accounts within the statement of financial position, and remeasurement of all accounts in accordance with IFRS.

3. Management choices

IFRS 1 permits the election of exemptive choices in specific areas where the cost of complying would exceed the benefit to financial reporting or where retrospective application would be impractical. Optional exemptions represent choices of accounting policies under IFRS. These accounting policy choices would be the same options for U.S. companies transitioning to IFRS. In a study examining European Union (EU) publicly-traded companies, these choices have demonstrated a significant impact on an entity's future financial results (Jermakowicz and Gornik-Tomaszewski 2006). Exemption choices represent compromises of the IFRS measurement system upon adoption and amounts are included as reconciling items in the IFRS 1 equity disclosure. The Canadian entities elected, on average, three optional exemption choices upon adopting IFRS. Exhibit 2 presents the top five optional exemption choices by entity, the percentage of entities which elected the exemption, and the average effect of the exemption on retained earnings.

Exhibit 2

TOP 5 OPTIONAL EXEMPTION CHOICES	Percentage of Entities electing exemption choice	Average effect on Retained Earnings as reported in millions
Business combinations	74%	$4.024
Share-based payments	74%	-2.073
Cumulative Translation Adjustments	59%	-1,221.733
Borrowing costs	41%	-14.729
Fair value or revaluation as deemed cost	28%	169.295

All amounts are reported in Canadian dollars.

Although business combinations and share-based payments represented the most commonly exercised management choices, the cumulative translation adjustment represented the largest magnitude adjustment to retained earnings at a decrease of $1,221.733 billion on average. This exemption permits firms to zero out balances of cumulative translation differences for all foreign operations at the transition date. Similar to U.S. GAAP, under CA GAAP, these differences were recorded in accumulated other comprehensive income as unrealized gains and losses. Upon transitioning to IFRS, the majority of the firms elected to reclassify aggregated unrealized gains and losses to retained earnings. Exemptive choices such as the cumulative translation adjustment represent elections which permit management discretion as to the timing of gain and loss recognition and the "permanent" by-passing of the income statement. Transparency of the magnitude effect of these elections is crucial to our ability to discern management choices from pronouncement differences. Because this accounting choice represents a material reclassification among the components of equity – accumulated other comprehensive income and retained earnings, this is only observable when equity is disaggregated.

4. Material reclassifications

As demonstrated by the cumulative translation adjustment example in the previous section, the transition to IFRS permits management choices which are treated as material reclassifications. The total reclassification effect for all companies is isolated and revealed in Exhibit 3. The largest reclassification effect was within the adjustment to retained earnings at $13,582.856 billion. Of this amount, $13,424 billion related to cumulative translation differences.

Exhibit 3

IFRS ADJUSTMENT TO EQUITY COMPONENTS AND THE RECLASSIFICATION EFFECT

	IFRS adjustment before Reclassification Adjustment in millions	Reclassification Effect in millions	As Reported in millions
Contributed capital	-$2.409	$43.538	$41.129
Retained earnings	16,399.252	-13,582.856	2,816.396
Accumulated other comprehensive income	-0.219	13,539.318	13,539.099
Total stockholders' equity	$16,396.624	$0.000	$16,396.624

These material reclassifications are not observable when analyzing the effect of IFRS on total shareholders' equity because the adjustments net out to zero. These material reclassifications and the accounting choices or standards which triggered the adjustment can only be properly evaluated upon the disaggregation of the components that comprise shareholders' equity and emphasize the need for accountants to understand and analyze IFRS 1 disclosures.

5. GAAP-TO-GAAP differences

The impact of IFRS adoption for any individual company can only be properly understood by analyzing the underlying GAAP differences which give rise to the cumulative adjustments. Exhibit 4 eliminates the effect of equity reclassifications to reveal the true GAAP-to-GAAP differences. IAS 16, *Property, Plant, and Equipment*, IAS 40, *Investment Property*, and IAS 12, *Income Taxes* demonstrate the greatest magnitude effect on retained earnings with average adjustments of $6,526.822 billion, $2,465.221 billion, and -$842.656 million, respectively.

Exhibit 4

STANDARDS AFFECTING REPORTED ADJUSTMENT TO RETAINED EARNINGS

Standard	Percent of Companies affected by Standard	Average retrospective adjustment to Retained Earnings in millions
IAS 16 Property, Plant, and Equipment	18%	$6,526.822
IAS 40 Investment Property	15%	2,465.221
IAS 12 Income Taxes	31%	-842.656
IAS 41 Agriculture	9%	288.879
IAS 18 Revenue Recognition	18%	-264.501

All amounts are reported in Canadian dollars.

On average, IAS 16 triggered the largest retrospective adjustment to retained earnings which affected 18% of all companies. An examination of company financial statement notes disclosed fair value orientation of IFRS and componentization as explanations for the reconciling difference. IAS 16 which permits two subsequent measurement models for an entire class of assets – the cost model which recognizes assets at historical cost less accumulated depreciation or the election of the revaluation model. Upon electing the revaluation model, an entire class of assets are recorded at their fair value and evaluated regularly to ensure the asset's book value does not differ materially from fair value at the end of the reporting period. IAS 16 also prompts a retrospective adjustment to retained earnings in its required application of component accounting which requires an asset's cost to be segregated into its components for depreciation. A separate component can be physical (e.g. aircraft engine) or nonphysical (major overhaul). Similar to U.S. GAAP, CA GAAP permitted component accounting, but did not mandate it.

The adjustment to retained earnings attributable to IAS 16 exemplifies the necessity to disaggregate the effect on equity to discern management choices related to the implementation of IFRS from the magnitude effect of pronouncement differences. Exhibit 5 brings forward the financial effects of IFRS 1 and IAS 16. Both standards are associated with the remeasurement of Property, Plant, and Equipment; however, IFRS 1 *Fair Value or Revaluation as Deemed Cost* is a transition choice made by management which permits a one-time revaluation of property, plant, and equipment on an item-by-item basis to fair value. The adjustment related to IAS 16 represents the application of IFRS. The retrospective application to retained earnings is a measurement of the difference between reporting systems – CA GAAP and IFRS.

As demonstrated by this example, these balance sheet items are not only affected by pronouncement differences, but accounting choices made at adoption.

Exhibit 5

Standard	Percent of Companies affected by Standard	Average retrospective adjustment to Retained Earnings in millions
Fair value or revaluation as deemed cost (IFRS 1)	28%	$169.295
IAS 16 Property, Plant, and Equipment	18%	$6,526.822

All amounts are reported in Canadian dollars.

The evidence from the Canadian Early Adopters of IFRS underscores the importance of the IFRS 1 detailed disclosures which disaggregate equity into its components. The decomposition of equity distinguishes standard by standard differences from material reclassifications among the components of equity. This information is critical to practitioners, investors, and academics to enhance their ability to evaluate and assess the impact of accounting standard changes to financial reporting.

These observations should put practitioners and professionals on notice that the way in which we disclose and analyze equity components could be consequential to our ability to assess a GAAP change, be it a single standard or a wholesale GAAP changeover such as IFRS.

6. References

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