

Perspectives on the Canadian Banking Industry



Putting International Financial Reporting Standards (IFRS) in Motion

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Putting IFRS in motion – background

International Financial Reporting Standards (IFRS) were adopted by the International Accounting Standards Board (IASB) with the objective to achieve uniformity and transparency in the accounting principles used by businesses and other organizations for financial reporting around the world¹.

IFRS is much more than a change in accounting rules or a GAAP reconciliation exercise. Adopting IFRS will require changes across organizations.

More than 70 countries have mandated the use of IFRS by public companies, including banks and other financial institutions. Financial institutions in Europe have been applying these standards since January 1, 2005. Indeed, investors outside North America are becoming increasingly comfortable with IFRS. A recent PricewaterhouseCoopers (PwC) survey of European fund managers found that 59% felt IFRS provided a good basis for assessing the historical performance of a company, while 45% considered it more useful than US Generally Accepted Accounting Principles (GAAP).

In Canada, Canadian GAAP will migrate to IFRS over a transition period in the next five years. The move to IFRS will change the way Canadian companies present their business results to analysts, investors and other stakeholders. The implementation of IFRS for Canadian financial institutions may, at first, look like a complicated, expensive and difficult process. However, the size and complexity can be managed if companies plan ahead before the new accounting and reporting standards become effective.

Canadian financial institutions arguably will have a head start on the adoption of IFRS that was not afforded to their European counterparts. Existing Canadian GAAP is principles based, like IFRS, not rules based. By the IFRS transition date, Canadian financial institutions will have already adopted IFRS-like rules for accounting for financial instruments. However, differences in accounting between the two standards still remain. IFRS rules on derecognition of financial assets and liabilities (which may impact securitizations and other structured transactions) need to be examined as differences exist. New emerging rules on accounting for certain insurance contracts can have an impact on banks with significant insurance activities. Canadian financial institutions will need to closely examine these and other IFRS standards to identify all relevant differences.

Moving to IFRS – key considerations

Given that IFRS will become the primary reporting language for Canadian financial institutions, the implementation of IFRS is not a straightforward process. Nor is it simply a technical exercise for the finance function. Financial institutions that have already implemented IFRS know that it places a sizeable responsibility on management to be able to communicate effectively to the market in the new language. Following are some of the key considerations for those moving towards implementation.

The Canadian Accounting Standards Board (AcSB) announced its objective to migrate Canadian GAAP to IFRS through a five-year transition period. In July 2006, the AcSB's IFRS Implementation Plan (the Plan) was released. There are a number of areas that may cause uncertainty for adopters. This uncertainty will most likely impact project timelines and work effort.

Timeline considerations

Within the Plan it indicates that the exact changeover date to IFRS will not be formalized until 2008² which may cause uncertainty for adopters. Furthermore, the changeover date

¹ PwC recently published "International Financial Reporting Standards – A Pocket Guide 2006" which covers details of IFRS that are not presented herein. This publication, along with those shown at the end of this document, can be found on our website (www.pwc.com/ifrs) or by contacting one of the partners listed on the last page.

² For illustrative purposes, the timelines herein assumes an enterprise with a calendar year end.

Transition and timing

being considered in the Plan is a financial institution's 2011 fiscal year at the latest. This means that companies will be required to have 2010 comparative figures in compliance with IFRS.

A financial institution cannot afford to wait for the final confirmation of the changeover date given that companies will need to disclose to key investors and stakeholders the following:

- 2008 – companies' plan for convergence; and
- 2009 – expected impact on financial results as a result of the adoption of IFRS.

Financial institutions' project plans will need to be nimble.

Accounting considerations

The AcSB intends to work towards eliminating existing differences between Canadian GAAP and IFRS over the transition period by adopting new IFRS that will continue to emerge as a result of global accounting standard setters' (including the US) desire to harmonize frameworks. Financial institutions' project plans will need to be nimble to take these changes into account.

Regulatory considerations

The Plan contained some actions that the AcSB will be undertaking in the interim period. The most significant of these is to address the US Securities and Exchange Commission (SEC) requirement for two years of comparative financial statements in SEC filings. The AcSB will approach the SEC to request an exemption from this requirement in the year of transition for Canadian SEC registrants. If this request is not granted, Canadian SEC registrants will be required to have IFRS financial statements in fiscal 2011 presenting two years of comparative figures prepared using IFRS compared to one for non-SEC registrants.

PwC's worldwide experience in assisting numerous financial institutions that have already adopted IFRS shows that, for some, full conversion and adoption can take anywhere from two to five years, depending on the complexity of the organization.

Smaller financial institutions with few geographic locations and the requirement of limited systems changes will tend to have a shorter implementation period. Larger multinational financial institutions with decentralized operations around the world, old legacy systems and numerous business platforms will typically have longer implementation periods. Regardless of size and complexity, if a financial institution waits until 2008 before commencing the conversion to IFRS, it may not have sufficient time to complete the process.

Technical implications

Our experience has shown that the scoping phase of the project, where accounting differences should be highlighted, is extremely important. One of the most significant challenges in converting from Canadian GAAP to IFRS is determining the relevant GAAP differences that will impact the organization. The impact of these differences depends on the financial institution and its accounting policy choices made to date. The upcoming adoption of the new Canadian GAAP financial instruments standards (including CICA 3855 – Financial Instruments: Recognition and Measurement) which are based on IFRS principles, represents the first phase in the move towards IFRS. However, there still remain differences between the two accounting frameworks relating to financial instruments.

Significant accounting differences between IFRS and Canadian GAAP often reside in the details, causing recognition, measurement and/or presentation differences. Careful planning and proper use of certain options available under IFRS, however, can eliminate some of these GAAP differences.

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Some of the accounting areas where the more significant differences arise between Canadian GAAP and IFRS include:

- Financial instruments (recognition and measurement);
- Loan loss provisioning (including additional disclosures);
- Accounting for insurance contracts;
- Derecognition;
- Consolidation of special purpose entities (SPEs);
- Financial instrument disclosures (proposed effective date for year ends beginning on or after October 1, 2007);
- Impairment;
- Stock-based compensation;
- Contingent liabilities;
- Exit and restructuring costs;
- Employee future benefits;
- Business combinations; and
- Income taxes.

Canadian institutions that are also SEC registrants should also keep in mind the accounting differences between IFRS and US GAAP in their migration exercise.

Communication

The financial statements of a Canadian financial institution will look different under IFRS than they currently do under Canadian GAAP. Senior executives need to be prepared to discuss the reasons for, and nature of the differences to board members, shareholders, the investment community, financial analysts and banking regulators. A detailed communication plan is necessary to educate stakeholders and to actively manage perceptions. There are a number of ways this is achieved. PwC's experience with financial institutions in Europe has shown that early communication, including the sharing of pro forma financial statements with preliminary figures and/or opening balance sheets under IFRS—in advance of transition date—has allowed investors and analysts to understand and get comfortable with financial results and their presentation.

PwC experience in Europe has shown that late or absent dialogue with key stakeholders concerning the financial implications of the adoption of IFRS could result in a direct impact on share price.

The reality is that there are differences in the specific application of IFRS from one institution to another.

Because IFRS and its underlying International Accounting Standards are a global set of standards that are judgment based, they are subject to differences in interpretation. While a primary aim of the IASB is to have a global set of standards applied consistently, the reality is that there are differences in the specific application of a particular accounting rule from one institution to another. Communication of key policy choices, interpretations and accounting decisions in some detail may also be necessary to differentiate and explain a financial institution's financial results under IFRS as compared to its peers. As previously noted, the AcSB has recommended that companies disclose their transition plans by 2008. Furthermore, those financial institutions that are subject to Canadian Securities Administrators (CSA) regulations are also required to disclose the effects of anticipated accounting policy changes—including the anticipated effects of IFRS on the financial statements.

Managing the business in an IFRS environment

IFRS will present unique challenges for senior management, the financial reporting function, the treasury function and many other areas across the organization. IFRS may impact existing management reporting including budgets, forecasts, performance measures, reward schemes and bonus structures, key performance indicators and covenants. Furthermore, new procedures should be considered to ensure IFRS implications are considered as part of the approval process for all new strategic investments.

Impact on systems and processes

Performing the systems realignment outside of a “fire-drill” environment would lead to better decisions on IT investment and more user-driven engagement.

Education, awareness and culture

Regulatory

IFRS compliance may require the realignment of reporting systems for new and additional data. PwC experience has shown that those implementing IFRS underestimate the time and resources needed to meet this challenge. This is especially true with existing management systems or “legacy systems” from past acquisitions that have never been updated and are not geared to provide sufficient or appropriate data for preparing new and increased disclosures. Performing the systems realignment outside of a “fire-drill” environment would lead to better decisions on IT investment and more user-driven engagement.

Other process changes under the move to IFRS can be equally as important and may include the following:

- Expanding existing reporting templates and other checklists to incorporate supplementary data required for additional disclosures under IFRS;
- Rationalizing or expanding the chart of accounts to post additional measurement changes and/or collect additional disclosures under IFRS;
- Reviewing period-end close procedures to achieve efficient close times;
- Reviewing outsourced operations’ controls and capability in producing IFRS compliant information; and
- Obtaining IFRS information from significantly influenced investees and/or variable interest entities.

The migration to IFRS may require a training program that combines knowledge transfer with the ability to address skills, attitudes and motivation. The entire organization, not just finance and accounting, will need to be trained in this area—internal audit and investor relations as examples. Building out from the finance and accounting groups, training should focus on what information individual business units will need to provide in order to comply with IFRS and how IFRS will affect their decision-making and value creation strategies.

PwC experience has shown that early awareness training for key executives and board members, highlighting the more important impact areas and changes under IFRS, will allow for a smooth adoption/conversion program. This will enable key stakeholders to be fully briefed on the new requirements and help drive a positive spirit of change management throughout the organization.

The adoption of IFRS will require financial institutions to consider various regulatory requirements.

The Canadian environment

In Canada, key items such as capital ratios and capital adequacy tests will be impacted as a result of the new IFRS financial reporting requirements. Canadian regulators are continuing to assess the implications of new accounting requirements and it is clear that the changes will at a minimum impact the structure and content of regulatory returns for Canadian financial institutions.

The Office of the Superintendent of Financial Institutions (OSFI) will likely also have a voice on the adoption of IFRS. Recently, OSFI has published guidance that restricts the use of fair value accounting under emerging Canadian GAAP. It is possible that further OSFI guidance could be issued as they review the lessons learned by global regulators in countries already reporting under IFRS.

If there are more accounting restrictions imposed by Canadian regulators, there may be options available under IFRS that Canadian financial institutions will not be able to use. It is expected that any new regulations imposed in Canada will align with those of other global regulators. If not, this potentially modifies the goal of a “global GAAP” that is

consistently applied around the world and enables apples to apples comparisons of financial results.

US considerations

Financial institutions that prepare US GAAP financial statements or reconciliations for their US GAAP filings may see the elimination of these requirements with the move to IFRS. The SEC is working towards eliminating the need for companies reporting under IFRS to reconcile to US GAAP by 2007 or 2009 at the latest.

This may provide incentive for Canadian financial institutions that are also SEC registrants to adopt IFRS early; however, careful consideration is required. Early adoption of IFRS will require a Canadian financial institution to be fully compliant with IFRS in a shorter time period and will therefore require consideration of additional IFRS standards that are not currently in effect—an accounting risk that may not outweigh the benefit of avoiding US GAAP accounting. Furthermore, financial institutions must not forget certain current legal requirements to have Canadian GAAP financial statements right up to the IFRS changeover date.

Management's assessment process under Sarbanes-Oxley 404 needs to be modified and updated to align with new processes as the institution migrates to IFRS.

Internal controls over financial reporting

Public financial institutions will also need to consider Multilateral Instrument 52-109 (certification of disclosure in issuers' annual and interim filings) and Sarbanes-Oxley requirements (management assessment of internal controls) as they adopt IFRS as their primary GAAP. Specifically, financial institutions will need to update their documentation on the internal controls over financial reporting and related evaluation procedures for processes and changes impacted by the IFRS migration.

Mergers and acquisitions (M&A) implications

The move to IFRS will add increased complexity to M&A transactions and may delay or prevent their completion. The main challenges will be the need to translate the target's historical and projected performance into IFRS to assess the accounting implications of the transaction and to understand the impact on the acquirer's earnings per share.

Complexities in IFRS accounting will lead to tougher due diligence requirements when evaluating targets in the financial services sector, even if the target is already reporting under IFRS.

Given that IFRS are principles based rules, comparability and consistency in the application of IFRS across countries and companies could vary markedly. Acquirers may need to devote more time and resources to scrutinizing how the targets' numbers have been produced.

The potential cost of bringing the target's reporting systems up to the acquirer's standards, and the time required to do this, could be a significant factor in synergy realization and integration timelines, especially as we get closer to the changeover date.

Most unlisted companies will not prepare IFRS accounts as the majority of jurisdictions around the world do not require IFRS financial statements for non-public enterprises. To the extent that a Canadian financial institution completes any acquisition of a target company not currently reporting under IFRS before 2011, they will need to include the targets in their IFRS conversion and readiness plan.

PwC's experience assisting financial institutions on M&A transactions has shown that they have struggled to obtain the additional data and disclosure requirements of target companies under IFRS.

Effective implementation, organization and resources

It is easy to underestimate the volume and complexity of the work involved with the implementation of IFRS. A Canadian financial institution adopting IFRS for the first time must retroactively apply the standards in a consistent manner across its reporting groups. To ensure uniform application of IFRS throughout the organization, a financial institution must document its accounting policy selections and make sure they are consistently followed. Communication and implementation across the various constituencies in a matrix organization will need careful planning and skilled resources.

PwC experience in Europe and Asia has shown that financial institutions transitioning to or applying IFRS for the first time will often try to make manual adjustments from local GAAP to IFRS using spreadsheets or similar tools. However, this “quick fix” conversion can often prove not to be the most cost or operationally effective choice in the long run—especially as it can be prone to error, confusion and typically lacks the appropriate internal controls surrounding its preparation.

Our experience has been that a more comprehensive approach to conversion with systems, process, policies and procedures designed to embed IFRS into day-to-day operations, internal management information systems and the mindset of staff has proven to be a much more sustainable approach.

There are already several exposure drafts and recently issued new standards from the IASB which are expected to be effective in 2009 for those already adopting IFRS.

On the horizon

While the AcSB will continue to keep stakeholders apprised on the roadmap to IFRS adoption and conversion over the next five years, the essential framework is now in place. Financial institutions in Canada should pay attention to what is coming from the IASB during the intervening period until full adoption in Canada.

In February 2006, the FASB and the IASB released a memorandum of understanding that laid out a joint program of work with the goal of convergence of the US and international accounting standards. As recently as July 2006, the FASB and IASB have published a first draft of a partial joint, common conceptual framework. Furthermore, in July 2006 the IASB announced that in order to ensure stability of the IFRS platform of standards, they will not require the application of new IFRSs under development or issue major amendments to existing standards before January 1, 2009. The establishment of this approach does not preclude the publication of new standards and/or exposure drafts before that date. Canadian financial institutions should keep abreast of any new standards and consider their implications within their conversion plan before they are even effective.

There are already several exposure drafts and recently issued new standards from the IASB which are expected to become effective in 2009 for those already applying IFRS. Given the timing of the changeover date (2011) and the adoption of these new IFRS standards (2009), companies need to watch the horizon closely to ensure decisions are nimble and flexible.

How can PwC help?

The most viable approach to IFRS conversion will vary from one organization to another; however, our experience has shown that a critical success factor is early consideration and a well-planned implementation approach.

Through its global network, PwC has unparalleled experience helping global financial institutions adopt IFRS and has assisted with IFRS conversion projects for a significant portion of the world's largest financial institutions.

If you would like to discuss any of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers, or any one of the following partners:

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PricewaterhouseCoopers has published the following publications on International Financial Reporting Standards and corporate practices; they are available from your local PricewaterhouseCoopers office and can be found at www.pwc.com/ifrs.

- Accounting for change: A survey of banks' 2005 IFRS annual reports
- Reporting under the new regime: A survey of 2005 IFRS insurance annual reports
- Acquisitions – Accounting and transparency under IFRS 3
- Adopting IFRS – A step-by-step illustration of the transition to IFRS
- Financial instruments under IFRS
- IAS 39 – Achieving hedge accounting in practice
- IFRS Disclosure Checklist 2006
- IFRS Measurement Checklist 2006
- IFRS News – Shedding light on the IASB's activities
- IFRS Survey: The European investors' view
- Illustrative Consolidated Financial Statements 2006 – Banks
- Illustrative Corporate Consolidated Financial Statements 2006
- Illustrative Financial Statements 2006 – Investment Funds
- Making the Change to International Financial Reporting Standards
- Ready to take the plunge? IFRS readiness survey 2004
- Share-based Payment – A practical guide to applying IFRS 2
- SIC-12 and FIN 46 R – The substance of control
- Similarities and Differences – A comparison of IFRS and US GAAP
- Understanding IAS 29 – Financial Reporting in Hyperinflationary Economies

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