IFRS WILL CHANGE FINANCIAL STATEMENT ANALYSIS AS WE KNOW IT

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Get ready to rethink everything you know about traditional financial statements. When International Financial Reporting Standards (IFRS) comes to Canada in January 2011, the basic look and feel of financial statements will change substantially. Much of the underlying accounting will become more subjective and open to more management discretion, which may not be welcome news to analysts who have spent years optimizing financial models to properly depict the true picture of a company.

IFRS is a standardized set of accounting principles for public companies that has been sweeping the world. Most countries, with the exception of Canada and the United States, have been using it for a few years. As we join the ranks of our global peers, we will lose much of our analytical prowess and will seemingly start from scratch in determining the best way to analyze statements. The United States is in the process of converging U.S. GAAP with IFRS and is expected to adopt it several years after Canada, although the exact date has not yet been decided. In the meantime, U.S. GAAP will prevail south of the border. Although Canada will be taking a leadership role in moving to IFRS before the United States, the result will be that much of the American analytical software we use may not easily apply to the new financial norms.

For everyone who derives comfort from the fact that balance sheets "balance," that comfort level is about to disappear. In a few years, instead of being split into the traditional categories of assets, liabilities, and equity, the new balance sheet will be divided into five categories–operating, financing, investing, taxes, and discontinued operations. Assets and liabilities will be scattered within each section while equity will remain intact. Companies won't be required to show a total for assets or liabilities on the new balance sheet as long as these totals are included somewhere in the financial statement notes. The same holds true for subtotals related to short-term or long-term assets and liabilities. Calculating common ratios, such as debt-equity ratios or current ratios, will become challenging. Of course, the balance sheet still balances but it just isn't obvious. (See the accompanying diagram.)

Companies may see their unadjusted ratios decrease as result of IFRS accounting policies. Equity is the denominator in many common ratios used in financial statement analysis, for example debt to equity and return on equity. Under GAAP, non-controlling interest is located between the liability and equity sections of the balance sheet, but under IFRS it will be part of the equity section. In addition, many ratios used in debt covenants will need to be recalculated or companies may be at risk of breaching their covenants.

The income statement will also be split into operating, financing, and investing categories and will be much more detailed than it is now.

One welcome change with IFRS is the new cash flow statement, which will show clearly and concisely the sources and uses of cash in the organization. Current cash flow statements often don't show this directly and instead require a number of adjustments to net income. The new format will simplify this.

There are also a substantial number of new financial notes under IFRS–in some case running to over 300 pages. A typical set of notes for a Canadian public company might currently only be 40 to 50 pages long. The new, lengthier disclosures are required because IFRS has more accounting choices available to management and it is important for users of financial statements to read through these notes to understand how the numbers are being calculated.

At the same time, IFRS won't be used by all organizations immediately. In 2011, IFRS will become mandatory for public Canadian companies. Private companies and not-for-profit organizations will be able to continue reporting under existing Canadian accounting standards but could opt to convert to IFRS. This means that there will be two financial statement formats in use and CFA charterholders must be comfortable with both.

The new format of the financial statements makes sense, giving a common look and feel to different financial statements so that it is easier to link between statements. That being said, after years of optimizing financial models to decipher the meaning behind financials, there is no doubt that IFRS will increase the complexity and value of financial statement analysis. This, compounded by the increase in management subjectivity inherent in the financial statements, means that the already challenging task of analyzing financial statements is about to become far more complex.

SAMPLE STATEMENT OF FINANCIAL POSITION

BUSINESS	2010	2009
Operating		
Receivables	16,320	12,960
Less: allowance for bad debt	(480)	(240)
Inventory	6,240	4,800
Prepaid expenses	4,560	5,760
Property, plant and equipment	8,160	5,760
Less: accumulated depreciation	(2,160)	(1,440)
Goodwill	4,800	6,000
Intangibles (net)	14,640	16,320
Accounts payable	(4,560)	(3,840)
Accrued liabilities	(13,440)	(17,760)
Accrued long-term liabilities	(1,200)	(720)
Net operating assets	**32,880**	**27,600**
Investing		
Available for sale assets (short-term)	480	720
Investment in sub (long-term)	1,440	1,200
Total investing assets	**1,920**	**1,920**
NET BUSINESS ASSETS	**34,800**	**29,520**
FINANCING		
Financing assets		
Cash	34,320	22,560
Total financing assets	34,320	22,560
Financing liabilities		
Dividends payable	(720)	(720)
Short-term debt	(3,360)	(240)
Long-term debt	(17,040)	(11,760)
Total financing liabilities	**(21,120)**	**(12,720)**
NET FINANCING ASSETS	**13,200**	**9,840**
INCOME TAXES		
Short-term		
Income tax payable	(1,920)	(2,880)
Long-term		
Deferred tax assets	2,520	3,240
NET INCOME TAX ASSET	**600**	**360**
DISCONTINUED OPERATIONS		
Assets held for sale	4,800	5,280
Liabilities related to assets held for sale	(1,920)	(1,920)
NET ASSETS HELD FOR SALE	**2,880**	**3,360**
EQUITY		
Share capital	(10,800)	(11,040)
Retained earnings	(38,460)	(30,000)
Accumulated other comprehensive income	(2,220)	(2,040)
TOTAL EQUITY	**(51,480)**	**(43,080)**

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