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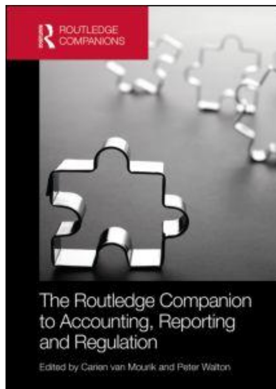

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Multinational Corporations and IFRS

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20

Multinational Corporations and IFRS

Malcolm Cheetham, Manfred Kaeser and Juliane Scheinert

1. Introduction

For the assessment of the impact of IFRS on multinational corporations (MNC) one is tempted to take a narrow view and to think of the burden of increasingly complex standards and increased disclosure requirements which often are only for compliance purposes with little additional value to the users. However, the comparison of today's financial statements with the ones presented twenty or thirty years ago clearly shows the progress made in the area of financial reporting. Many terms and concepts have been created and have become common accounting language, such as goodwill, fair value less costs to sell, value in use, and which now have a very clear common definition.

This longer term view gives hope that the difficulties companies have faced with the changes in accounting standards is the price to be paid for constant improvements which will ultimately result in high quality financial reports. Rome was not built in a day. Such massive undertaking, such as building international accounting standards, cannot be done without pain and effort from all participants. As a Swiss-based multinational company in the pharmaceuticals industry, Novartis is directly impacted by the changes in the accounting standards. Like its peers, the company has to live up to high standards in terms of quality of its products and ethical behavior in a global and transparent environment. The compliance with rules and regulations for financial reporting just as with other standards is expected. Therefore, Novartis is keen to actively participate in the project of developing high quality accounting standards.

2. MNCs' participation in, or influence on, international accounting standard setting

Novartis's participation in the standard setting process happens in various ways: the company's involvement in the standard setting process of the IASB; exchange of information with other pharmaceutical companies on the European and global levels; and intensive discussion with

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other preparers within Switzerland. The involvement of entities in the standard setting process is important as it helps companies to take ownership in the development of requirements for financial statements. If they can participate in new IFRS standards they are in a better position to understand where financial reporting is heading and to adjust systems and procedures on time to cope with new reporting requirements.

2.1 Involvement in the standard setting process of the IASB

The IASB itself offers various possibilities for participation in the due diligence process. The most common form is the comment letter on exposure drafts in which Novartis tries to provide the business view on new standards or on amendments to existing ones. Novartis considers this an important tool especially where it considers that the proposed changes do not add value or the changes could even provide a misleading picture. This means that Novartis does not issue comment letters in the company's name on all standards which are exposed but works together with peer companies within the pharmaceutical industry or with other preparers in Switzerland. When these comment letters cover all Novartis issues, it does not generally produce another comment letter just to repeat the issues already covered by others.

IASB outreach sessions, or field-tests, which are organized from time to time and where Novartis participates whenever possible, is an efficient form of involvement as it permits a dialog with the IASB staff and allows for a better understanding of the proposed changes. There are mutual benefits for both IASB staff and the preparers and users when issues can be discussed in these outreach sessions face-to-face on the basis of specific transactions.

A significant number of the IASB Board members and some of its staff also meet several times a year with representatives of companies that have an interest in the development of IFRSs at meetings known as the Global Preparers Forum, normally at the Board's offices in London. Currently one of the 16 members of this forum is the Chief Accounting Officer of Novartis. The purpose of the Global Preparers Forum is to provide input into concepts and proposals that the IASB is developing and offer advice to the IASB on the practical implications of its intended proposals for preparers of financial statements.

Last, but not least, the conferences and workshops organized by the IFRS Foundation as part of its education initiatives are a valuable source for entities to provide continued professional education to associates working in the finance and reporting departments. The information and the material received through these conferences can be used internally to train management at all levels of the organization in a continued process of improvement of technical accounting knowledge.

2.2 Discussions with peer companies within the same industry

Representatives of multinational pharmaceutical companies meet on a regular basis to discuss the implications of proposed or newly implemented accounting standards. These discussions are often driven by auditors, who have a vested interest in a common interpretation of accounting standards and a common solution for practical issues within the industry. There are also industry specific congresses on accounting and reporting issues where a wide range of speakers from the audit profession, enforcement bodies and consultants present their involvement and their views on changes in accounting standards.

2.3 Discussions with other preparers

In Switzerland, SwissHoldings, which is an association representing the interests of Swiss industrial and service groups, has a subgroup on accounting and financial reporting. This subgroup pro-actively monitors developments and trends regarding IFRS, provides feedback statements to the IASB, and supports principles-based standards based on well-defined and clear rules. This feedback is normally in the form of comment letters on proposed changes to the accounting standards. In other countries, our peer companies work with similar local associations and with the national standard setters to represent the interests of their constituents in the development of IFRS.

On a European level, Novartis also participates in the technical discussions organized by the EFRAG (the European Financial Reporting Advisory Group) on the implications of new accounting standards.

2.4 Particular situation of Swiss multinational companies

Switzerland, even though a relatively small country with only approximately 8 million inhabitants, is nevertheless home to a substantial number of world-renowned companies in the fields of banking, insurance, pharmaceuticals, luxury goods and food processing, to name just a few areas. At the end of 2011 it had three companies listed in the top 50 worldwide companies by market capitalization according to the *Financial Times*.

Due to the importance of these Swiss MNCs on the world scene there has been an increasing need for these companies to be considered on a level playing field financially with their peer companies from especially Anglo-Saxon countries with a long history of producing high quality financial statements for the use of investors, Swiss companies therefore participated at a very early stage in the development of the IAS (International Accounting Standards – now IFRS). This was due to the lack of local regulations in Switzerland. A law to mandate companies to establish consolidated accounts was only presented by the government to the Swiss Parliament in 1983, becoming effective only in 1992. During this period, Swiss companies had a keen interest in developing accounting standards which would help the production of their consolidated accounts. When the presentation of consolidated accounts became mandatory, many Swiss companies established their accounts based on IAS. They could have based them also on the Swiss GAAP or on US GAAP. However, many companies considered that IAS provided a better framework than the local GAAP, which was more adequate for small and medium-size companies, or US GAAP, which was considered to be too focused on the US business and legal environment.

2.5 MNCs' participation: conclusion

The exchange of information between companies during the standard setting process has a benefit which goes far beyond the shared view on specific accounting issues. It intensifies the dialog between entities across the globe and allows entities an insight into alternative methods on how to face the challenges of industry in particular and of the financial community in general. It fosters discussions on systems, procedures and organizational structures which otherwise may not take place. These intense discussions also prepare the ground for a consistent application of new accounting standards once they have been adopted.

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In summary, IASB generally follows due process which allows companies to assess implications of new accounting standards and to provide feedback on their concerns. However, some accounting standards or specific disclosure requirements which are presently written for a particular industry such as the financial services industry do not provide useful information in other industries and therefore reduce the relevance of financial statements in those other industries and as a result often reduce financial reports under IFRS to a mere compliance exercise. For example, IFRS 13 on fair value measurement prescribes that for quoted instruments the market price is the basis of their fair value. As long as a single share or a single debt instrument is the unit of account this concept makes sense. However, in certain circumstances, for example in a business combination, the unit of account is not a single share, but an entire stake. Due to the existence of minority discounts and control premiums the value of an entire stake might be different from the market price of a single share multiplied by the number of acquired shares. The concept underlying IFRS 13 ignores such situations even though IFRS 3, the relevant standard for business combinations, explicitly accepts this situation. The result of this is that currently there is a conflict between the measurement guidance in IFRS 3 and IFRS 13, which could be due to the fact that IFRS 13 was written mainly to address the issues related to specific transactions in the financial services industry.

3. Financial reporting in Multinational Corporations (MNCs) before and after the adoption of IFRS

The evolution of accounting standards, and of IFRS in particular, has changed the financial accounting and reporting departments of MNCs. Accounting and reporting managers have increasingly become business partners who are involved at a very early stage in strategic decisions such as acquisitions, divestments and reorganizations in order to understand and assess the impact of these transactions on the financial statements. This has changed the accounting department from performing backward-looking compliance tasks towards business partnering, helping to create or preserve value. For example, the requirement to perform a purchase price allocation for a business combination forces accountants to identify the key value drivers of a business. It is not sufficient just to determine that a certain transaction is strategically appealing. Instead the strategic rationale has to be quantified and the value of the entire transaction has to be split between the net identifiable assets of the acquiree and its future growth platform. As a result, the expected future value creation of the combined business is expressed in terms of future earnings and helps to quantify the strategic rationale. As a result certain proposed transactions might not be entered into in the first place.

Novartis's predecessor companies, Sandoz and Ciba, carried out the adoption of IAS (now IFRS) in the early 1990s. IAS was much simpler in those days so that the most important impact of its adoption was the alignment of internal management reporting with external financial reporting. This concentration on one set of accounts brought a higher focus on externally published financial results and thereby contributed to the overall quality of the financial statements. However, the adoption of IAS also brought with it the need to educate finance associates on the existing standards and keep them up to date on ongoing changes.

As a result of the Novartis listing at the US SEC in May 2000, a reconciliation from IAS to US GAAP had to be provided for the Group's net income and equity. This reconciliation was provided from the date of the listing until the discontinuance of this requirement at

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the end of 2006. Although there were considerable differences between IAS and US GAAP during this period, the information provided with this reconciliation did not attract much attention from the financial community because the differences were clearly related to the different accounting standards and were of a non-cash nature. Fortunately, this extremely onerous requirement was removed which shows that even the US SEC shares the preparers' concerns about the cost–benefit analysis of financial reporting. See Table 20.1, which shows the details of the US GAAP reconciliation for 2006 and 2005.

Table 20.1 Novartis US GAAP reconciliation for the periods ending 31 December 2006 and 2005

	2006 USD millions	*2005 USD millions*
Net income from continuing operations under IAS/IFRS	**7,019**	**6,072**
US GAAP adjustments:		
Available-for-sale securities	–114	278
Inventory	103	20
Associated companies		–6
Intangible assets	–1,743	–1,238
Property, plant and equipment	58	53
Pensions and other post-employment benefits	–198	–181
Deferred taxes	125	178
Share-based compensation	–5	–44
Non-controlling interests	–27	–11
Others	–68	
Net income from continuing operations under US GAAP	**5,150**	**5,121**
Net income from discontinuing operations under US GAAP	114	69
Net income under US GAAP	**5,264**	**5,190**
Earnings per share under US GAAP		
- Continuing operations earnings per share (USD)	2.19	2.19
- Discontinuing operations earnings per share (USD)	0.05	0.03
- Total earnings per share (USD)	2.24	2.22
Diluted earnings per share under US GAAP		
- Continuing operations diluted earnings per share (USD)	2.18	2.19
- Discontinuing operations diluted earnings per share (USD)	0.05	0.03
- Total diluted earnings per share (USD)	2.23	2.22

(*Continued*)

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Table 20.1 Continued

	31 Dec. 2006 USD millions	*31 Dec. 2005 USD millions*
Equity under IAS/IFRS	**41,294**	**33,164**
US GAAP adjustments:		
Available-for-sale securities	–37	–24
Inventory	–11	–23
Associated companies	–307	25
Intangible assets	1,349	4,092
Property, plant and equipment	–436	–409
Pensions and other post-employment benefits	15	3,133
Deferred taxes	130	–1,438
Share-based compensation	–186	–96
Non-controlling interests	–183	–174
Others	61	
Net assets related to discontinuing operations	–19	50
Total US GAAP adjustments	376	5,136
Equity under US GAAP	**41,670**	**38,300**

4. Opportunities that IFRS offers to Multinational Corporations

The advantages offered by IFRS to MNCs go far beyond the preparation and presentation of financial statements. As discussed above, IFRS have significantly contributed to turning the accounting departments into business partners. IFRS have also created the base for a more intensive exchange of information on accounting and financial reporting between all interested parties.

4.1 Single global accounting standard increases quality of reporting

The IFRS have made a significant contribution to the quality of today's financial statements. The global footprint of IFRS has made it much easier for MNC to recruit skilled local accounting specialists who understand international accounting standards as well as local regulations. Without the introduction of IFRS it would have been difficult to achieve the same level of common understanding of technical accounting matters within the MNC.

The wider base of common understanding of technical accounting also facilitates the exchange of information between peer companies and a proactive identification of accounting issues and the development of commonly accepted and high-quality accounting solutions for industry specific issues. This common base also enables frequent benchmarking of a company's accounts against those of competitors, which potentially leads to incremental improvements to produce higher quality information.

The importance of IFRS to today's global businesses also requires IFRS to keep its momentum for continuous improvement by leveraging the input from preparers, regulators, auditors, researchers, and analysts from across the world. During the due process for new standards the proposed principles are challenged and tested by people with diverse

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backgrounds, both geographically and industry specific, which helps to create robust principles. However, there are situations in which the standard setter is not able to cope with the substantial amount of input and is therefore forced to focus on a certain industry which seems to be most affected. This may lead to inappropriate solutions for other industries.

4.2 Basis for a global process and control framework within a multinational group

Historically, due to the diversity of local accounting standards, there were often diverse practices in place within MNCs to convert local accounts into their group accounts, prepared using a single set of accounting rules. The acceptance of IFRS in many jurisdictions enables MNCs to standardize the process around producing statutory and group accounts thereby strengthening the related internal controls. One example is the establishment of a global Chart of Accounts (C.A.). If such a C.A. had to reflect the needs of different accounting rules in the various jurisdictions, the sheer volume of the accounts to be covered would impair the ability to maintain and understand the C.A. However, if the C.A. is based on a global accounting standard, local specialties may still need to be addressed, but there is a higher likelihood a specific requirement in one jurisdiction being essentially the same as in another jurisdiction, so that one local account is needed instead of two.

5. Challenges that IFRS presents to Multinational Corporations

5.1 Introduction

IFRS prescribes the production of financial statements based on theoretically coherent models. However, the drive for consistency between the various standards sometimes requires entities to present issues in a very complex way as shown below.

5.2 Complexity of standards impairs communication with stakeholders

As principle-based standards, IFRS accounting guidance is usually founded on well-established theoretical concept. However, theoretical concepts are usually based on simplified assumptions, thereby reducing the complexity often encountered in practice. As long as the different aspects of the complexity can be explained by the theory underlying the respective IFRS standard, the implementation of the standards usually leads to appropriate results. However, not all economic aspects of certain transactions may be covered by the concept of the applicable standard. In some cases, the theoretical concept even leads to counterintuitive results. This impairs the understandability of a company's financial reports. Often such issues are addressed by voluminous disclosure on certain transactions, which can be difficult to understand. Even if all transactions of a business fitted well into a specific accounting framework, the amount of additional disclosures to be provided to explain the details is often enormous. Important facts and circumstances are typically buried somewhere in these notes and are not easy to detect. Analysts often call companies with specific questions to which the answer is already provided in the notes. Extensive disclosures do not always help to increase transparency but can even decrease it. As a result, the financial statements can no longer be used as a communication tool; instead their preparation becomes more of a compliance exercise.

The following are some examples of situations in which theoretically sound concepts lead to results which are difficult to communicate.

a) Deferred tax on unrealized intercompany inventory profit at the buyer's tax rate

According to IAS 12 deferred tax assets and liabilities have to be measured using the tax rate and the tax base consistent with the expected manner of recovery. This requires the application of the buyer's tax rate when setting up a deferred tax on the elimination of unrealised intercompany profits in inventory in consolidated accounts. As shown below this may lead to anomalies in the income tax recognized in the consolidated accounts:

> *Example:* Subsidiary A resides in a tax jurisdiction with a tax rate of 20 percent and sells products intercompany which remain in subsidiary B's inventory. Subsidiary B is domiciled in a tax jurisdiction with an applicable tax rate of 30 percent. Subsidiary A generates a profit taxable of CU 100 on the transaction which is fixed at 20 percent (CU 20). As this is an intercompany transaction the profit gets eliminated in the consolidated accounts. One would expect that the current tax expense of CU 20 is offset by an equal deferred tax income on the unrealized profit eliminated on consolidation. However, this is not the case as the buyer's tax rate has to be used to calculate the deferred tax income (ie. CU 30). As this is different from the seller's tax there is a net tax income of CU 10 recorded on the consolidation.

The theoretical rationale is embedded in the standard's principle that the deferred tax rate should be based on the expected manner of recovery: the buyer (subsidiary B) carries the inventory; accounting and tax base in the buyer's accounts is equal to the purchase price. However, for the consolidated accounts the unrealized intercompany profit embedded in the inventory is eliminated. This creates a difference between the accounting base and the tax base on which a deferred tax asset has to be set up. As the asset is recovered through the third-party sale of the inventory by subsidiary B, the higher tax rate of subsidiary B has to be applied to calculate deferred taxes.

As shown, this concept results in a net deferred income tax income expense on intercompany transactions, if the seller and buyer are subject to different tax rates. This is a counterintuitive result and not straightforward to explain to management and investors.

b) Difference in accounting for contingent consideration for assets acquired as part of a business or on a standalone basis

An asset can be acquired on a standalone basis or as part of a business in a business combination. Although the economic value of the asset is the same, some potentially significant differences might arise in the accounting where there is contingent consideration to be paid on the outcome of a future event. These differences are of particular importance if the acquisition is of a single asset in a transaction which needs to be treated as a business combination. This is the case if an asset is acquired along with employees and contracts so that the definition of a business (requiring inputs, processes, and outputs) is deemed to be fulfilled.

In a business combination the asset, on initial recognition, is valued at its fair value less costs to sell. In a single asset purchase transaction, the asset is valued at the consideration exchanged for the single asset plus transaction costs. Barring transaction costs, the two values should be equal in theory, an assumption which usually holds true as long as the consideration is not contingent on future events. For transactions with contingent considerations, IFRS 3 requires that the fair

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value of the contingency payment is part of the consideration to be allocated to the identifiable assets and liabilities. If there is only a single identifiable asset in the transaction, the contingency payment is implicitly allocated to the asset. Any change to the fair value of the contingent consideration after initial recognition is recognized in profit and loss. In contrast under the relevant guidance for a single asset transaction, all payments are only recognized as part of the cost base if and when they become due. In the specific case outlined above, it may be possible to structure the transaction to achieve the required accounting treatment. As a result, where there is discretion as to whether an asset is purchased in a single asset transaction or in a business combination there is a possibility for accounting arbitrage. This is of great importance in the pharmaceutical industry where acquisitions often involve intangible assets and where contingent consideration occurs frequently in the form of very substantial milestone payments dependent on the development success of a drug.

The reason for the treatment under IFRS 3 is that the agreement of the acquirer to make contingent payments as the obligating event at the time of the acquisition. Therefore the fair value of the contingency has to be included in the transaction price. Further, IFRS 3 explains that changes in the fair value of the contingency should be recognized in profit and loss as laying out that they are usually due to post-acquisition events and should therefore not impact the fair values assigned to assets or liabilities at the acquisition date. Although this theoretical rationale is valid in many situations, in particular when the contingency relates to the future performance of a group of assets, it leads to the following result for the acquisition of a single not ready for use asset structured as a business combination. Failure of the development asset results in an income due to the reversal of the probable amount for the contingent consideration whereas success of the development asset usually results in an expense due to the increase in the amount of the probable contingent consideration. Furthermore, in the case of success the contingent payments represent costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. As an asset is created, these costs should be fully capitalized and not recognized in profit and loss.

c) Technical goodwill arising in a business consideration

Another difficult point to explain is the creation of 'technical' goodwill in a business combination. In many tax jurisdictions the amortization of an asset acquired in a share deal is not tax deductible, while the amortization of an asset acquired in an asset deal is tax deductible. Accordingly, the price a buyer is willing to pay for an asset acquired in a share deal is lower than in an asset deal as the tax amortization benefit, i.e. the value of tax deductibility of the asset amortization, is not available. However, IFRS 3 requires that the fair value of an asset acquired in a business combination should be determined as if it were acquired on a standalone basis. Therefore the tax amortization benefit needs to be included in the asset value. While the theoretical concept has merit, it leads to a benefit being capitalized as part of the asset, which the acquiring entity is not able to realize in its ongoing operations. On an aggregated level this impact is more than offset by a deferred tax liability which has to be set up for the difference between the tax and the asset value. However, as this deferred tax liability cannot be discounted per IAS 12 it is higher than the tax amortization benefit, which is discounted. This leads to so called 'technical' goodwill that arises in a business combination performed through share transaction and which does not occur in a single asset transaction and which is difficult to explain:

> *Example:* A single asset was identified in a business combination and the consideration paid for the business/asset was CU 100. The tax amortization benefit increased the asset value

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by CU 20, i.e. an asset of CU 120 was recognized. The related deferred tax liability is CU 25. The difference of 5 resulting from the difference between the tax amortization benefit of CU 20 and the deferred tax liability of CU 25 is due to not discounting the deferred tax liability. Accordingly, net identifiable assets are CU 95, so that a goodwill of 5 arises, which can only be explained by the fact that deferred tax liabilities are not discounted. The reason given in IAS 12 for not discounting deferred taxes is that a detailed schedule of the timing of the reversal of each difference would be required, which is considered to be too complex to produce in many cases. In the situation described above, however, it would not be complex to arrive at a reversal schedule, but it is complex to explain the accounting result of not discounting deferred taxes.

5.3 Need for "core" figures to provide useful information

IFRS aims to provide a correct theoretical approach to present activities in the reporting period. The underlying concepts are often complex and not well understood by non-experts. Furthermore, even disclosure requirements often lead to voluminous disclosures as explained above and often fail to address the requirements of investors in, for example, forecasting an entity's business activities. For example, IFRS does not provide a concept for separating recurring business income/expense from exceptional income/expenses. However, investors request such information as it allows a detailed analyses of the underlying business performance and sustainable cash flows. In order to address this need, companies are increasingly developing their own analyses of income and expenses. Unfortunately, the method to present such "non-core" items of income and expense is not unified across companies. Table 20.2 shows the Novartis presentation of its core results for 2011.

Table 20.2 Novartis presentation of core results for 2011

2011	*IFRS results*	*Amortization of intangible assets*	*Impairments*	*Acquisition-related divestment gains, restructuring and integration charges*	*Exceptional items*	*Core results*
Gross profit	40,392	2,918	278	5	246	43,839
Operating income	10,998	3,028	1,224	148	511	15,909
Income before taxes	10,773	3,238	1,224	148	552	15,935
Taxes	–1,528					–2,445
Net income	9,245					13,490
Basic earnings per share (USD)	3.83					5.57

(*Continued*)

2011	*IFRS results*	*Amortization of intangible assets*	*Impairments*	*Acquisition-related divestment gains, restructuring and integration charges*	*Exceptional items*	*Core results*
The following are adjustments to arrive at Core Gross Profit:						
Net sales	58,566				117	58,683
Cost of Goods Sold	–18,983	2,918	278	5	129	–15,653
The following are adjustments to arrive at Core Operating Income:						
Marketing & Sales	–15,079				2	–15,077
Research & Development	–9,583	905	31		90	–9,239
General & Administration	–2,970	13				–2,957
Other income	1,354		–3	–102	–806	443
Other expense	–3,116	4	608	245	1,159	–1,100
The following are adjustments to arrive at Core Income before taxes:						
Income from associated companies	528	210			41	779

Note: All figures given are in USD millions

5.4 Frequency of change

IFRS standards are subject to constant changes and principle-based guidance does not by nature provide implementation rules. It is up to the preparer to interpret and implement a principle. Often there is no single interpretation of a principle, which means, for example, the application of a new or changed standard by the user and a regulator may differ. Stability of interpretation is often only reached after a number of years. Frequent material changes to the IFRS accounting guidance therefore lead to recurring application "uncertainty." Furthermore, by the time stakeholders have developed a full understanding of an IFRS standard it has often

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been revised, so that it is often very challenging for users to obtain a complete understanding of the financial statements. This is also increasingly undermining the acceptance of IFRS in many parts of the world.

5.5 Summary comments

In summary, there is increasing concern about the extensive disclosure requirements of some standards which are mainly relevant for the core business of a few specific industries but need to be applied to the same extent by all other preparers. In these cases the disclosures often do not provide additional useful information to the user of the financial statements and, therefore, possibly in various cases, result in a compliance exercise with little added value (e.g. standards on financial instruments which mainly focus on the banking industry).

Some changes contemplated by the standard setter such as the implementation of the direct cash flow method, or the changes in the leasing standard which could result in the capitalization of all financial leases, may have a good theoretical justification and would result in a better way of reporting. However, the implementation of these requirements would lead to extensive costs (e.g. re-engineering of IT systems and processes) in particular in a multinational environment, which may not be justified by the expected benefits. A suggestion for dealing with this situation is to consider emphasising more the importance of relevance and materiality in the IFRS framework. Information which is not used by management for running the business and is not useful to the financial community, should not be provided in the notes.