

# Lessons learned

How did the financial crisis  
affect corporate financial  
reporting?

# Executive summary

The economic turbulence over the last two years has impacted the revenues and asset values of many organisations. For many companies, 2009 was the first time their financial reporting had to reflect a full year of the business in recession. Market commentators predicted further reductions in asset valuations as companies continued to reduce costs and adjust their business forecasts. Signs of recovery are emerging in several sectors and countries, but uncertainty remains.

During this same period, the International Accounting Standards Board (IASB) continued to develop International Financial Reporting Standards (IFRS), issuing a significant number of new and amended standards. Many of these were aimed at improving the quality of disclosures and became effective for the first time during the 2009 calendar year. Some preparers felt that the increased disclosure requirements were onerous.

It is within this context that we undertook a financial statement survey of 60 large public companies, the results of which were presented in an Ernst & Young Thought Centre Webcast *Lessons learned from year-end reporting* presented live on 25 May 2010.<sup>1</sup>

This publication presents selected survey findings in greater detail. We have also included the results from questions that we asked of the approximately 3,000 registered participants who attended our webcast.

Our survey focused on financial statements prepared in accordance with IFRS by 60 public companies across six sectors (excluding the financial services industry). We compared this with a similar survey we performed in 2008.

Our survey set out to address the following key questions:

- ▶ What impact did the economic environment have on financial statement measurement, and in particular, asset impairments and pension obligations?
- ▶ What impact did the economic environment have on companies' operating and financing cash flows?
- ▶ What did management identify as the critical judgements and sources of estimation uncertainty? How was this important information communicated to users of the financial statements?
- ▶ How much of an impact did the change in the requirements for segment reporting and the disclosure of restatements have on reporting entities?

<sup>1</sup> You can listen to an archive of this webcast through the following link: [www.ey.com/ifrs](http://www.ey.com/ifrs)



# Key findings

**Most companies were impacted by impairment across all asset classes.**

### *Impairment of assets*

Impairment of non-current assets continued to be a focus area in 2009, across all sectors and all non-current asset classes. The average value of reported impairment increased slightly from 2008, but was generally within our expectations.

With respect to available-for-sale financial assets, the number of companies reporting impairment was consistent with the prior year. In addition, the level of impairment continued to be low relative to the value of these financial assets. We noted some companies measuring their available-for-sale equity investments using the cost approach. When IFRS 9 becomes effective, this option will no longer be available. Instead, these assets will need to be measured at fair value.

**Companies' pension obligations increased, however 41% of respondents did not recognise the full liability on their balance sheet.**

### *Pensions*

As in 2008, a significant portion of companies' defined benefit plans did not have sufficient plan assets to fund their liabilities (i.e., they are in deficit). Recognised pension liabilities should, in theory, reflect a company's obligation to cover the deficit. However, depending on methods used to account for actuarial gains and losses, the recognition of some of this obligation may be deferred, for example, when using the corridor approach. We found that 41% of companies with defined benefit plans had not fully recognised their plan deficit.

If standard-setters continue with their current plans to eliminate the corridor approach and require the unrecognised liability to be fully recognised, there could be a significant impact on companies' reported net assets.

**Companies had to actively manage their cash flows to stay liquid in the uncertain economic environment.**

### *Cash flows*

Where net positive operating cash flows had been achieved, this was done primarily by managing working capital effectively.

Companies raising funds in the market seemed to have a preference or requirement for debt funding. Funds raised were often used to repay existing lines of credit.

Eighty percent of the companies that we surveyed reduced both the level of capital expenditure and capital commitments reported at the end of the 2009 financial year.

**The top three critical accounting judgements and estimates identified by most companies were deferred tax, pensions and impairment.**

While all companies disclosed some critical judgements and estimates information, improvement in the quality of these disclosures is still needed to help ensure clear communication to users of financial statements.

### *Judgements and estimates*

All of the companies we surveyed presented a 'critical judgements and estimates' footnote disclosure. Forty-nine percent of the surveyed companies presented quantitative information either within this note or clearly cross-referenced to other notes in the financial statements.

The disclosure of critical judgements and estimates are two separate and distinct requirements within IFRS. However, in our sample, very few companies explicitly differentiated between the two.

**Contrary to expectations, most companies' disclosures did not change significantly with changes in requirements for segment reporting and restatements.**

Very few companies disclosed changes to reported segments and none disclosed non-GAAP measures in their segment reporting. Less than half of the companies who reported a restatement disclosed a third balance sheet.

***Segment reporting***

Eighty-three percent of companies applying IFRS 8 *Segment Reporting* for the first time presented segment information based on IFRS compliant measures. The remaining 17% of companies presented segment information based on IFRS adjusted measures.

Less than 25% of companies applying IFRS 8 for the first time reported a change in either the classification or number of reported segments. Half of these companies indicated the changes were due to structural or organisational change rather than due to the adoption of IFRS 8.

***Restatements and the third balance sheets***

Forty-three percent of companies in our survey reported a restatement. Interestingly, none of the reported restatements related to an error. Fifty-four percent related to the adoption of a new standard or interpretation, the rest were due to factors such as reclassification, group restructuring and business combinations.



# Our findings in detail

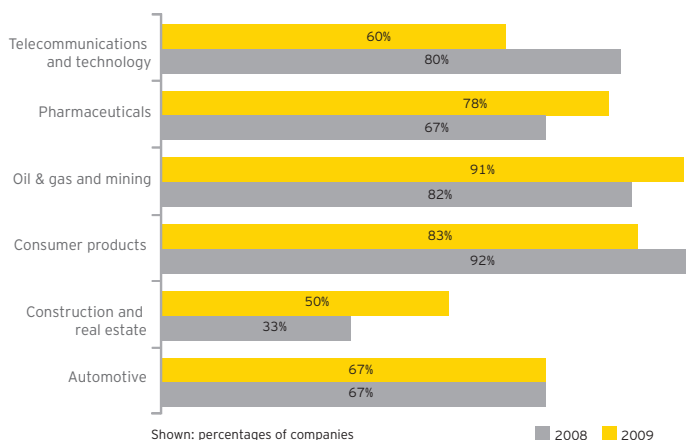
- ▶ What impact did the economic environment have on financial statement measurement, in particular, asset impairments and pension obligations?

**Most companies were impacted by impairment across all asset classes.**

### Impairment of non-current assets – sector breakdown

In 2009, 73% of the companies we surveyed across all sectors reported some level of impairment charge relating to non-current assets, which includes property, plant and equipment, goodwill, other intangibles and equity accounted investments (2008: 70%).

**Figure 1: Percentage of companies by sector that reported impairment charges**



In our 2009 publication *Meeting today's financial challenges – Impairment reporting: improving stakeholder confidence*, we presented survey participants' expectations regarding the sectors they believed would have the greatest number of impairments in 2009. Excluding financial services, the top three sectors they identified were real estate, automotive and consumer products. However, as can be seen in Figure 1, our findings indicate that oil and gas and mining, consumer products and pharmaceuticals were the most affected by impairment. Fewer construction and real estate companies reported impairment. This may be due to these entities reporting reductions in the fair value of investment properties rather than as impairment.

### Impairment of non-current assets – size and composition

The average impairment charge across all companies surveyed was 4% of non-current assets (2008: 2%). Sixty-four percent of companies had a higher impairment charge than in 2008 and 36% had a lower impairment charge than in 2008. The sectors with the highest average impairments (in monetary terms) were telecommunications and technology, pharmaceuticals and automotive.

While more impairment charges were reported in 2009, 30% of the companies surveyed reported reversals of impairment (2008: 27%). Not surprisingly, the average impairment reversal was only 0.4% of non-current assets (2008: 0.3%).

As Tables 1 and 2 show, the majority of impairments primarily related to property, plant and equipment (PP&E). This may be because PP&E is tested for impairment at a much lower level than other assets, such as goodwill, which is tested at a cash-generating unit level.

**Table 1: Percentage of impairment charges recorded by categories of non-current assets**

	Composition of impairment charges	
	2009	2008
Property, plant and equipment (PP&E)	53%	56%
Goodwill	15%	13%
Other intangibles	26%	16%
Equity accounted investments	6%	15%



**Table 2: Sector-specific results – composition of impairment charges**

		PP&E	Goodwill	Other intangibles	Equity accounted investments
Automotive	2009	50%	8%	24%	18%
	2008	70%	1%	16%	13%
Construction and real estate	2009	33%	31%	26%	10%
	2008	15%	0%	41%	44%
Consumer products	2009	72%	7%	16%	5%
	2008	64%	9%	8%	20%
Oil & gas and mining	2009	73%	21%	4%	2%
	2008	81%	16%	3%	0%
Pharmaceuticals	2009	43%	0%	56%	1%
	2008	43%	0%	56%	1%
Telecommunications and technology	2009	15%	41%	42%	2%
	2008	38%	32%	9%	21%

#### Impairment of goodwill – disclosures

Of the 60 companies we surveyed, 52 had goodwill on their balance sheet in both 2009 and 2008. Twenty-five percent of those companies had a goodwill impairment charge in 2009 (2008: 27%). Testing goodwill for impairment must be done by testing the related cash-generating unit (CGU), or group of CGUs, which can be a complex and judgemental process. Therefore, we were interested in what information was disclosed in relation to this assessment. Specifically, we considered the methodologies applied and the disclosures made in relation to assumptions and sensitivities.

► *Approach to determining recoverable amount:* in our survey, we observed that companies sometimes used a mixture of value in use (VIU) and fair value less cost to sell (FVLCS) to determine the recoverable amount for their CGUs. For those companies that reported goodwill impairment in 2009, 85% used a VIU approach. While the remaining companies used a FVLCS approach, they had done so based on a discounted cash flow (DCF) model.

- *Disclosure of key assumptions:* as expected, due to disclosure requirements in IFRS, all of the companies that reported goodwill impairment disclosed their key assumptions. Most focused their discussion on growth rates, discount rates and the factors considered in estimating operating cash flows, such as sales prices, operating costs, earnings before interest and tax (EBIT) or margins. Only 15% of these companies discussed additional assumptions, such as commodity prices and foreign exchange rates.
- *Disclosure of sensitivity:* Eighty-five percent of companies who reported goodwill impairment in 2009 presented a sensitivity analysis. Presentation approaches varied widely from high-level narrative comments to quantitative sensitivity analyses in relation to key assumptions, typically growth rates and discount rates. The most comprehensive sensitivity disclosures provided extensive quantitative analyses, including management's assessment of reasonably possible change for key assumptions, beyond growth rates and discount rates, as well as the potential impact on the reported impairment.



### Insights from our webcast participants

During our webcast on *The lessons learned from year-end reporting*, we gauged our audience's experience by asking which area they found most challenging when preparing their impairment assessments for all non-current assets, to which:

- ▶ 29% thought developing future cash flow assumptions was the most difficult
- ▶ 24% considered obtaining reliable fair value estimates related to determining the recoverable amount to be the most difficult
- ▶ 14% felt determining an appropriate discount rate to be their key challenge

These results are consistent with a similar poll conducted last year.

**Table 3: Impairment of AFS financial assets as a percentage of the asset value**

	2009	2008
1%–5%	58%	52%
6%–10%	26%	4%
11%–15%	0%	9%
16%–20%	5%	4%
> 20%	11%	31%

### Trouble ahead?

We noted a number of companies that measured some of their AFS equity instruments at cost rather than fair value. The introduction of IFRS 9 in relation to the recognition and measurement of financial assets will be of particular interest to these companies as they will no longer be able to use this measurement approach. Instead, they will need to use a fair value approach.

### Impairment of available-for-sale financial assets

In 2009, 78% of the companies we surveyed had financial assets recognised on their balance sheet that were classified as available-for-sale (AFS). Nineteen percent of those companies with AFS financial assets recognised impairment (2008: 23%).

As can be seen in table 3, the size of the impairment charges recognised, compared to the value of the AFS financial assets, was relatively small.

Given the improvements made by markets during the last quarter of the 2009 calendar year, the fact that any impairment was reported on an AFS financial asset may be due to the IFRS Interpretations Committee clarifying that a significant or prolonged decline in fair value is sufficient to require recognition of an impairment loss.



**Companies' pension obligations increased, but many did not recognise the full liability on their balance sheet.**

Of the companies we surveyed, 90% had defined benefit plans (DBP). The recognition and measurement of pension assets and liabilities is complex and can be subject to judgement. A complicating factor is the options available under IAS 19 *Employee Benefits* to account for the actuarial gains and losses arising from measurement of their DBPs.

Ninety-one percent of the companies with a DBP had an unfunded deficit at the end of 2009, which is consistent with the same measure at the end of 2008 (89%). That means the plan's assets were not sufficient to fund the present value of the obligations due under the plan. Generally, companies sponsoring the plans have an obligation to cover this shortfall. The net pension liability recognised in a company's financial statements should reflect this obligation. To what extent it is recognised depends to some extent on the methodology applied.

Our survey confirmed that the most commonly used method to account for a DBP is to take actuarial gains/losses into other comprehensive income (OCI) (as shown in Table 4). However, alternatives to this method include taking the differences directly to profit or loss and using the delayed recognition approach (the 'corridor method'), which defers recognition of actuarial gains and losses over an estimated future service period.

**Table 4: Method to account for actuarial gains/losses arising from a defined benefit plan**

Method to account for actuarial gains/losses	Percentage of companies with a DBP
OCI	67%
Corridor (delayed recognition)	28%
Profit and loss (immediate recognition)	5%

Forty-one percent of companies with a defined benefit plan had not recognised the entire unfunded deficit in their balance sheet (see Table 5). Of those companies, only half had recognised 80% or more of the unfunded deficit in 2009, down from approximately 67% in 2008.

**Table 5: Percentage of companies – pension deficit compared to the recognised net liability**

	Deficit > recognised net liability	Deficit = recognised net liability	Deficit < recognised net liability
2009	41%	42%	17%
2008	35%	46%	19%

**Trouble ahead?**

It is worth noting that standard-setters are evaluating the continuation of the use of the corridor approach under DBP accounting. If the corridor approach were to be eliminated as an option and the unrecognised liability were to be required to be recognised, there could be a significant impact on companies' reported net assets.



► **What impact did the economic environment have on companies' operating and financing cash flows?**

**Companies had to actively manage their cash flows to stay liquid in the uncertain economic environment.**

In an uncertain economic environment, an entity's ability to maintain net positive cash flows is arguably one of the most critical performance indicators. The cash flow statement reflects not only what cash flows have affected an entity, but also gives clues to how cash is being managed.

**Operating cash flows**

In 2009, 93% of surveyed companies had a net cash inflow from operating activities (2008: 92%). Eighty-eight percent of surveyed companies had net cash inflows in both 2008 and 2009 and 60% of those companies improved their net cash flows in 2009, compared with 2008. Almost half of those companies with improved operating cash inflows had increases greater than 50%. These improvements were observed primarily in the automotive and consumer products sectors. Information presented in the financial statements we surveyed indicated that improvements in cash inflows were primarily due to working capital management.

**Financing cash flows**

Thirty-two percent of surveyed companies had a net positive cash flow from financing activities in 2009 (2008: 37%). Eighteen percent had net cash inflows in both 2008 and 2009 (one-third of these showed an improvement in their net cash inflows from financing activities). Fifty percent had net cash outflows in both 2008 and 2009 (five percent of these reduced their net cash outflow). Overall 38% of surveyed companies improved their cash flows through financing activities either by improving net inflows or reducing net outflows. This improvement was generally observed in connection with entities issuing bonds or refinancing. In particular, we noted significant renegotiation of financial liabilities.

**Insights from our webcast participants**

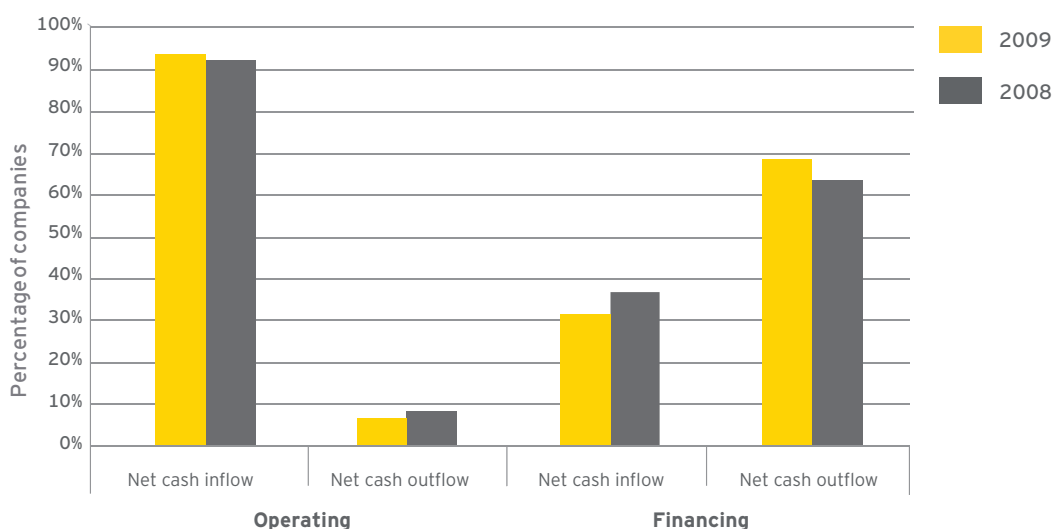
We asked our webcast audience whether they had raised new funding in 2009. Twenty-eight percent of respondents had raised new funding through debt, 15% had issued new equity.

**Capital expenditure and commitments**

Twenty percent of the companies we surveyed increased their capital expenditure on average by 41% compared to the prior year. However, the majority (80%) reduced their capital expenditure compared to 2008 by an average of 30%.

Seventeen percent of surveyed companies disclosed capital commitments in 2009; 80% of those companies had reduced the amount committed for capital expenditure, on average by 52% compared to 2008.

**Figure 2: Operating and financing cash flows**



- ▶ What did management identify as the critical judgements and sources of estimation uncertainty? How was this important information communicated to users of the financial statements?

**The top three critical areas identified by most companies were deferred tax, pensions and impairment.**

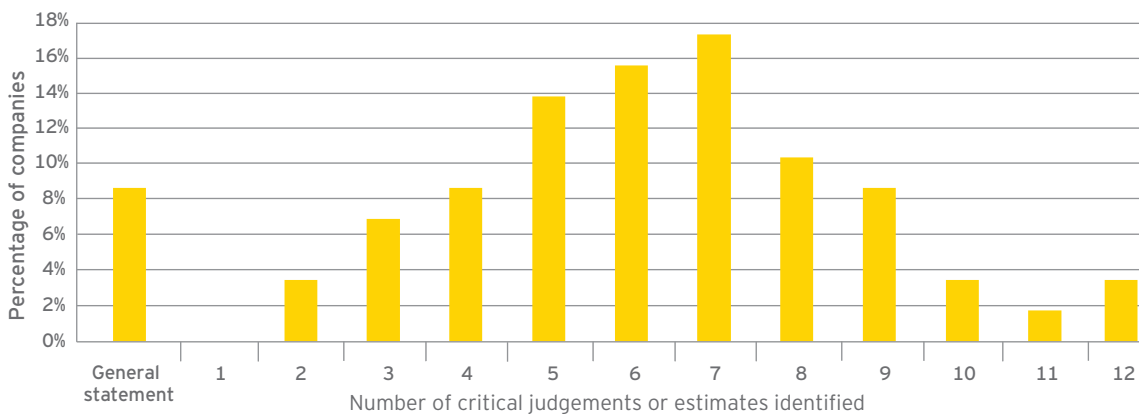
On average, the companies we surveyed identified six areas of critical judgement or estimation (as shown in Figure 3). The most commonly identified were deferred tax (identified by 76% of companies), pensions (71%) and impairment of non-financial assets (56%).

**Insights from our webcast participants**

We asked our webcast audience whether their disclosure of estimates and assumptions had changed from last year. Thirty-six percent of respondents indicated that their disclosures had increased from last year, while approximately 44% said that the disclosures were either reduced or similar to those in the previous year.

Judgements and estimates identified by each sector were similar between companies within that sector and consistent with complex accounting issues for their sector. For example, fair value measurement of investment properties was the most commonly identified critical judgement or estimate for the construction and real estate sector (83%). In the oil and gas and mining sector, 55% of companies identified exploration assets and 55% of companies identified reserves (fields).

**Figure 3: Number of critical judgements or estimates identified**





**While all companies disclosed a critical judgements and estimates note, improvement is still needed to help ensure clear communication to users of financial statements.**

IAS 1 *Presentation of Financial Statements* (IAS 1) requires the disclosure of both judgements that have been made in applying accounting policies, including the judgements and estimates that have the most significant effect on the financial statements, as well as sources of estimation uncertainty in determining the carrying values of assets and liabilities.

***Distinction between judgements and estimates***

The disclosure of critical judgements and estimates are two separate and distinct requirements. However, in our sample, very few companies explicitly differentiated between the two. The former relates to application of accounting policies, such as defining what management considers a 'significant' or 'prolonged' decline in the fair value of AFS financial assets. The latter refers to those assumptions and estimates that may have a significant bearing on the future results, such as cash flow assumptions and discount rates used in impairment testing.

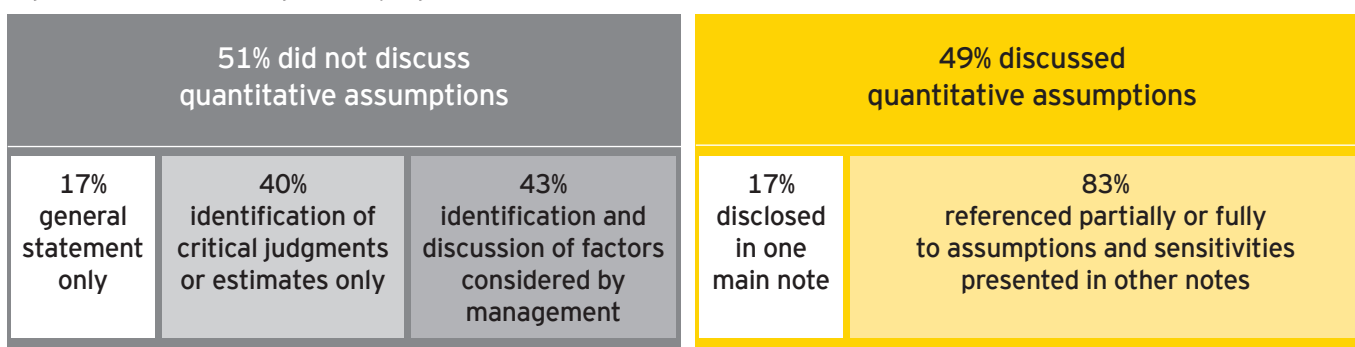
***Presentation approaches***

All of the companies we surveyed presented a note that discussed critical judgements and estimates. Our survey therefore focused on the content of this note: how the information was being presented and what was identified as being critical.

Our survey revealed a range of disclosure practices as is illustrated in Figure 4.

- ▶ Fifty-one percent of the companies we surveyed did not include any quantitative disclosure of assumptions in their critical judgements and estimates note. This information may have been provided elsewhere in the notes. However, note references would have likely assisted users of the financial statements.
- ▶ Forty-nine percent of all companies surveyed disclosed quantitative assumptions. Some disclosed the assumptions within a separate note. However, the most user-friendly and comprehensive disclosures used the critical judgements and estimates note to 'sign post' or reference (either partially or fully) to disclosures made in other notes to the financial statements. In this way, management was able to take advantage of any existing disclosure of assumptions and sensitivities.

**Figure 4: Disclosure of significant judgements and estimates**





► How much of an impact did the change in the requirements for segment reporting and the disclosure of restatements have on reporting entities?

Contrary to expectations, most companies' disclosures did not change significantly resulting from changes in the requirements for segment reporting and restatements.

**Very few companies disclosed changes to reported segments and none disclosed non-GAAP measures.**

The introduction of IFRS 8 *Segment Reporting*, a replacement for IAS 14, was somewhat controversial. While it is not a new concept to present segmental information, IFRS 8 requires entities to externally report internal information, without exemptions for commercially sensitive information and with greater focus on what information is used in operating decision-making (see Table 6). It also opened the door for disclosure of information based on non-GAAP measures.

As a result of the conceptual differences between IFRS 8 and IAS 14 (see Table 6) and the criticism that the new standard had received during its development, we expected widespread changes in the number of segments reported and at least some information presented to be based on non-GAAP measures. However, our findings led us to question whether the controversy was warranted.

**Table 6: Key differences between IFRS 8 and IAS 14**

	IFRS 8	IAS 14
<b>Identification of segments</b>	Based on the way information is reported to the chief operating decision-maker (CODM)  No distinction between internal and external activities	Based on risks and returns; predominantly business or geographic  Focus on external business activities
<b>Measurement</b>	Measure based on what is reported to CODM – may not be GAAP measures	Must align with the entity's accounting policies
<b>Disclosures</b>	Based on what is reported to CODM  Reconciliation required of non-GAAP measures	All disclosures specified in IAS 14

**Identification of segments**

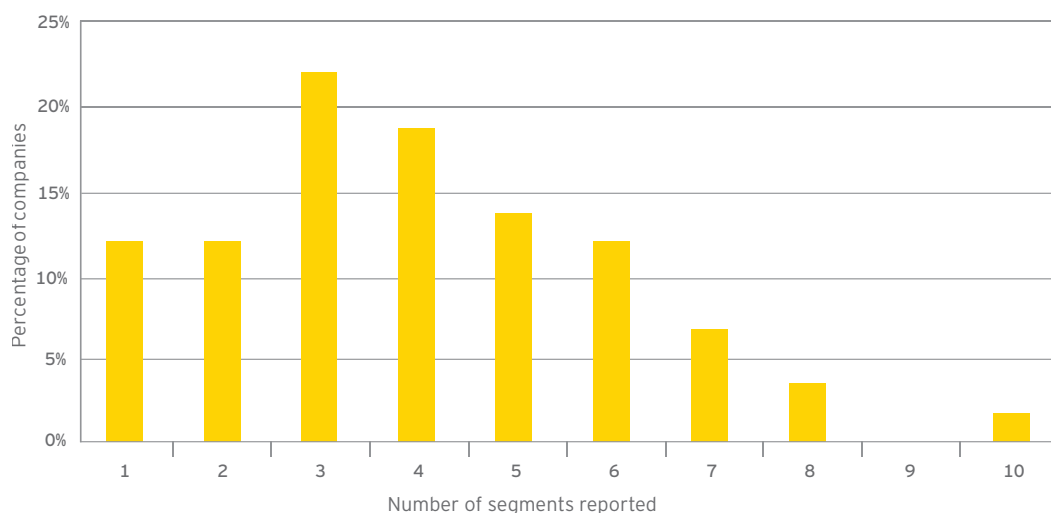
Of the 60 companies we surveyed, two had a financial year ending on 30 September 2009. As such, IFRS 8 was not yet applicable for those companies. Of the remaining 58 companies:

- 7% had changed the number of reported segments
- 12% disclosed changes in their organisation or structure, but made no mention of IFRS 8
- 5% disclosed changes in classification, but not in the number of segments

On average, most companies reported four segments, as is shown in Figure 5. One company disclosed a total of 10 segments; however, this reflected that company's diverse operations and monitoring of operations by both product and brand.



**Figure 5: Number of segments reported**



Interestingly, the average number of segments reported was reasonably consistent across all of the sectors we surveyed (see Table 7).

In general, we observed that the segments identified by companies within each sector tended to be consistent and homogeneous; that is, they may be similarly named or management may have taken a similar approach to identification.

**Table 7: Sector-specific trends in segment reporting**

	Average number of segments reported	Segments reported based on geography (% companies)	'Corporate' reported as a separate segment (% companies)
Automotive	3.8	11%	11%
Construction and real estate	4.5	17%	33%
Consumer products	4.3	50%	17%
Oil & gas and mining	4.0	9%	55%
Pharmaceuticals	2.6	10%	0%
Telecommunications and technology	4.4	30%	40%

### **GAAP vs. non-GAAP measures**

As noted above, IFRS 8 was applicable for the first time to 58 of the 60 companies we surveyed.

- ▶ Eighty-three percent presented segment information based on IFRS compliant measures.

The most common performance indicators were earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortisation (EBITDA). While some may argue these are not GAAP measures, interest, tax, depreciation and amortisation are all items that are required disclosures under IFRS. As such, they are essentially derived from IFRS compliant measures.

In some cases they were disclosed within the segment reporting note (in some cases they were additional line items compared to what was disclosed on the face of the income statement) and in other cases they were disclosed directly on the face of the income statement and then split by segment.

- ▶ The remaining 17% of companies presented segment information based on IFRS adjusted measures.
- ▶ IFRS adjusted means that certain items were not included in determining the operating profit for each segment (Including instances where these items were described as exceptional).
- ▶ For example, one company disclosed "management profit" as a line item. It was determined by adjusting the operating profit as disclosed in the income statement to include the results of joint ventures accounted for in accordance with IAS 31 *Joint Ventures* using the equity method.

### **Internal use of IFRS?**

IFRS 8 requires the disclosure of information reported to the chief operating decision-maker and, as such, the measures used do not need to comply with IFRS.

All of the companies for whom IFRS 8 was applicable used IFRS-based or IFRS-adjusted measures. Since segment reporting disclosures must be based on internally reported information, are companies reporting IFRS compliant information internally?

### **Interaction between IFRS 8 and impairment reporting**

When IFRS 8 was introduced, an amendment was made to the requirements in IAS 36 *Impairment of Assets*. Essentially it required that when an entity identified a CGU for the purpose of testing assets for impairment, a CGU could not be greater than an operating segment under IFRS 8.

As a result of this amendment to IAS 36, it was thought that when IFRS 8 was first applied entities would not only have to redefine their CGUs and re-allocate the goodwill, but also report goodwill impairment as a result.

In practice, only one of the companies we surveyed disclosed a re-allocation of goodwill between CGUs on adoption of IFRS 8. However, this company did not record a goodwill impairment charge as a result of that re-allocation.



**While required for all restatements, less than 50% of the companies who reported a restatement disclosed a third balance sheet.**

For most companies, 2009 was the first year they applied the new amendments to IAS 1 affecting the disclosure of restatements. The key amendment required a third balance sheet to be presented when an entity applies an accounting policy retrospectively, makes a retrospective restatement of items or when it reclassifies items in its financial statements.

When this amendment had been introduced, there was some speculation that, with the volume of new standards and interpretations that became effective in 2009, a significant number of companies would have to present a third balance sheet.

***Types of restatements reported***

Forty-three percent of companies disclosed a restatement of some sort in 2009. Of these:

- ▶ None related to errors
- ▶ 54% related to the adoption of a new standard or interpretation
- ▶ 46% were attributed to other reasons (e.g., reclassification, group restructuring, business combinations)

***The third balance sheet***

Only 42% of companies who had disclosed a restatement presented a third balance sheet (that is only 18% of companies surveyed). Some of the companies that reported a restatement stated they had not presented a third balance sheet as the restatement was not material.

**Where is the third balance sheet?**

The IAS 1 requirement to present a third balance sheet applies when an entity presents a retrospective restatement. The standard does not provide any exemptions from presenting the extra comparative period.

Fifty-eight percent of the companies who reported a restatement did not present a third balance sheet. This led us to question whether the requirements in IAS 1 were clearly understood.

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