

FP INVESTING

COMMENT

Revenue, earnings to take on new meanings

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Recent columns have explained how Canada's auditors are planning to turn the investing world upside down with the adoption of International Financial Reporting Standards (IFRS). The impact for investors will be something akin to waking up one morning and misinterpreting everything in the newspaper because the meanings of basic words have changed overnight.

Income will not be income the way you have come to know it, and the same goes for other investment measures. The good news is that you can slowly educate yourself about the accounting changes, and in contrast to most of the information available on IFRS, this column examines issues

from an investor's perspective.

In looking for a place to start explaining IFRS, it might as well be the top of the income statement with revenue. Ideally, revenue should be recorded by a company only when a real customer exists and that customer will be paying in accordance with what has been contracted. It sounds simple, but in real life, situations are more complex and interpretive rules are often needed to apply the basic ideas.

A general theme that will emerge over the next few years is that IFRS is much less prescriptive than either Canadian or U.S. accounting rules. In other words, IFRS contains basic guidance but stops short of addressing many industry or situation-specific issues. Therefore, differences

in reported revenue will arise when companies switch over.

In the area of revenue recognition, there are several differences between North American accounting and IFRS, including the recognition of up-front payments, the evidence of whether a sales arrangement exists, and the recognition of what are known as multiple-deliverable arrangements.

A multiple-deliverable arrangement exists when there are several components (goods and/or services) attached to a sale. For instance, telecom companies provide equipment, software, upgrades and maintenance often all in the same package. While the equipment is received up-front, the maintenance services are provided over several years.

The customer will have a cash payment schedule, but

this does not necessarily have any bearing on when revenue is, or should be, recognized. Perhaps the cost of the equipment was subsidized, and is being recouped by future service charges that exceed the fair value of the maintenance provided. Anyone with a cellphone could relate to this scenario. Often you are overcharged on your monthly bill to effectively pay for the free or subsidized phone you received.

Therefore, the issue of when to recognize revenue comes down to multiple questions concerning the fair value of the equipment and services, and whether the goods and services can be reasonably separated from each other without affecting their value.

The difference between North American accounting and IFRS for the treatment of

up-front fees is particularly noteworthy because of the impact it can have on perceived value. For a good illustration, we must turn to a company that reports in both North American and International accounting rules.

Italy's **Enel SpA** (ENEL/BIT), is the third largest energy provider in the world. When it connects a new customer to its gas and electricity networks, it charges a fee that it recognizes as revenue in full under IFRS. By contrast, that same revenue is spread over the next 20 years under North American accounting.

The impact on Enel's financial statements is quite large. For the last three years reported, the additional revenue recorded under IFRS as a percentage of net income was 12%, 11%, and 18% respectively.

Thus for investors, it should be clear that IFRS can have a significant impact on the reported performance and valuation of a company.

Many possibilities exist under IFRS, and some companies will choose to stretch the rules in comparison to others, and thus could easily mislead investors.

More important, though, is the impact the new accounting standards already have on Canadian investors with respect to their international equity holdings, and their Canadian holdings when the values are determined by comparison to international peers.

It's just all the more reason for investors and investment managers to get serious about IFRS today and stop delaying any longer.

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