

## Chapter 3

### Fiat Group's first time adoption of IFRS

#### Teaching Note

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#### Introduction

This case focuses on the institutional and firm-specific factors that affect the accounting analysis. The case has two objectives. The first objective is to illustrate that accounting rules are the result of national accounting objectives and, consequently, have a significant influence on the usefulness of financial statements to investors. The adjustments that Fiat made as the result of the company's switch from Italian GAAP to IFRS clearly reflect that the primary objective of IFRS is to make financial reports useful for shareholders in making economic decisions (i.e., contracting and valuation). The new rules, however, also allow Fiat's management more accounting discretion (in order to benefit from management's firm-specific knowledge and private information). The discussion of Fiat's switch to IFRS reporting thus nicely illustrates the trade-off between having rigid accounting rules that may introduce noise and having flexible accounting rules that may introduce bias into financial statements. The second objective of the case is to teach students how to identify red flags for potential misuse of reporting discretion, i.e., assess the probability that Fiat's management will abuse the flexibility of IFRS rules to strategically bias the company's financial reports. In the end, the case also illustrates that although the adoption of investor-oriented accounting principles, such as IFRS, potentially improves the usefulness of Fiat's financial statements to investors, management's reporting incentives might conflict with investors' reporting demands and, consequently, mitigate the influence of the adoption of IFRS on accounting quality.

The case starts with the discussion of Fiat's business environment and key accounting policies (objective: determining the initial focus of the accounting analysis), continues with the discussion of Fiat's accounting changes (objective: understanding the different natures of Italian and international accounting rules; identifying and evaluating (differences in) accounting discretion), and ends with the discussion of management's reporting incentives (objective: understanding the importance of reporting incentives and learning to identify red flags).

#### Questions for students

1. What are Fiat's key accounting policies? Which of Fiat's key accounting policies are affected by the adoption of IFRS?
2. Summarize the differences between Fiat's key accounting methods under Italian GAAP and those under IFRS. What characterizes the differences between the two sets of methods? From the perspective of a minority investor in the company's shares, which methods provide better information about the economic performance of Fiat?

3. Summarize the main factors that affect management's reporting incentives and strategy in fiscal year 2005. Which factors might reduce management's incentive to fully comply with the IFRSs?

## Case analysis

### Question 1

Fiat's primary operational activities are the development, manufacturing and selling of passenger cars and trucks. The company's key accounting policies are:

- *Accounting for research and development costs.* Fiat's R&D expenditures are capitalized if (1) they classify as development costs (i.e., relate to a particular product), (2) can be measured reliably, and (3) will generate future economic benefits. Fiat's own estimates of the technical and economic feasibility of newly developed car models thus determines whether or not such costs are expensed as incurred or amortized over the models' estimated lives (i.e., 4-5 years for cars; 8 years for commercial vehicles/trucks).

At the end of 2004, close to 4.0 percent of Fiat's (IFRS-based) total assets consisted of capitalized development costs. During 2004, the company's research and development expenditures amounted to €1,791 million (3.9 percent of sales), of which 58 percent was immediately expensed. (The amount of amortized development costs of 312 million was substantially lower than the amount of newly capitalized expenditures (€753 million).) The key question is whether Fiat is overly conservative (or possibly overly aggressive) in immediately expensing 58 percent of its research and development costs.

- *Revenue recognition (and accounting for inventories and property, plant & equipment).* Fiat recognizes revenues when "the risks and rewards of ownership of the goods are transferred to the customer, the sales price is agreed or determinable and receipt of payment can be assumed: this corresponds generally to the date when the vehicles are made available to non-group dealers, or the delivery date in the case of direct sales." Hence, Fiat's revenue recognition policies are relatively straightforward. One issue may complicate Fiat's recognition of revenues: the company sells some of its vehicles in combination with a buy-back option and some under operating lease agreements. Sales with buy-back commitments are recognized as operating leases: the difference between carrying value and resale value is depreciated on a straight line basis; the initial sale price received is recognized as an advance payment; the difference between the initial sale price and the buy-back price is recognized as rental revenue on a straight-line basis. The treatment of sales with buy-back commitments therefore also affects inventories (passenger cars) and property, plant and equipment (commercial vehicles/trucks).
- *Accounting for receivables from financing activities.* Fiat provides financing services to a proportion of its customers. This activity creates long-term receivables on the company's balance sheet (amounting to close to 28 percent of total assets at the end of 2004). With regard to these long-term receivables, important accounting choices that the company makes are particularly those concerning derecognition of factored or securitized receivables.

All of these policies were affected by the first-time application of IFRS. Hence, the most critical changes that Fiat made to its reporting were (1) the capitalization of development

expenditures, (2) the delayed recognition of sales with buy-back commitments, and (3) the re-recognition of previously derecognized “sold” receivables.

### Question 2

The following discussion describes many of the accounting changes—also less critical changes—that Fiat implemented as a result of its first time adoption of IFRS. To speed up the discussion, the instructor could choose to focus on the changes in critical accounting policies only. Three accounting changes are related to Fiat’s critical accounting policies: the change to capitalization of development expenditures, the change in (de)recognition of “sold” receivables, and the change in the recognition of margins on sales with buy-back commitments (see also question 1).

The accounting changes that Fiat made illustrate the influence of national objectives of accounting regulation on accounting practices. Like in many other Continental European countries, pre-IFRS financial reporting practices in Italy were influenced by government through the commercial code, which set out the laws that governed accounting. Reporting practices were also strongly influenced by tax rules: some expenses must be recognized in the financial statements in order to be tax deductible. As a consequence, Italian accounting rules typically focused on assuring the reliability (verifiability) of recognized income components.

Fiat’s switch to IFRS-based reporting allows students to benchmark Fiat’s accounting practices under Italian GAAP (focusing on verifiability) with those under IFRS (focusing on relevance but, of course, not ignoring verifiability). The key takeaway from such an analysis would be that changing from Italian GAAP-based reporting to IFRS-based reporting typically improves the usefulness of financial reports for the purpose of making economic decisions (such as investment decisions). This is because IFRS is to a greater extent designed to make financial statements “decision useful” than Italian GAAP. A side-effect of the change from Italian GAAP to IFRS is, however, that management’s reporting discretion increases. This is because management can best decide which accounting methods and estimates are most appropriate given the economics of their firm and, consequently, improve the informative value of financial reports.

One way to discuss this question is to shortly summarize one change and randomly call upon one student to reflect on whether and why the change “improves” Fiat’s financial reports (from the perspective of an investor). A second student could then be called upon to identify the areas where management’s discretion increases under IFRS. The discussion could conclude by asking the class whether and how the accounting analysis should address the identified area(s) of discretion.

A possibly more appealing strategy to discuss Fiat’s accounting changes is to first let students identify the common characteristics of Fiat’s most critical changes. The main differences between Italian GAAP and IFRS relate to the following two questions:

- Who owns the assets?
- How should the firm adjust the carrying value of assets and liabilities to changes in the fair value of the asset?

Fiat’s accounting changes can be used to illustrate how Italian GAAP and IFRS provide different answers to these questions. Italian GAAP tends to avoid the recognition of difficult-to-verify fair value changes in accounting profits (especially when such changes are positive). In addition, the Italian accounting rules tend to link asset recognition decisions to

legal ownership rather than economic ownership. This typically reduces the relevance of financial statements but increases their reliability (verifiability).

### Reporting issue 1: Who owns the assets?

One important accounting issue for Fiat was and is the determination of asset ownership. Several Italian accounting rules emphasized legal ownership rather than economic ownership as the basis for asset recognition decisions. Consequently, some of the changes that Fiat made upon adoption of IFRS were those that guaranteed that the company's balance sheet recorded all assets (and associated liabilities) for which it carried (substantially) all the risks, including some assets that it did not legally own. Following are a few examples of such changes. These changes all improve the usefulness of Fiat's financial statements for making economic decisions. At the same time, however, most of these changes give management more accounting discretion: management now has discretion in deciding which assets Fiat economically owns (which is more difficult than establishing legal ownership).

#### *Sales with a buy-back commitment*

*Description of the change.* Under Italian GAAP, Fiat only recognized a provision for sales with buy-back commitments when the company expected that the guaranteed residual value exceeded the estimated realizable value of the vehicles. Assuming that the guaranteed residual value was generally not much different from the expected realizable value, the recognized provision was generally low and margins on sales with buy-back commitments were typically fully and immediately recognized. Under IFRS, such sales receive a much more conservative treatment: margins on sales with buy-back commitments are gradually recognized over the contract period. This implies that, upon adoption of IFRS, Fiat capitalized margins from previous years (that the company had previously recognized), resulting in an increase in equity of €180 million (because vehicles "sold" now remained on Fiat's balance sheet). Liabilities also increased because (1) Fiat treated the cash inflow from these sales as advanced payments and (2) recognized trade payables for the amount it had guaranteed to its customers. Because the margins on prior years' sales with buy-back commitments were relatively constant, the effect of the change on fiscal 2004 net profits was marginal.

*Why is this change an improvement?* The IFRS treatment better accounts for the economic risks that Fiat remains to bear after the inception of the sales agreement.

*What is the effect of this change on reporting discretion?* Note that this change does not affect management's financial reporting discretion. It might reduce the impact of discretion: under Italian GAAP, the overstatement of realizable values directly affects current year's net profit; under IFRS, this effect is spread across the contract period.

#### *Derecognition of financial assets and liabilities (IAS 39)*

*Description of the change.* Fiat regularly sells receivables to a third party. Under Italian GAAP all sold receivables were derecognized from the balance sheet. The difference between the carrying amount of the sold receivables and the amount received from the SPE was recognized as expense or income in the income statement. Footnote Q suggests that securitization transactions in the recent past did, however, not result in material income or expenses.

IAS 39 disallows derecognition of “sold” receivables when the risks and rewards of the receivables remain with the seller. Under IFRS, Fiat therefore cannot derecognize receivables sold *with* recourse as well as the proportion of receivables sold *without* recourse for which the risks and rewards remain with Fiat. Because the revised standard IAS 39 became effective after the mandatory IFRS adoption date, Fiat needed not to comply with its requirements. The firm, however, decided to (voluntarily) retrospectively apply IAS 39 to its asset and liability derecognition decisions. Although this decision had almost no effect on opening equity and net profits (given that prior transactions were, on average, neither profitable nor loss-making), it did affect Fiat’s assets and liabilities. In particular, Footnote Q indicates that “trade receivables increase[d] by 3,563 million euros and 2,134 euros at January 1, 2004 and at December 31, 2004, respectively”. Further, “financial receivables increase[d] by 6,127 million euros and 6,997 euros, and financial debt increased by 10,581 million euros and 10,174 million euros, respectively.”

*Why is this change an improvement?* The IFRS treatment better accounts for the economic risks that Fiat remains to bear after the sale of receivables.

*What is the effect of this change on reporting discretion?* Management must determine whether the risk and rewards of sold receivables have been effectively transferred to the buyer. This is a discretionary decision.

#### Disposal of shareholdings

*Description of the change.* Similar to the sales of receivables, under IFRS disposals of shareholdings can only result in derecognition when all the risks and rewards of the shareholdings have been effectively transferred from the seller to the buyer. Consequently, Fiat had to reverse the derecognition of a 14 percent interest in Italnergia Bis. Because the buyer of the shares owned a put option, not all risks had been transferred from Fiat to the buyer. The gain on the sale was reversed, decreasing equity (more specifically, equity increased due to the re-recognition of the investment but decreased due to the delay of recognizing of the cash receipt). Fiat also recognized an additional liability for the amount of cash received in the transaction. The effect on 2004 net profit was zero. The effect on future net profits is likely to be positive (when the delayed gain is recognized).

*Why is this change an improvement?* The IFRS treatment better accounts for the economic risks that Fiat remains to bear after the disposal.

*What is the effect of this change on reporting discretion?* Management must determine whether the risk and rewards of the shareholdings have been effectively transferred to the buyer. This is a discretionary decision.

#### Consolidation of subsidiaries with dissimilar activities and Special Purpose Entities

*Description of the change.* IFRS requires Fiat to consolidate subsidiaries also when such subsidiaries have dissimilar activities. In addition, IFRS (SIC 12) requires Fiat to consolidate Special Purpose Entities. Because of both requirements, Fiat was forced to reverse gains on past sales transactions with unconsolidated subsidiaries and SPEs as well as recognize liabilities for the cash received in such transactions.

*Why is this change an improvement?* Special Purpose Entities are often controlled by the company creating them, even though they may be legally independent. The IFRS treatment better accounts for the economic risks that Fiat bears and the economic benefits that it receives from the SPEs.

*What is the effect of this change on reporting discretion?* Management must determine whether it controls the SPE. This is a discretionary decision.

Reporting issue 2: How should the firm adjust the carrying value of assets and liabilities to changes in the fair value of the asset?

### Derivatives (IAS 39)

*Description of the change.* The Fiat Group reports that “Beginning in 2001 the Fiat Group adopted – to the extent that it is consistent and not in contrast with general principles set forth in the Italian law governing financial statement – IAS 39” (footnote M). IAS 39 governs, amongst other things, the recognition of derivatives. Italian GAAP and IAS 39 both distinguished between (1) derivatives that were held with the objective of effectively hedging the variation in the fair value of a hedged item (fair value hedge: e.g., futures hedging the value of steel inventories) or the variation in future cash flows (cash flow hedge: e.g., variable interest payments hedged by a variable-to-fixed rate swap) and (2) derivatives that were held for speculative purposes.

The main differences between IAS 39 and Italian GAAP were the following:

- Although under IFRS inventories are typically not revalued to their fair values, if the fair value of such inventories is hedged by means of a derivative (e.g. a future), changes in the fair value of the derivative must be accompanied by a similar change in the carrying value of the hedged inventories. (Since both are recorded in the income statement, the net effect on net profits will be zero; however, the carrying values on the balance sheet will accurately reflect the value of the hedge transaction/position.) Hence, under IAS 39, the change in the derivative’s fair value determines the change in the carrying value of the hedged item. Under Italian GAAP, derivatives’ fair values are only adjusted if the hedged item is recorded at fair value on the balance sheet. Hence, the change in the hedged item’s fair value determines the change in the carrying value of the derivative. These accounting differences have no effect on net profits.
- Under IFRS, changes in the fair value of cash flow hedges are recorded in equity when they occur. Under Italian GAAP, these changes are deferred until the cash flow occurs. This accounting difference has an effect on equity.
- Under IFRS, derivatives designated as held for speculative purposes are recorded at fair value. Under Italian GAAP, these derivatives are only recorded at fair value when the fair values are below the derivatives’ contractual values. This accounting difference has an effect on net profits: Italian GAAP net profits will, on average, be lower than IFRS-based net profits because the gains on derivatives are not recognized under Italian GAAP.

On January 1, 2004, Fiat was party to a Total Return Equity Swap on General Motors shares. This swap did not qualify for hedge accounting. Under IFRS, Fiat would therefore record the fair value of the equity swap (of €450 million) in opening equity. Under Italian GAAP, Fiat had not recognized the fair value in opening equity because the fair value was positive. In 2004, Fiat terminated the equity swap contract, thereby realizing a gain of €300 million in its Italian GAAP-based income statement. Under IFRS, however, the termination of the contract at a value below the beginning-of-year fair value (of €450 million) would cause the recognition of a loss (of €150 million) in the income statement.

*Why is this change an improvement?* In comparison with IFRS, Italian GAAP's treatment of positive changes in the fair value of derivatives held "for speculative purposes" is relatively conservative: increases in the fair value above the contractual value are delayed until realized (i.e., until the derivative has been sold). Also, the balance sheet better reflects the fair value of cash flow hedges under IFRS.

### Other changes

#### Accounting for research and development costs

*Description of the change.* Under Italian GAAP, Fiat had the choice between immediately expensing versus capitalizing and amortizing R&D costs. IAS 38 requires Fiat to capitalize development costs when these meet the recognition criteria for assets (see above). Retrospective application of this standard has increased intangible assets at the end of 2004 by €2.5 billion and increased equity by a (slightly) smaller amount.

*Why is this change an improvement?* The development costs do represent an asset since it is probable that the costs will yield future economic benefits. Immediate expensing of these costs leads to asset understatement and, possibly, to overstatement of future abnormal profitability.

*What is the effect of this change on reporting discretion?* Reporting discretion is similar under Italian GAAP and IFRS. However, Fiat's management uses its discretion differently (i.e. to a greater degree) under IFRS. Given that under Italian GAAP, the company was allowed to capitalize development costs (but chose not to do so), the current switch to capitalization is a breach with past reporting practices. A few questions arise. What inspired Fiat's change? Is the company anticipating an increase in R&D expenditures (of which the potentially negative impact on earnings can be postponed through capitalization)? IAS 38 typically implies a conservative treatment of R&D expenditures: development costs do not easily meet the recognition criteria. However, relative to Fiat's previous practice of immediately expensing all R&D expenditures, the new treatment might appear aggressive. This raises the question as to whether the capitalization rate of 58 percent (of total R&D costs) is aggressive relative to Fiat's competitors. Note, for example, that Volvo, one of Fiat's most successful competitors, capitalized "merely" 46 percent of its R&D expenditures in 2005. Because in the past Fiat never disclosed the amount of development expenditures that would have classified as an asset, it is difficult—if not impossible—for outsiders to assess the validity of Fiat's 58 percent capitalization rate. The effect of the capitalization decisions can be substantial: a downward adjustment of capitalized development costs by 10 percent (or close to €180 million) would have reduced Fiat's ROE by close to 3.5 percentage points in 2004.

#### Employee benefits (IAS 19)

*Description of the change.* Although Fiat used (and continued to use) the corridor approach for recognizing the actuarial gains and losses on its pension obligations, upon adoption of IFRS the company decided to recognize all cumulative actuarial losses into its January 1, 2004 opening equity balance. IFRS 1 allows (but does not require!) this treatment of cumulative actuarial gains and losses. Consequently, Fiat's equity decreased (by €1,247 million) and pension liability increased.

*Why is this change an improvement?* The rationale for allowing firms to immediately recognize all actuarial gains or losses upon adoption of IFRS is that this makes previously less visible off-balance sheet pension liabilities and assets visible on the balance sheet.

*What is the effect of this change on reporting discretion?* The advantage of this treatment (to Fiat) is that it reduces the amortization component in future pension expenses. In other words, by getting rid of all cumulative actuarial losses at once, Fiat's management has made it easier to use overly optimistic pension assumptions (again) in future financial statements. A few questions arise. How realistic were Fiat's pension assumptions in the past? Has Fiat's management been unrealistically optimistic in its assumptions, thereby creating actuarial losses that are unlikely to reverse in the future? This would justify immediate recognition of current actuarial losses: If prior pension assumptions have been unrealistically optimistic, the current decision to immediately recognize the cumulative amount of actuarial losses avoids the dragging effect of current cumulative actuarial losses on future earnings (thereby making future earnings more informative of future performance). However, in this situation, it is important that Fiat's management becomes less optimistic in its assumptions. This appears not to be the case. Both in 2004 and 2005, Fiat reported new actuarial losses on its pension obligations, which may suggest that Fiat's management remains to be overly optimistic in its pension assumptions. The instructor could show Fiat's pension note to illustrate this. Noteworthy is that if Fiat had not decided to immediately recognize its cumulative actuarial losses (in equity) at the beginning of 2004, the corridor rule would have forced Fiat to recognize part of its actuarial losses in earnings. Note B reports that this would have reduced Fiat's 2004 profit by € 94 million (approximately 0.2 percent of sales).

#### Property, plant and equipment

*Description of the change.* Under Italian GAAP, Fiat revalued certain buildings and depreciated the revalued amounts over the buildings' economic lives. In addition, Fiat depreciated a proportion of its land. These treatments were not allowed under IFRS. However, although Fiat's decision to adjust the book values of its buildings to their historical costs upon adoption of IFRS appears nondiscretionary, IFRS 1 allowed companies to consider the "fair" value of its buildings as "deemed" historical cost. One could, therefore, argue that the switch to historical cost was a discretionary accounting choice.

*Why is this change an improvement?* At first sight, the change to historical cost appears not to improve Fiat's financial statements. In particular, the historical-cost based carrying values of Fiat's building and land are likely to be less accurate measures of their fair values than the revalued amounts. In addition, when depreciation is tied to historical cost, current depreciation (and net profit) is generally less predictive of future depreciation (and net profit). On the other hand, Fiat used to revalue its buildings and land only in the years that the Italian government mandated Italian companies to do so (by decree), using a prescribed percentage. It is questionable whether these mandated revaluations have produced carrying values that accurately reflect the fair values of the buildings and land.

#### Question 3

Red flags for potential misuse of reporting discretion are the following:

- a) Like most other Italian public firms, the Fiat Group decided not to adopt IFRS before it became mandatory to do so. Academic research suggests that the voluntary adoption of IFRS prior to the mandatory adoption date is a cost-benefit trade-off.



That is, firms for which the benefits of IFRS (presumably: better information provision, lower information asymmetry between the firm and outsiders, and, consequently, a lower cost of capital) do not exceed the costs (presumably: costs of changing accounting systems, collecting additional information, having less opportunity to misreport performance) are not expected to adopt IFRS voluntarily. The fact that the Fiat Group has waited until 2005 might suggest that the firm considered the benefits of IFRS too low. Consequently, the firm might have relatively weak incentives to comply with the new reporting standards.

- b)** The Fiat Group has one large shareholder, the Agnelli Family, who has a substantial voting block and can exercise much influence over management. In addition, four out of twelve non-executive directors are not independent from the company and its shareholders. The Chairman of the Board is a protégé of the Agnelli Family; the Vice-Chairman a family member. If such an influence of one large shareholder on management leads to the consumption of private control benefits at the expense of other shareholders (or creditors), financial reports might be manipulated to conceal this.
- c)** Several of the “independent” board members are relatively old and/or relatively busy directors, which may impair their effectiveness.
- d)** The Fiat Group has performed poorly in the past years, also because of mismanagement. Since the end of 2001, the company’s shares have performed much worse than the index. At the beginning of 2006, Fiat Group’s debt was rated at BB. The poor share performance and low debt ratings make it expensive for the company to attract new equity or debt capital. This provides management an incentive to misreport performance and let shareholders, investment analysts, and credit analysts believe that the situation of poor performance has reverted. (Also note that Fiat has issued new debt in 2005.) In addition, the poor performance might have resulted in a situation in which Fiat is close to violating some of its debt covenants. This could also provide an incentive for earnings management. (Note that Fiat’s debt ratings had already improved a little during 2005.)
- e)** Financial transactions such as the selling of receivables are typically red flags pointing to an increased risk of manipulation. However, it is important to realize that selling receivables to a third party is a common source of financing in the automobile industry, and even more common in Italy (see Chapter 10 of the text book).

Note that management explicitly emphasizes that 2005 was the turning point for Fiat. The objective of the following accounting analysis is to assess whether the change in performance is truly an improvement or merely an artifact of the initial application of IFRS.

### Conclusion

From the perspective of an investor, the switch to IFRS has clearly improved the informative value of Fiat’s financial statements. The switch has, however, also increased management’s accounting discretion. Consequently, the accounting analysis should focus on identifying and evaluating management’s use of discretion.