ACT Briefing Note

International Financial Reporting Standards (IFRS)

Communication with lenders about IFRS

1. Borrowers and lenders will already be very well aware that the application of International Accounting Standards by all EU listed companies may have a significant effect on the numbers reported in a group's or an entity's financial statements. If not already planned or completed companies will need to communicate sufficiently with their lenders and the credit rating agencies so that the implications of IFRS are properly understood. If need be this can form the basis of any negotiation over waivers or variations in financial covenants.

2. This note summarises some of the crucial elements required in such a communication programme. The exact needs will depend on individual circumstances. Over time actions taken by leading companies should help establish best practice in this area, and a selection of cross references are provided to companies that have already reported their IFRS position.

3. Communications with equity analysts will also concern the treasurer not least because from a lender's perspective some credit default models incorporate the current share price as a significant factor. Adverse share price movements could contribute to slippage in ratings, even triggering immediate increases in margins on debt in many instances and thus actual increases in cash outflows and the cost of all capital.

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Briefing pack for lenders / credit agencies

4. An information pack or presentation to lenders could include:

- Itemisation of crucial IFRSs that will affect the company and quantification of effects by reference to already published financial results, covering P&L, B/S and cash flow effects.

Recent Company Examples:

Astra Zeneca statements, October 2004
http://www.astrazeneca.com/sites/7/imagebank/typearticleparam502958/astrazeneca-2004-restatement-announcement.pdf

GlaxoSmithKline, October 2004
http://www.gsk.com/financial/IFRS-Financial-Statements.pdf

Cadbury Schweppes presentation, December 2004
http://www.cadburyschweppes.com/EN/MediaCentre/Presentations/

Vodafone, January 2005
http://www.vodafone.com/assets/files/en/IFRS_pr_final.pdf and
http://www.vodafone.com/assets/files/en/IFRS_press_appendices.pdf

British Land, January 2005
http://www.britishland.com/pdf_news/n250105.pdf

- Commentary on any changes in policies or behaviours of management which will change the true economics e.g. employee options, pensions, acquisition policy or dividend policy
- Details and explanation of any new accounting policies
- Progress report on the transition process within the group's organisation and on its systems
- Timetable for public disclosures under the new IFRS
- Explanation of the taxation consequences / risks. The Inland Revenue has issued guidance on this that includes a useful summary of the new standards where there could be implications. This is available at: http://www.inlandrevenue.gov.uk/practitioners/int_accounting_index.htm
- Explain any new risk factors applicable e.g. volatility in the numbers, systems breakdown, personnel adequacy / training needs, cost of transition, compliance with agreements / regulation, management distraction from running the business or having adequate management information, US compliance if applicable

Assessment of the significant IFRS changes and effects

5. Certain reported numbers are frequently used in financial covenants and are likely to be subject to changes, positive or negative, because of the IFRS rules. This note is not intended to be a comprehensive accounting explanation and is of necessity heavily generalised. Nonetheless the new standards likely to cause the biggest impacts are listed in the appendix, along with the implications for commonly used ratios which depend on EBITDA, Interest, Debt and Net Worth. OCF (Operating Cash Flow) has begun to be used in recent years and this it may be that this can be defined so as to be less affected by IFRS volatility

6. It is worth reiterating to analysts that a change in accounting treatments does not change the underlying strengths of the business and its actual cashflows. That said, the reported cashflow can change if more subsidiaries and/or joint ventures are proportionally consolidated and thus this will be an area of interest for lenders when considering cash flow debt service cover as a covenant.

7. A summary of some the main areas where there are likely to be differences between IFRS and the previous UK GAAP is included in Appendix 1

Commentary on any commercial behaviours that will change and what new accounting policies will be needed

8. Apart from quantifying the direct effect of IFRS on the reported accounts, consideration of whether IFRS will trigger a change in corporate policies and behaviours has to be the most important point to consider. The major credit rating agencies (Fitch, Moody's and Standard and Poor's) have each stated that they do not expect the adoption of IFRS to have a significant effect on credit ratings except if the new accounting reveals risks not previously evident or if the changed accounting causes changes in the issuer's behaviour to managing risk, remunerating staff, pensions policy etc.

9. High up on the strategic agenda will be the question whether the group's acquisition policies and its dividend policy are to continue unchanged.

10. Tomkins plc, for example, has publicly and very forcefully let it be known that they are solely driven by what is economically sensible to do and that the resulting accounting appearance is not driving their actions. This stance appears sound, but will necessitate a good explanation for analysts if there is any subsequent volatility in numbers reported. For a company operating close to its financial covenant ratios, however, it may not be prudent to neglect appearances.

11. Certain very prudent treasury hedging policies may give rise to volatility in P&L or reserves. For example hedging forecast FX exposures for a time horizon that fails to meet the 'highly probable' test, or hedging floating rate borrowing costs into fixed rates out to a time period where it is difficult to demonstrate with certainty that there will be floating rate debt in existence will mean revaluations of hedging transactions going through P&L. If to avoid this volatility the issuer ceases to hedge where it is economically sensible to do this could be detrimental to a credit assessment.

12. Even when hedge accounting is permitted in a cash flow hedge the revaluation effects are held over in equity until the cashflows occur so that net worth will be volatile and gearing affected. In a fair value hedge of debt the P&L effects from marking to market the hedge and the hedged item will net off, but volatility will in this case remain in the reported amount of the debt which is being marked to market.

13. The costs of certain share options under IFRS 2 must be charged to P&L. Consideration will be needed as to the valuation methodology used, e.g. Black-Scholes or a binomial model. To improve reported P&L a company may cease to offer employees options which could be argued as detrimental to staff motivation and performance.

14. Likewise a company may encourage its pension fund to invest more in equities in order to increase the expected returns and hence the discounting rate applied to liabilities. An apparent reduction in funding liability comes at the expense of an increased risk in the fund.

15. IFRSs are generally very rule based so that there is limited discretion available in how the standards are applied. However there can be areas where the company needs to set a new accounting policy, the use of the 'fair value through P&L option' in IAS 39 being a case in point. A company may decide that documenting and testing hedges is too onerous to be worth doing, so that as a matter of policy it does not seek to obtain hedge accounting for most of its treasury deals.

16. Explanations are needed of how the initial transition provisions will be handled. The company should communicate the extent to which it has reached agreement with its auditors or whether there remain some open issues, such as the methodologies for assessing impairment of goodwill, or the like.

17. Analysts will want to know if subsidiaries of listed companies will themselves apply IFRS, particularly if the subsidiaries are potential or actual borrowers with financial tests based on those subsidiary accounts.

18. For similar reasons lenders will want to know if IFRS is to be applied to management accounts and budgets, or if not is there a timetable for a transition.

19. Finally there is the "Catch all" - Does IFRS have any other business related implications for the company, e.g. capital markets, regulatory, legal solvency etc?

Progress report on transition process

20. Throughout 2004 surveys revealed that many corporates are not that far advanced in their preparations for the introduction of IFRS. The risks of system failures, poor information quality and even the breakdown in controls will be a concern to lenders. The status of the group's IFRS changeover programme should be explained to lenders.

21. IAS 39 is probably the most complicated of the new standards and will almost certainly be the one that is most difficult for which to predict the implications. It will fall to the treasury department to be leading the implementation of this standard, and this will mean a need for a Treasury specific work plan. This could include:

    Review and reassessment of hedging activity and appropriate strategy.

    Hedging policies may have grown up over time and never been rigorously checked as being the optimal solution. Attention to the detail of individual cashflows can sometimes mean that the wider implications have been neglected, for example, a great deal of effort may be directed to short term cash forecasting and FX hedging of committed orders, while in reality it may be that the effort and benefit are not justified. Is the fundamental risk to the business rather the longer term forecast cashflows which should be managed on a general portfolio basis?

    Have embedded derivatives in treasury and in general corporate contracts been identified?

    Have guarantees requiring mark to market been identified?

    Are the systems and market rate data feeds required up and running?

    Systems and procedures must be able to cover the recording of designations, doing revaluations and testing effectiveness.

    Do there exist any off balance sheet arrangements?

    If these are not effective for accounting is their continued existence justified?

Explanation of the timetable for provision of accounting information under the new GAAP

22. The change to IFRS is a significant step change so that users of the accounts need time to assimilate the effects. A set transition timetable for publicly available information is needed. To that end best practice guidance was provided by CESR

(Committee of European Securities Regulators) in December 2003 (see Appendix 2) and in August 2004 from The Hundred Group of Finance Directors.

23. The CESR guidance was not intended to create compulsory reporting deadlines. Companies will still need to consider what makes best sense in their circumstances. It may be helpful to first introduce users to the impact of IFRS on previously published numbers so that understanding the effects is separated from any reaction to news on the latest trading and performance.

24. Recognising that listed groups have a significant workload on them during the transition the UK's FSA, in its Dear CEO letter of October 2004, has given permission for the first interim accounts under IFRS in 2005 to be produced within 120 days from period end rather than the normal 90 days.

Financial covenants compliance

25. A separate note has been issued by the ACT on how IFRS adoption may affect financial covenants. It is available on http://www.treasurers.org/technical/papers/resources/ifrs_briefingnote_dec04.pdf and is summarised in Appendix 3.

26. It is at this stage far from clear what the reaction from lenders will be if a borrower seeks to negotiate new covenants or one off waivers. The credit rating agencies have implied that because their ratio analysis depends heavily on cashflow ratios a change in financial accounting should not have a significant effect, or that they will make suitable adjustments for distorting volatility.

27. EBITDA is widely used in banking agreements as a proxy for cashflow, but this is unlikely to be satisfactory going forward. Companies may wish to negotiate specific adjustments to EBITDA to back off fair value adjustments or pension deficits for example. However while this may be sensible for some companies, for other companies amounts under these headings may be very real and be likely to be realised imminently, so prudently must be taken into account.

28. For some companies OCF (Operating Cash Flow) may already be in use. Typically OCF is derived from EBITDA adjusted for movements in working capital and excluding exceptionals to give the real ongoing change in cash.

29. It is worth noting that the FSA is proposing certain adjustments to reported numbers for its regulatory purposes, which sets an interesting precedent for the use of adjusted numbers, with the caveat that the FSA is more concerned with capital measures rather than P&L or cashflow measures. CP 04/17 published in October 2005 proposes that:

- Fair value gains and losses that have accumulated in equity from fair valuing derivatives that are cashflow hedges be eliminated.
- Unrealised gains and losses arising from the fair valuation of a firm's own credit risk should be eliminated from capital.
- The actuarial gains and losses arising from accounting for defined benefit pension schemes should be eliminated for regulatory purposes and replaced with the firm's best estimate of the level of additional funding that it will provide over the next five years.
- Certain adjustments be made between the categorization of debt and equity
- Certain assets and liabilities should be netted even if they do not meet the strict test in IAS 32 of having 'the intention to settle net'.

UK Accounting

30. For the moment UK entities which are not listed will not have to apply IFRS, but it should be remembered that the ASB is moving quickly to introduce UK accounting standards which mirror the requirements of IFRS. For example FRS 26 which implements most of IAS 39 will be applicable for most UK unlisted companies from 2006

Appendix 1

Summary of major difference between IFRS and previous UKGAAP

Intangibles (IAS 38) and Goodwill (IFRS 3)
More intangibles will be recognised and as before will be amortised, but starting from the time the asset comes into use. Goodwill will be held at cost or occasionally at fair value and be subject to annual impairment testing instead of annual amortisation. The result will depend on circumstances so that the flow to reserves may be different - plus or minus. Affects net worth.

Joint Ventures and Subsidiaries (IAS 31)

Wider definition of jointly controlled entities for which proportional consolidation or equity accounting will be required in the group accounts. Associates or subsidiaries may be recategorised. Effects will vary with circumstances and may affect line by line detail of the P&L even if not the overall result. Consolidation of debt and cash flow may alter. Likewise changes to the definition of subsidiaries can flow through in their use in defining carve outs too.

Share Options (IFRS 2)
Previously many share schemes did not appear in the P&L. Under IFRS the fair value of the equity instrument is charged to P&L at inception (or spread over vesting period if relevant). ESOPs were a net asset but will become a deduction from shareholder funds. Result will be negative on EBITDA and net worth (same treatment as UITF 38 / FRS20).

Research and Development costs / software (IAS 38)
Research will be an expense, but development will be capitalised. Result will generally be positive for EBITDA and net worth

Property Plant and Equipment (IAS 16 and IAS 40)

Property plant and equipment may be carried at cost less depreciation and impairment, or at fair value. Revaluation increases are credited to equity. Positive for Net Worth. Investment properties will be held at depreciated cost or fair value with changes recognised through P&L (UKGAAP at fair value through STRGL).

Consolidation of Special Purpose Entities (SIC 12)
SPEs will come back onto the balance sheet gross instead of being totally off balance sheet or shown net via a linked transaction presentation. Result will be negative for Interest and Debt.

Operating Leases (IAS17)
IAS 17 is largely similar to SSAP 21 but some operating leases on buildings will become finance leases and therefore be treated as debt. In the future further changes may bring far more operating leases into the finance lease category. Result is negative on interest and debt, although some analysts may already impute leases as debt. . May have impact on EBITDA (operating cost replaced by depreciation plus interest). Property leases will be split: Building = finance, land = operating.

Pensions (IAS 19)
For defined benefit schemes IAS 19 will require recognition of pension deficits as a liability, either charged to P&L immediately or via a spreading method, or taken to a new 'statement of recognised income and expense'. This will be negative to net worth and there will be changed amounts flowing to interest and EBITDA and, depending on definitions, the liability may be treated as debt by some lenders.

Definitions of debt and equity (IAS 32)
The definitions of debt and equity will alter which can flow through to what is treated as interest rather than dividends. For example some preference shares previously classed as non-equity minority interests will become debt. Will affect debt and Interest and gearing.

Netting (IAS 32)
IAS 32 introduces an additional test of 'intention to settling net' so cash and debt may end up being grossed up.

Associates (IAS 28)
The share of an associate's profit, interest and tax no longer have to be shown separately but will be brought in as a single net amount. Can affect Interest.

Dividends (IAS 10)
Proposed final dividends will not be accrued until they have been approved. Result will be positive for net worth over the year end date.

Financial Instruments (IAS 39)
The required revaluation to fair value will introduce potential variability in EBITDA. Even where cashflow hedge accounting is achieved the gains and losses are parked temporarily in reserves so that net worth can even be affected by valid hedging.

Provisions (IAS 37)
Provisions will be calculated by discounting futures cashflows, so the adjustment of a provision as time passes will affect interest. (Similar to FRS 12)

Deferred Taxation (IAS 12)
Full provision needed and discounting prohibited. Generally negative to Net Worth. Key areas where it is different (i.e. provision required) are on revaluation of non-monetary assets and un-remitted earnings of subs, JVs & associates.

Distributable Reserves
Many IFRS effects will affect distributable reserves either at a subsidiary or parent level, depending on group structures. The potential for dividend block exists

Segmental Reporting (IAS 14)
IAS 14 may mean that information has to be broken down across more segments, which could result in disclosure of previously confidential information or trigger more probing questions from analysts.

Transitional adjustments (IFRS 1)
Analysts will want to see comparatives and to understand what day one transitional adjustments have been taken via reserves.

Appendix 2

CESR (Committee of European Securities Regulators) guidance on timetable for making IFRS information public. (December 2003)

CESR's advice, using a December year end group as the example, was phased around certain milestones in the reporting calendar:

- **On Publication of 2003 financial statements.** Companies should be encouraged to describe their IFRS conversion plans (and degree of achievement) and also the major accounting differences in narrative form.

- **On Publication of 2004 financial statements.** As soon as a company can quantify the impact of a change to IFRS on its 2004 financial statements in a sufficiently reliable manner, it is encouraged to disclose the relevant quantified information. Companies should not publish quantified information without having gone through sufficient quality controls and possibly audit checks.

- **2005 interim financial statements.** Where any interim financial statement (whether quarterly or half-yearly) is published in 2005, companies should start applying as from 1 January 2005 either IAS 34 "Interim Financial Reporting" or, if this is not possible, at least the IFRS recognition and measurement principles that will be applicable at the year end. Comparatives using the same IFRS accounting rules should be provided.

- **2005 financial statements.** Required under IFRS. CESR does not go beyond the existing requirement that only one year of comparatives (e.g. 2004) be prepared and presented under IFRS.

Appendix 3

Financial covenants compliance

A separate note has been issued by the ACT on how IFRS adoption may affect financial covenants and is available on
http://www.treasurers.org/technical/papers/resources/ifrs_briefingnote_dec04.pdf

In summary:

- There is unlikely to be a major issue with bank loan covenants arising from the change to IFRS for most companies, because they can continue to observe covenants based on previous Generally Accepted Accounting Principles. However the work required to maintain frozen GAAP means that this is not a long term solution.
- A few companies may have to test new IFRS compliant figures against loan covenants. Of these a small number may find that on an IFRS basis they are not compliant with covenants.
    - This default may trigger cross-default clauses in other loan agreements. Cascading defaults can make difficulties unmanageable - so such companies must take early action to agree variations in loan terms to substitute appropriate covenants adapted to IFRS
    - Such companies need to consider if they will be able prepare accounts on a going concern basis
    - and if an announcement about any aspect of this is required under the continuing obligations under the Listing Rules of the United Kingdom Listing Authority.
    - This problem may arise earlier than expected if covenants have to be observed at all times or on a new advance or roll-over of an existing advance.
- All companies also need to ensure that no obligations under their articles of association (such as borrowing limits) or in other contracts or, in regulated businesses, under relevant regulations or operating licences, will be affected by a change to IFRS compliant reporting and take any necessary actions – including in respect of going concern and disclosure obligations.

Appendix 4

Further commentaries

Moody's, October 2004: *The impact of IFRS on the credit ratings of European Corporates*

Click here for link:
http://www.treasurers.org/technical/papers/resources/moody_ifrsoct04.pdf

Standard & Poor's, December 2004: *Transition without tears; A five-point plan for IFRS disclosure*

Click here for link:
http://www.treasurers.org/technical/papers/resources/sp_transitiondec04.pdf

Fitch Ratings, November 2004: *hedge accounting and derivatives study for corporates*

Click here for link:
http://www.treasurers.org/technical/papers/resources/fitch_hedgeaccounting.pdf

Fitch Ratings, July 2004: *IFRS and international accounting convergence: revolution or evolution?*

Click here for link:
http://www.treasurers.org/technical/papers/resources/ifrs_fitch.pdf

ASB guidance issued in December 2004 on IAS 39 and how it inter-relates to the EU carved out standard and what is required by EU accounting law and UK companies law: see http://www.frc.org.uk/asb/press/pub0666.html

The Department of Trade and Industry (DTI) guidance (issued November 2004) for British companies on the changes to the reporting and accounting provisions of the Companies Act 1985 is available at http://www.dti.gov.uk/cld/N0000J8Q.doc