Communicating with lenders over IFRS

The ACT's technical department has produced a briefing note on planning a comprehensive communication package for lenders. Martin O'Donovan reports.

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.

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.

The ACT's technical department has produced a briefing note on some of the main elements to be considered in planning a comprehensive communication package for lenders and which is available on the ACT website. The information pack should cover:

- 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. Examples of the sort of detail needed can be found on the websites of companies that have been at the forefront of presenting the consequences of IFRS to equity analysts (e.g. AstraZeneca, GlaxoSmithKline, Vodafone);
- 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
- Explanation of 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 not having adequate management information, US compliance if applicable.

SIGNIFICANT IFRS CHANGES AND EFFECTS 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.

The ACT's briefing note has a summary of the main areas where there are likely to be differences between IFRS and the previous UK GAAP and the more significant ones are shown in *table 1.*

CHANGES TO COMMERCIAL BEHAVIOURS
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 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.

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.

Certain very prudent treasury hedging policies may give rise to volatility in P&L or reserves. If, to avoid this volatility, the issuer ceases to hedge where it is economically sensible to do so this could be detrimental to a credit assessment.

High up on the strategic agenda will be the question of whether the group's acquisition policies and its dividend policy are to continue unchanged. But there can be other areas where the accounting might trigger management to act differently. With the cost of share options being charged to P&L under IFRS 2 will employee schemes be discontinued? Will the pensions fund be encouraged 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.

THE TRANSITION PROCESS 2004 surveys revealed that many corporates were 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.

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. The company's approach to IAS 39 implementation and progress to date will be important.

TIMETABLE FOR NEW ACCOUNTING INFORMATION The change to IFRS is a significant step change so users of the accounts need time to assimilate the effects. It

Table 1. Difference between IFRS and previous UK GAAP

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.

Deferred Taxation (IAS 12)
Full provision needed and discounting prohibited

Definitions of debt and equity (IAS 32)
The definitions of debt and equity will alter which can alter what is treated as interest rather than dividends. Some preference shares previously classed as non-equity minority interests will become debt.

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

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.

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.

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. May affect line by line detail of the P&L even if not the overall result. Consolidation of debt and cash flow may alter.

Operating Leases (IAS17)
Some operating leases on buildings will become finance leases and therefore be treated as debt. Property leases will be split: Building as finance, land as 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'.

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.

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. Investment properties will be held at depreciated cost or fair value with changes recognised through P&L. (UK GAAP at fair value through STRGL)

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.

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. This is certainly what is being done by companies that have already gone public on the effects and consequences of IFRS.

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 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 any distorting volatility.

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 likely to be realised imminently, so prudently must be taken into account.

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 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. For actuarial gains and losses arising from defined benefit pension schemes the FSA plans to eliminate them and replace them with the firm's best estimate of the level of additional funding that it will provide over the next five years.

The full ACT briefing note, communication with lenders about IFRS is available at www.treasurers.org./technical/papers/resources/ifrs_guidanceactfeb05.pdf.
It includes links to further research reports and useful guidance notes produced by other parties. ■