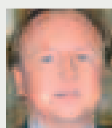
Ask the experts:

Getting to grips with IFRS and banking covenants

What effect are International Financial Reporting Standards (IFRS) having for treasurers negotiating with their bankers?



Paul Reynolds, Executive Director, Rothschild DCM Advisory

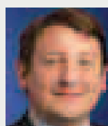
Not a lot – yet. But as soon as treasurers are comfortable that they understand the impacts, they should immediately begin the process of educating their banks in anticipation of future negotiations.

Most deals are covenanted on a static Generally Accepted Accounting Practice (GAAP) basis, swapping basis risk for the administrative burden of reconciling future financial statements (on whatever tortured basis the International Accounting Standards Board (IASB) deemed appropriate) back to the covenant calculations in their loan agreements (based on the latest accounts prior to the agreement). Most existing deals, therefore, are unaffected. Where there are IFRS issues and deals were not originally static GAAP, they are likely to have been so amended by now.

Although very few companies are not already under IFRS and the first full IFRS results are only some 120 days away, most borrowers and their bankers remain more comfortable anchoring new deals to the last set of old UK GAAP accounts rather than push off into uncharted IFRS waters at this stage. Understandable given the complexity and volume of new International Accounting Standards (IAS), differing advice on interpretation and that the EU is not expected to confirm which will be adopted until March 2006.

However, there are already some exceptions (typically where borrowers only have an interest cover covenant) and the aversion or inability to reconcile back will render an IFRS basis as the norm very quickly. However, (just as the FTSE 100 Group of Finance Directors favours voluntary publication of results on a pre-IFRS basis because it will be more helpful) early signs are that – at least while conditions remain favourable for borrowers – covenant definitions will be almost fully adjusted so that the covenants in effect resemble the old UK GAAP construction.

Once publishing under IFRS, treasurers will need to focus on amending covenant definitions to remove non-operating volatility (reversing out pension related and fair value adjustments) and amending covenant levels or definitions to recognise structural changes such as leasing, non-recourse debt, capitalised costs and goodwill amortisation. A number of material adjustments will be necessary when using IFRS accounts for bank covenants – and concerted communication will be necessary to secure these. The real conundrum for many, however, is if or how to deal with US Private Placement Notes.



Lee Edwards, Director, Corporate Treasury Services, KPMG

Following the first implementation of IFRS this year, corporate treasurers are grappling with its consequent effects and the communication of the treasury hedging results to the outside world. A key area in this regard is the banking covenant arrangements which are becoming increasingly prominent at board level.

Most covenants (such as interest cover and net worth) set out in loan agreements are based on "frozen GAAP" (that is, based on UK GAAP at a point in time). The year end financial statements will normally provide sufficient clarity on the financial data to provide the lenders with information to assess the likelihood of non-compliance. Where this is not the case, corporates provide the lender with a reconciliation between current and "frozen" GAAP, normally using numbers in the audited financial statements; going forward, this is less likely to be viable with a different GAAP.

Corporate treasuries are now focussing on the pros and cons of whether or not "frozen GAAP" should be kept (with the potential consequent impact of an audited reconciliation being prepared) or start to negotiate new financial covenants. Where they can, most corporates appear to favour retaining "frozen GAAP" due to the uncertainty around the volatility of the IFRS numbers and the impact of further IFRS updates. In addition, banks appear to be trying to come to grips with sensible covenant definitions and acceptable measures.

It seems only a question of time until banks require loan agreement covenants to be based on audited IFRS numbers. However, in the short term, corporate treasuries may possess an IFRS information advantage which could lead to potentially more advantageous covenants being negotiated.

Lee Edwards was assisted in this article by Bernd Kremp, Manager, Corporate Treasury Services, KPMG.

It seems the detail of how banking covenants are being set up in the new era of international accounting standards is one area which is a work in progress.

Some treasurers are going for a fall back position of using UK GAAP if the international GAAP figures give a funny answer. Fine in theory, not sure how that will work in practice. How exactly can UK GAAP be used when a company has moved onto IFRS? Other treasurers have managed to avoid the issue altogether by negotiating a position where covenants exclude the impact of IFRS. That may help in the short-term but it is not a long-term answer. At the moment treasurers, bankers and lawyers are just starting to think through the issues, but answers are needed quickly. *- Ed.*