Special Comment

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The Impact Of International Financial Reporting Standards ('IFRS', formerly known as IAS) On The Credit Ratings Of European Corporates

Summary

At present, fewer than 10% of the corporates rated by Moody's in Europe prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) and the rating agency strongly supports efforts to achieve greater consistency in accounting practices. Where different accounting standards distort the comparability of financial information, significant additional effort is required on the part of users, and conclusions often have to be tempered.

Moody's has developed adjustments that permit reasonable comparisons of key financial data produced under a number of different accounting conventions. However, the adoption of European Commission-endorsed IFRS from 2005 onwards by nearly all publicly traded companies incorporated in the European Union (EU) should improve the efficiency and transparency of Moody's analytical processes.

In this report, Moody's sets out the more significant changes that it anticipates will have to be made to financial statements from 2005 onwards. The expected impact on key credit metrics such as EBIT, interest expense, cash flow from operations (CFO) and debt is also examined.

Several factors could potentially impact the credit rating of an individual issuer converting to IFRS. These include:

- Disclosure of risks or financial characteristics not previously evident from the reporting under local GAAP.
- Market perceptions changing to the detriment of the issuer.
- Restrictive banking or other covenants being breached when the numbers are restated.
- Adverse regulator behaviour in response to the new financial metrics.
- Changes in the behaviour of the issuer – to managing risk, or remunerating staff, or issuing particular types of financial instruments, to name a few examples.

However, in Moody's view it would be surprising if the above factors manifested themselves to a material degree in other than a very limited number of cases. In general, the impact of converting to IFRS should be mitigated by:

- Moody's "looking through" the reported financial statements in order to focus on the underlying financial reality and economic substance; and
- Moody's continuing to place strong emphasis on cash flow-based measures and metrics.

Moody's Investors Service
Global Credit Research

Background

Endorsed IFRS is mandatory for listed EU companies from 1 January 2005

In September 2002, the Regulation requiring the use of IFRS in the consolidated financial statements of EU companies that are publicly traded came into force. However, the standards are not legally binding until they have been endorsed by the European Commission, after consulting Member States in the Accounting Regulatory Committee (ARC). This mechanism is intended to assess the output of the International Accounting Standards Board (IASB) and to ensure appropriate political oversight.

In September 2003, the Member States endorsed the existing standards, with the exception of IAS 32 and IAS 39. These standards, which deal with financial instruments, were disputed by a number of European banks and financial institutions. On 1 October 2004, the ARC voted to adopt a version of IAS 39 that had been amended by the European Commission, rather than IAS 39 as published by the IASB. The ARC vote is not the final stage in the EU adoption process, but it is a strong indication of the outcome.

The fair value option in the IASB's version of IAS 39 has been restricted so that it does not apply to financial liabilities. In addition, some of the criteria that have to be met if a hedge relationship is to qualify for hedge accounting have been deleted. However, the European Commission has stated that Member States will have the option of requiring companies affected by the Regulation to comply in full with the hedge accounting requirements of IAS 39.

The endorsed standards apply to financial years commencing on or after 1 January 2005. However, Member States may defer application to 2007 for those companies listed both in the EU and elsewhere that currently use internationally accepted standards (principally US GAAP) as their primary basis for reporting. This deferral is also available for companies whose debt securities only are publicly traded.

IFRS Will Result in Significant Changes to Financial Statements

IFRS differs from the accounting standards currently used in individual EU countries in a number of important respects. A detailed discussion of the differences is beyond the scope of this report, but the more significant changes required by IFRS include the following:

- Business combinations have to be accounted for as acquisitions, but goodwill amortisation is discontinued.
- Substance-based rules must be used for consolidating special purpose entities (SPEs).
- Derivatives have to be recorded at fair value, stringent rules restrict the use of hedge accounting and derecognition of financial assets is harder to achieve.
- Prescribed impairment tests apply to fixed assets, certain software and other development costs have to be capitalised, and tax-based depreciation is prohibited.
- More leases have to be brought on balance sheet.
- Provisions are restricted to committed liabilities only, specific rules apply to pensions, and expected cash outflows must be discounted to present value.
- Specific rules apply when distinguishing between liabilities and equity.
- Share-based payments have to be recorded at fair value.
- Funds flow statements are replaced by cash flow statements.
- More detailed guidance must be followed when recognising revenue.
- Liabilities for proposed dividends must be reversed, the last in first out (LIFO) method is prohibited, treasury stock is deducted from equity, temporary differences are used as the basis for deferred tax, and fair value changes in property and biological assets must be reported directly in income.

The above developments are explained in greater detail in the sections that follow, with extracts from published financial statements being used to illustrate existing practices and the changes required under IFRS.

Business combinations – All accounted for as acquisitions, no goodwill amortisation

IFRS 3 *Business Combinations* was issued in March 2004 and requires an acquirer to be identified for all business combinations. These must henceforth be accounted for using the purchase method. As a result, both the consideration given and the acquired identifiable assets, liabilities and contingent liabilities that satisfy certain recognition criteria, are measured at their fair values at the acquisition date. Goodwill arising on the acquisition must be recognised as an asset, but it will no longer be amortised. Instead, IFRS 3 requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. Any so-called "negative goodwill" will generally be recognised immediately in profit or loss.

The purchase accounting method required by IFRS 3 can be contrasted with the pooling of interests method under which fair values are not used and whereby goodwill is not recorded in the financial statements. Consequently, the balance sheet understates the capital employed in the business:

Extract 1: Business combinations under Spanish GAAP

'Under Spanish GAAP, business combinations that are realized through the issuance of shares are normally accounted for under the pooling of interests method.'

Source: Telefónica, S.A – Form 20-F for fiscal year ended 31 December 2003 (page F-100).

Extract 2: Business combinations under Italian GAAP

'Italian GAAP allows that, for certain transactions that use shares for part or all of the consideration, the shares exchanged be accounted for as a pooling of interest.'

Source: Telecom Italia S.p.A. – Form 20-F for fiscal year ended 31 December 2003 (page F-70).

IFRS 3 prohibits the immediate elimination of goodwill against equity, as previously permitted in the UK and in certain other countries such as France and The Netherlands. IFRS 3 also reverses the current policy of amortising goodwill that has not been eliminated against equity:

Extract 3: Accounting for goodwill under UK GAAP

'Under UK GAAP, the policy followed prior to the introduction of FRS 10, *Goodwill and Intangible Assets*, which is effective for accounting periods ended on or after 23 December 1998 and was adopted on a prospective basis, was to write-off goodwill against shareholders' equity in the year of acquisition. FRS 10 requires goodwill to be capitalised and amortised over its estimated useful economic life.'

Source: Vodafone Group Plc – Annual Report 2004 (page 117).

In common with US GAAP, IFRS 3 contains specific criteria for recognising certain intangible assets acquired as part of a business combination. These assets can no longer be subsumed within goodwill, as is currently the case in many European countries:

Extract 4: Accounting for acquired intangible assets under Dutch GAAP

'US GAAP requires that, in accounting for a business combination, intangible fixed assets that arise from contractual or other legal rights or are separable must be separately identified and recognized as intangible assets apart from goodwill. Under Dutch GAAP, these intangible assets are generally included in goodwill. The most significant intangible assets identified in the acquisition of E-Plus and BASE include brand name, customer base and other intangible assets. As the intangible assets recognized separately under US GAAP are amortized over shorter useful lives than the goodwill recorded under Dutch GAAP, the intangible asset amortization expense is higher under US GAAP as compared to Dutch GAAP.'

Source: Koninklijke KPN N.V. – Annual Report and Form 20-F 2003 (page 192).

Under IFRS 3, intangible assets must be recognised separately from goodwill if (i) they are identifiable (because they arise from contractual or other legal rights or are capable of being separated or divided from the entity) and (ii) their fair value can be measured reliably. Examples of assets that are often subsumed within goodwill, but which are likely to be recognised separately under IFRS include customer relationships, software, trademarks and in-process research and development projects.

Although all business combinations will henceforth be accounted for under the same rules, companies adopting IFRS in 2005 are not required to restate transactions entered into prior to 1 January 2004. However, goodwill arising on all acquisitions will cease to be amortised.

Special purpose entities ('SPEs') – Substance-based rules, more entities consolidated

IFRS requires SPEs – regardless of whether they are incorporated – to be consolidated where the substance of the relationship indicates that the SPE is controlled by the reporting entity. Control may arise through pre-determination of the activities of the SPE (operating on "autopilot") or otherwise. The following circumstances may be indicative of a relationship in which an enterprise controls an SPE:

- In substance, the activities of the SPE are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE's operation;
- In substance, the enterprise has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the enterprise has delegated these decision making powers;
- In substance, the enterprise has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- In substance, the enterprise retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

As a consequence of these requirements, many securitisation transactions will be reversed and accounted for instead as secured financings. However, the IFRS rules are wide-ranging and they could apply to other arrangements such as the following transaction which was recorded as an addition to fixed assets and financial debt in 2003 under Spanish GAAP:

Extract 5: Example of an arrangement likely to be consolidated under IFRS

'On November 23, 2001, REPSOL YPF acquired an irrevocable option, with a penalty for non-exercise, to purchase a 7,500 square metre land lot from Tecnicontrol y Gestión Integral, S.L. (a wholly-owned investee of Caja de Ahorros y Monte de Piedad de Madrid), which in turn had acquired it from Real Madrid Football Club. The acquisition cost of this land lot, located in the club's former sports complex on the Paseo de la Castellana in Madrid, was €188 million.

The premium paid by REPSOL YPF in connection with the irrevocable purchase option amounted to €1.2 million and the exercise period, which expired on December 29, 2003, was extended to March 30, 2004, at an additional cost of €20,000.

The exercise price will be determined by all the debts, interest, payments and related financial costs borne by Tecnicontrol y Gestión Integral, S.L. for the acquisition and subsequent management of this land lot.

If it fails to exercise the purchase option, REPSOL YPF will have to pay a penalty which will be determined as the difference between the option exercise price and the land sale price, provided that the latter amount is lower than the option exercise price.'

Source: Repsol YPF, S.A. – Form 20-F for fiscal year ended 31 December 2003 (pages F-88 to 89).

Financial instruments – Derivatives recorded at fair value, stringent rules for hedge accounting and derecognition, and many investments uplifted to fair value

In common with US GAAP, IFRS requires all derivatives, including forwards, swaps and options, to be recognised in the balance sheet at fair value (i.e. they must be 'marked to market'). The requirements are wide-ranging and apply to contracts to buy and sell non-financial items such as commodities where those contracts can be settled net by using or exchanging financial instruments, including cash. However, contracts entered into in order to meet normal purchase, sale or usage requirements are generally excluded under an 'own-use' exemption.

Under existing practice in Europe, derivatives are generally excluded from the financial statements until the transaction that is the subject of the hedge takes place:

Extract 6: Accounting for derivatives under UK GAAP

'…under its accounting policies, Unilever applies hedge accounting to its portfolio of derivative financial instruments, meaning that changes in the value of forward foreign exchange contracts are recognised in the results in the same period as changes in the values of the assets and liabilities they are intended to hedge. Interest payments and receipts arising from interest rate derivatives such as swaps and forward rate agreements are matched to those arising from underlying debt and investment positions.

Under US GAAP… all derivative financial instruments are valued at fair value…'

Source: Unilever – Annual Report & Accounts and Form 20-F 2003 (page 134).

Under IFRS, all of Unilever's derivatives will have to be 'marked to market' and recorded in the balance sheet as assets or liabilities, depending on whether their values are positive or negative. The other side of the entry depends on whether the derivative concerned qualifies for hedge accounting. The following strict conditions must be met before hedge accounting is permitted under IFRS:

- There must be formal designation and documentation of the hedge, including the risk management strategy;
- The hedging instrument must be expected to almost fully offset changes in fair value or cash flows of the hedged item that are attributable to the hedged risk;
- Forecast transactions being hedged must be highly probable;
- Hedge effectiveness must be reliably measurable – this means that the fair value or cash flows of the hedged item and the fair value of the hedging instrument must be capable of reliable measurement;
- The hedge must be assessed on an ongoing basis and be highly effective.

If these conditions are not met, changes in the fair value of the derivative are recognised in earnings. However, when hedge accounting is permitted, the outcome depends on whether the arrangement is a *fair value* hedge or a *cash flow* hedge:

Extract 7: Accounting for derivatives under IFRS

'Fair value hedges are derivative financial instruments that hedge the currency risk and/or the interest price risk. The changes in fair value of fair value hedges are recognised in the income statement. The hedged item is also stated at fair value in respect of the risk being hedged, with any gain or loss being recognised in the income statement.

Cash flow hedges are derivative financial instruments that hedge the currency risks of anticipated future export sales, cash flow risks of anticipated future purchases of industrial equipment, the currency and/or commodity risk of future purchases of raw materials as well as the cash flow risk from changes in interest rates. The effective part of the changes in fair value of cash flow hedges are recognised in equity, while any ineffective part is recognised immediately in the income statement.'

Source: Nestlé S.A. – Consolidated accounts for 2003 (page 14).

Gains and losses on *cash flow* hedges recognised in equity are recycled into earnings at the same time as the hedged transaction, so the impact on the income statement is not very different from the pre-IFRS position. However, due to different accounting methods currently used for *fair value* hedges, liabilities reported by Unilever under UK GAAP and Nestlé under IFRS may not be directly comparable. The following example shows how, in an extreme case, the IFRS requirement to present derivatives separately increases the reported liability by nearly 50%:

Extract 8: Higher liability under IFRS due to separate reporting of derivatives

'On July 10, 2001, Syngenta issued €800 million of 5 year Eurobonds with a coupon rate of 5.5%. At issue, these liabilities had a value of US$677 million. As at December 31, 2003, they are shown at a value of US$1,012 million… Cross-currency swaps were implemented at the time of issue to hedge this exchange movement and the fair value of the swaps is included in the derivative assets and liabilities shown in Notes 11 and 19.'

Source: Syngenta AG – Notes to the Group Consolidated Financial Statements for 2003 (page 66).

A European company with a US dollar-based business would, under local GAAP, usually report a foreign currency bond issue (similar to the above-mentioned €800 million Eurobond) at the dollar amount payable under the related cross currency swap (US$677 million), effectively deducting the US$335 million receivable due from the swap counterparty from the liability.

Converting to IFRS will also impact on the level of reported liabilities if the reporting entity is unable to meet the stricter criteria for the derecognition of financial assets such as receivables. Under IFRS, these items can only be removed from the balance sheet when the contractual rights to the asset's cash flows expire or when the reporting entity:

- Has transferred the asset and substantially all the risks and rewards of ownership, or
- Has transferred the asset, and has retained some substantial risks and rewards of ownership; however the other party may sell the asset. The risks and rewards retained are recognised as an asset.

As a result of these requirements, certain securitisation transactions may have to be restated as secured borrowings.

IFRS does not require debt to be reported separately from other financial liabilities. However, entities are required to disclose information about their exposure to interest rate risk which should help identify the inputs for credit metrics that include debt and debt-like items.

IFRS will also require most investments to be adjusted to fair value, regardless of whether any surplus has been realised. The exception is where the entity has the positive intention and ability to hold to maturity those investments having fixed or determinable payments and a fixed maturity.

Fixed assets – Prescribed impairment tests, mandatory capitalisation of some costs, tax-based depreciation prohibited

In addition to introducing a standardised methodology for impairment tests, IFRS will bring about other changes to the method of accounting for fixed assets. In particular, certain intangibles such as deferred start-up costs will no longer be recognised as assets, but other expenditures may have to be capitalised. These include software development costs which are currently expensed as incurred in certain countries such as Germany, but capitalised by companies that already adopt IFRS:

Extract 9: Capitalisation of software development costs under IFRS

'Generally, costs associated with developing or maintaining computer software programs are recognized as an expense as incurred. However, costs that are directly associated with identifiable and unique software products controlled by Swisscom, and have probable future economic benefits, are recognized as intangible assets and amortized using the straight-line method over their estimated useful life of three to five years. Expenditure which enhances or extends the performance of computer software programs beyond their original specifications is recognized as a capital improvement and added to the original cost of the software.'

Source: Swisscom AG – Form 20-F for fiscal year ended 31 December 2003 (page F-7).

IFRS also requires the capitalisation of other development costs. Renault reports under French GAAP, but the requirements of IAS 38 were applied voluntarily from 2002 onwards using the prospective basis under the transitional provisions then applicable. Conversion from French GAAP to IFRS in 2005 will result in retrospective adoption from 1 January 2004 of the accounting policy set out below:

Extract 10: Capitalisation of product development costs under IFRS

'As of January 1, 2002, development expenses incurred between the approval of the decision to begin development and implement production facilities for a new vehicle or part (e.g. engine or gearbox) and the subsequent approval of the design for mass production are capitalized as intangible assets (previously they were recorded as costs in the year incurred). They are amortized from the date of approval for mass production, over the expected market life of the vehicle or part, up to a maximum period of five years.

Expenses incurred before the formal approval of product development and research expenses are recorded as costs in the year they are incurred. Expenses incurred after the start of mass production are treated as production costs.'

Source: Renault S.A. – Annual Report 2003 (page 165).

Unlike US GAAP, IFRS allows companies either to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of an asset, or to recognise these costs as an expense in the period in which they are incurred. However, IFRS prohibits the use of tax-based depreciation methods used in some countries such as Germany:

Extract 11: Restated depreciation charge under IFRS

'Under IFRS/IAS, the useful life of property, plant and equipment is estimated on the basis of the economic life. As a rule, longer useful lives are applied under IFRS/IAS. The declining balance method of depreciation used in the past under HGB is generally replaced by the straight-line method. On aggregate, these two variances result in higher carrying amounts under IFRS/IAS.'

Source: Energie Baden-Württemberg (EnBW) AG – Annual Report 2003 (page 100).

Leases – More assets and liabilities brought on balance sheet

IFRS distinguishes between finance leases, which are required to be treated by lessees as borrowing in order to acquire an asset, and operating leases, which are accounted for as rentals. This approach is different to that currently adopted in certain European countries, although some companies have begun to anticipate the impact of adopting IFRS by changing their local GAAP accounting:

Extract 12: Finance leases capitalised in anticipation of IFRS

'Since 1 January 2003, the Group has applied the preferential method described in French Regulation CRC* 99-02, whereby finance lease contracts are recognized in the balance sheet as property, plant and equipment financed through borrowing. This method applies to all contracts in force at 1 January 2003.'

* CRC: *Comité de la Réglementation Comptable* (France's Accounting Regulation Committee)

Source: Electricité de France Group – Annual Report 2003 – Financial statements (page 13).

Following a recent revision, IAS 17 requires that, when classifying a lease of land and buildings, the land and buildings elements are considered separately. The land element is normally classified as an operating lease, unless title passes to the lessee at the end of the lease term.

Provisions – Committed liabilities only, specific rules for pensions, discounting required

Under IFRS, a provision is included in the balance sheet only where there is an actual obligation and when it is *probable* that a future outflow of resources will be required to settle the obligation. This approach is different to that currently adopted in some European countries:

Extract 13: Stricter rules for provisions under IFRS

'Under Spanish GAAP, foreseeable contingencies, including possible losses, are recorded as soon as they become known.'

Source: ENDESA, S.A. – Form 20-F for fiscal year ended 31 December 2003 (page F-88).

Liabilities recorded for pension obligations are likely to be higher under IFRS:

Extract 14: Pension liabilities under German GAAP

'The accruals for pensions and similar obligations are determined according to actuarial principles at the net present value defined by section 6a [of the German Income Tax Law *(Einkommenssteuergesetz)*] EStG, applying an interest rate of 6%. The effects of the 1998 Heubeck mortality tables have been fully considered.

…The accruals for pensions and similar obligations are formed on the basis of existing pension commitments for future benefits and current payments to eligible employees and former employees and their surviving dependants.'

Source: Energie Baden-Württemberg AG – Annual Report 2002 (pages 107 and 114).

On an IFRS basis, which also includes the impact of expected salary increases, the pension liability of €2.5 billion recorded by EnBW under German GAAP was increased by 40% to €3.5 billion:

Extract 15: Higher pension liability under IFRS

'The pension provisions previously recognised in accordance with Section 6a German Income Tax Law (EStG) have been determined using the internationally recognised projected unit credit method.'

Source: Energie Baden-Württemberg AG – Annual Report 2003 (page 100).

Many UK companies currently use Statement of Standard Accounting Practice (SSAP) 24 which permits actuarial valuations to be performed at three yearly intervals. Under IFRS, they will be required to base their pensions accounting on up-to-date measures. The gross obligation will generally be higher due to the lower discount rate prescribed under IFRS.

Another significant change required by IFRS is that it will no longer be possible to build up provisions for asset abandonment obligations on an incremental basis over the life of the related asset, as currently permitted in some jurisdictions:

Extract 16: Abandonment and dismantlement obligations under Spanish GAAP

'Future field abandonment and dismantlement costs (environmental, safety, etc.) are estimated, on a field-by-field basis, taking into account Spanish and international regulations. These costs are allocated to income each year based on production with respect to the proved reserves.'

Source: Repsol YPF, S.A. – Form 20-F for fiscal year ended 31 December 2003 (page F-25).

The obligations described above will henceforth be recorded in full when the asset is first brought into use. However, the amount recorded as a liability is required to be discounted:

Extract 17: Discounting of provisions under IFRS

'The other long-term provisions, which are carried in the HGB financial statements at their nominal amount, are accounted for at the settlement amount discounted to the balance sheet date under IFRS/IAS. The main effects here relate to the long-term provisions in the nuclear power area.'

Source: Energie Baden-Württemberg AG – Annual Report 2003 (page 100).

Given that the discounted asset retirement obligation is added to the cost of the asset under IFRS, the expense previously reported as an operating cost is reclassified as depreciation and interest. This has a favourable impact on measures such as EBITDA.

In some European countries, asset retirement obligations are required to be pre-funded via contributions to a central fund. The related asset is often deducted from the obligation – a practice not permitted under IFRS when the reporting entity retains ultimate responsibility for discharging the obligation:

Extract 18: Provisions required to be grossed up under IFRS

'According to the Swedish Act (1995:1544) on the Financing of Future Expenses of Spent Nuclear Fuel, etc., the holder of a licence to operate a nuclear reactor in Sweden must, as long as the reactor is in operation, pay an annual fee to finance the management of spent nuclear fuel and other radioactive waste. The fee is paid to the Nuclear Waste Fund and is based on the energy delivered by the reactor. The fund reimburses these fees as and when the nuclear power company incurs costs for the treatment and final disposal of spent fuel and radioactive waste from its reactors, after the fuel and waste have been removed from the reactors, the decommissioning and demolition of the nuclear installation and the research and development required to perform this… On December 31, 2003, the market value of Vattenfall Group's share of the Nuclear Waste Fund was SEK 20,012 million (2002: SEK 19,047 million).'

Source: Vattenfall AB – Annual Report 2003 (page 81).

Recording the Nuclear Waste Fund as an investment asset under IFRS also means that the annual fee is no longer recorded as an operating expense. Moody's expects the payment of the fee to be reclassified as an investing activity in the cash flow statement.

Clear distinction between liabilities and equity – Some reclassifications will be required

Under IFRS, differentiation between a liability and equity depends on whether there is an obligation to deliver cash or any other financial asset. Where a transaction may be settled by issuing shares, classification will depend on whether the number of shares to be issued is fixed or variable. In the following example, the expected issuance of equity is recorded as a liability under UK GAAP, which is consistent with the treatment required under IFRS:

Extract 19: Payment in shares classified as a liability, consistent with IFRS

'On 29 August BP and the Alfa Group and Access-Renova (AAR) combined their Russian and Ukranian oil and gas businesses to create TNK-BP, a new company owned and managed 50:50 by BP and AAR. TNK-BP is a joint venture and accounted for under the gross equity method. BP contributed its 29% interest in Sidanco, its 29% interest in Rusia Petroleum and its holding in the BP Moscow retail network. In addition BP paid AAR $2,306 million in cash and will subsequently pay three annual tranches of $1,250 million in BP ordinary shares, valued at market prices prior to each payment.'

Source: BP plc – Annual Report and Accounts 2003 (page 54).

Under IFRS, a compound financial instrument such as a low coupon convertible bond will usually be split into equity and liability components, with a consequent increase in the amount reported as interest expense. Alternatively, reporting entities are permitted to adopt a 'mark to market' approach. This will eliminate the interest expense entirely and replace it with an entry showing the changes in the fair value of the liability.

Share-based payments recorded at fair value – Staff costs will rise

IFRS 2 requires reporting entities to recognise share-based payment transactions, such as share options granted to employees, in their financial statements. Under present practice in Europe, expenses associated with the granting of share options are usually omitted altogether or understated because the accounting is not based on the fair value of the instruments. Equity-settled share-based payments will henceforth be measured at the fair value of the goods or services received or, where this cannot be estimated reliably (as in the case of employee services), the fair value of the equity instruments will be used instead.

Funds flow statements replaced by cash flow statements

In countries such as Italy and Spain, reporting entities are not required to prepare a cash flow statement. Under IFRS, the preparation of a cash flow statement is mandatory. This should eliminate difficulties sometimes encountered by Moody's and issuers when converting funds flow statements required under local GAAP into cash flow statements. The cash flow statement prepared under Statement of Financial Accounting Standards (SFAS) No. 95 referred to in the following extract is broadly consistent with its counterpart under IFRS:

Extract 20: Funds flow statements converted into cash flow statements

'The consolidated statements of cash flows for the years ended December 31, 2001 and 2002 have been restated from those previously reported to comply fully with the requirements of SFAS No. 95. These statements had been previously presented in the format required by SFAS No. 95 but the amounts provided were calculated and classified in accordance with Spanish GAAP. This restatement affects solely our consolidated statements of cash flow under US GAAP and does not in any way affect the financial information previously reported under Spanish GAAP nor our net income or shareholders' equity as reconciled to US GAAP and previously reported. The table below provides the cash flow amounts for the years ended December 31, 2001 and 2002 as previously reported and as restated:

	millions of Euro			
	2002	**As restated**	**2001**	**As restated**
Net cash provided by operations	6,656	3,491	3,063	2,720
Net cash used in investing activities	(2,020)	(756)	(4,198)	(3,715)
Net cash provided by financing activities	(3,633)	(1,732)	1,303	1,163
	1,003	1,003	168	168

Source: ENDESA, S.A. – Form 20-F for fiscal year ended 31 December 2003 (page F-105).

Revenue recognition – More detailed guidance

Under IAS 18, revenue is recognised when it is probable that benefits will flow to the entity and these benefits can be measured reliably. For sales of goods, revenue is recognised when significant risks and rewards of ownership have been transferred to the buyer, and the reporting entity has neither continuing managerial involvement nor effective control over the goods. For services, revenue is recognised as work is performed. This is often referred to as the percentage of completion method.

Some countries in Europe have recently amended their local GAAP to align it more closely with the above-mentioned IFRS principles:

Extract 21: Revenues reclassified and delayed under IFRS

'In 2003, Wolters Kluwer nv has made the following changes in its accounting policies, in accordance with changes in Dutch accounting standards:

- RJ* 270 (profit and loss account, corresponding with IAS 18)
- RJ 271 (employee benefits, corresponding with IAS 19)
- RJ 160 (which relates to post balance sheet events, corresponding with … IAS 10)

Guideline RJ 270 includes detailed revenue recognition criteria. The impact on Wolters Kluwer's business primarily relates to the definition of revenues and the timing of revenue recognition.

Revenues are defined as benefits arising in the course of ordinary activities. We concluded that shipping and handling fees should now be included in revenues and that the royalties owed to professional societies relating to contract publishing should, unless identified as an agency contract, be included in cost of revenues rather than in revenues. Previously, shipping and handling fees were credited to cost of sales and royalties were charged to revenues.

Revenues of products that consist of a combination of goods and services are now recognized based on a split of the fair value of the individual components. Previously, revenues of these products were mainly recognized upon shipment rather than based on a split of the fair value of the individual components. If returns on a product category exceed a threshold, it is assumed that the transfer of the ownership of the product has only occurred upon receipt of the payment from the customer. Previously, full revenues were recognized after a deduction of a provision for estimated returns.'

* RJ: *Raad voor de Jaarverslaggeving* (Council for Annual Reporting)

Source: Wolters Kluwer nv – Annual Report 2003 (page 61).

Other changes required under IFRS that are not specifically addressed in the sections above include (i) changes to segment reporting, (ii) flexibility to apply proportionate consolidation for interests in jointly controlled entities that are currently accounted for using the equity method, (iii) the reversal of liabilities for proposed dividends under IAS 10, (iv) the abolition of the LIFO method for determining the cost of inventory, (v) the deduction of treasury stock from equity, (vi) the adoption of a temporary difference approach to deferred tax and (vii) recording any changes in the fair value of property and biological assets (like forest plantations) directly in income.

Credit Metrics as Reported by Issuers Will be Significantly Affected

The most likely impact of the aforementioned accounting changes on credit metrics such as EBIT, Interest expense, CFO and Debt is summarised in the table below. "Uncertain" signifies that the impact could be favourable or unfavourable, depending on the particular facts and circumstances of each case.

Item	EBIT	Interest expense	CFO	Debt
Non-amortisation of goodwill	Favourable	No impact	No impact	No impact
Regular impairment tests	More volatile	No impact	No impact	No impact
Consolidation of SPEs	Uncertain	Unfavourable	Uncertain	Unfavourable
Derivatives at fair value	Minimal	Minimal	No impact	Uncertain
Strict rules for hedging	Uncertain	Uncertain	No impact	Uncertain
Software costs capitalised	Favourable*	No impact	Favourable	No impact
Development costs capitalised	Favourable*	No impact	Favourable	No impact
No tax-based depreciation	Uncertain	No impact	No impact	No impact
More leases capitalised	Favourable	Unfavourable	Favourable	Unfavourable
Actual obligations recognised	Uncertain	No impact	No impact	No impact
Specific rules for pensions	Uncertain	Uncertain	No impact	No impact
Asset retirements provided for	Favourable	Unfavourable	No impact	No impact
Provisions at present value	Favourable	Unfavourable	No impact	No impact
Clearer equity: liability distinction	No impact	Uncertain	Uncertain	Uncertain
Splitting of convertible debt	No impact	Unfavourable	No impact	Favourable
Share-based payments at fair value	Unfavourable	No impact	No impact	No impact
Mandatory cash flow statements	No impact	No impact	New info†	No impact
Revenue recognition guidance	Uncertain	No impact	No impact	No impact
Abolition of LIFO	Uncertain	No impact	No impact	No impact
Investment properties at fair value	More volatile	No impact	No impact	No impact

** Favourable while spending is increasing. Unfavourable once amortisation exceeds additional costs capitalised.*
† CFO will be revealed for the first time.

Although the credit metrics reported by issuers are likely to change significantly, many of Moody's more important ratios are based on the reported figures as adjusted by the application of the rating agency's methodologies.

Some Changes Will be Largely Overridden by Moody's Current Methodologies

In order to enhance its usefulness and to maximise its value to rating committees in assessing credit risk, Moody's routinely adjusts the financial information provided by issuers in accordance with a series of published methodologies,[1] the main features of which are summarised below:

- Unrecognised actuarial gains and losses (which impact on the balance sheet liability) are ignored in the assessment of pension obligations. The actual return on plan assets is substituted for the expected return.
- All leases are capitalised – the accounting distinction between finance and operating leases is not regarded as satisfactory for credit analysis purposes.
- Securitisations are usually viewed as secured borrowings, regardless of how they are accounted for.
- Other off balance sheet exposures such as put options, guarantees and take-or-pay contracts are factored in when assessing the extent of the issuer's financial obligations.
- Hybrid securities are allocated to baskets on the debt-equity continuum regardless of their presentation in the financial statements.
- Share options are factored in at fair value.
- Goodwill amortisation and one-off impairment charges are added back.
- Interest and development costs capitalised by some issuers, but not by others, are reversed.

Some of the above-mentioned adjustments anticipate changes required by IFRS whereas others may reverse the accounting under IFRS and reinstate existing practice under local GAAP. In making these adjustments, Moody's principal objective is to focus the rating process on the underlying economics, bearing in mind that financial reporting practices vary by geography and industry. Clearly, it is also important to seek to improve the comparability of the reported numbers in circumstances where accounting standards permit a choice, or where standard-setters differ in prescribing the accounting method to be used.

1. *See Related Research section at the end of this report.*

Impact on Ratings is Expected to be Limited

In assessing the impact of accounting changes, Moody's will usually "look through" incremental financial reporting volatility if it is not reflective of additional economic volatility. The rating process will continue to be focused on the underlying economics. However, several factors could potentially impact the credit rating of an individual issuer converting to IFRS. These include:

- Disclosure of risks or financial characteristics not previously evident from the reporting under local GAAP. In particular, Moody's ability to adjust debt for off balance sheet commitments and contingencies is sometimes constrained by poor disclosure under local GAAP.
- Market perceptions changing to the detriment of the issuer, for example an inability to access the capital markets.
- Restrictive banking or other covenants being breached when the numbers are restated under IFRS.
- Adverse regulator behaviour in response to the new financial metrics.
- Changes in the behaviour of the issuer – to managing risk, or remunerating staff, or issuing particular types of financial instruments, to name a few examples.

In Moody's view, it would be surprising if the above factors manifested themselves to a material degree in other than a very limited number of cases. In general, the impact of converting to IFRS should be mitigated by:

- Moody's "looking through" the reported financial statements in order to focus on the underlying financial reality and economic substance; and
- Moody's continuing to place strong emphasis on cash flow-based measures and metrics.

Of the 20 items listed in the table summarising the more important changes expected when issuers convert to IFRS, 14 have no impact on CFO and three of the remaining six changes are overridden by Moody's methodologies. The rating agency also expects virtually all of the likely changes to debt to be already factored in via its existing methodologies or, where this is not the case, to have a limited impact in the vast majority of cases.

Related Research

Rating Methodologies:

Moody's Approach to Analyzing Pension Obligations of Corporations, November 1998 (39330)

Off-Balance Sheet Leases: Capitalization and Ratings Implications, October 1999 (48591)

Analytical Implications of Employee Stock-Based Compensation, December 2002 (76852)

Demystifying Securitization, January 2003 (77213)

Analytical Observations Related To U.S. Pension Obligations, January 2003 (77242)

Hybrid Securities Analysis, November 2003 (79991)

Moody's Basic Definitions for Credit Statistics, User's Guide, June 4 2003 (78480)

The Analysis of Off-Balance Sheet Exposures – A Global Perspective, July 2004 (87408)

Special Comments:

Moody's Comments on Convergence of International Accounting Standards, May 1999 (45044)

Analytical Observations Related to "Underfunded" Pension Obligations when using UK and IAS GAAP, May 2003 (78060)

Transition and Bridging: The European Insurance Sector Moves towards IFRS, February 2004 (81218)

Expected Impact of International Financial Reporting Standards (IFRS) on European Banks, February 2004 (81277)

The Impact of Moody's Financial Reporting Initiative on European Corporates, March 2004 (81673)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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