

CFO insights: Will IFRS trip up your debt covenants?

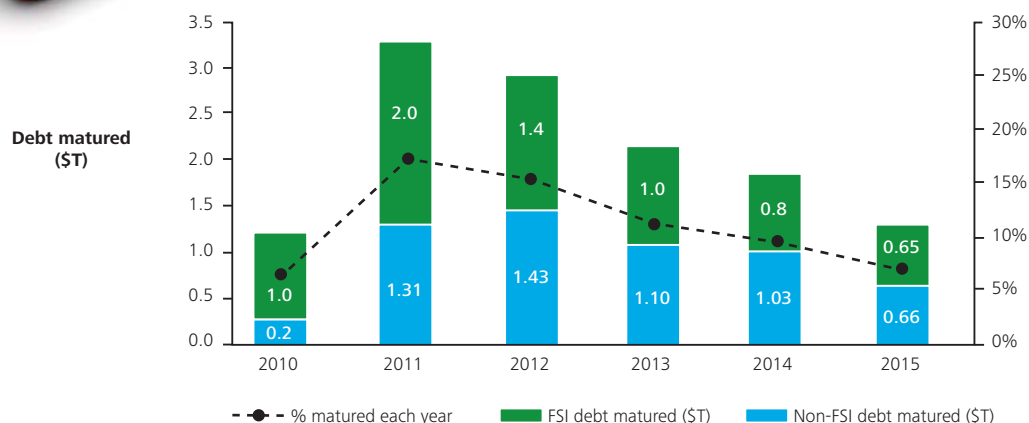
Accounting standards worldwide are converting to or converging with International Financial Reporting Standards (IFRS). This change has the potential to impact many companies' performance metrics, and potentially causing them to inadvertently violate debt covenants. To navigate the transition to IFRS without unwelcome surprises, among other considerations, CFOs should ensure that their credit documents include language to address impacts from the shift to IFRS. As many companies approach loan maturities over the next few years, CFOs that are refinancing should be cognizant of the impact of pending IFRS changes on covenant calculations when negotiating financial covenants. CFOs should consider seeking legal counsel and where deemed necessary, proactively seek technical amendments to their existing agreements that will address covenant issues in advance of IFRS adoption.

Debt and IFRS: The Convergence of Issues

In the next five years there is a significant amount of corporate debt coming due that needs to be refinanced. Deloitte's analysis of 9,000 of the largest global companies finds about \$11.5 trillion dollars in corporate debt coming due in the next five years, with the largest portion of the debt requiring refinancing in the financial services industries. Just as this wave of debt matures, companies in the United States may be implementing new accounting standards or planning a migration to IFRS.

The new accounting standard proposals related to convergence with IFRS can change a number of critical metrics and ratios used in existing debt covenants. These include earnings before interest, taxes, depreciation, and amortization (EBITDA), leverage ratios and fixed charge covenants. Some key drivers of change in critical metrics may include some of the following changes in accounting:

- **Revenue recognition** – Under U.S. Generally Accepted Accounting Principles (GAAP) specific revenue recognition accounting rules evolved in certain industries. In contrast, existing IFRS rules and the new revenue recognition exposure draft will try to tackle revenue recognition across industries and



Year 2010 data is only for reference purposes. It has not been used for this analysis.
Source: Bloomberg

companies through a unified standard that would apply broad principles to contracts for the sale of goods or services. The proposed guidance will also necessitate an evaluation of customer contracts to ensure that revenue is recognized when performance obligations are satisfied. This change has the potential to alter the timing of earnings and EBITDA in particular industries.

- **Lease accounting** – The proposed lease accounting standard will likely result in some of the following changes:
 - Discontinuing the operating lease classification, resulting in all leases being recorded on the balance sheet
 - Replacing rental expense with depreciation/amortization and interest expense, impacting performance measures such as earnings before interest and taxes (EBIT) and EBITDA
 - Changing the timing of income statement recognition, as interest expense/income under the effective interest method will be higher in early years, compared to the current straight-line recognition of rental expense/income under an operating lease
- Other accounting changes are also expected in areas such as financial instruments and insurance contracts as GAAP converges with IFRS. In addition, if the Securities and Exchange Commission (SEC) ultimately requires a migration to IFRS for U.S. companies, there are many other IFRS to U.S. GAAP differences that will impact debt covenants and buy ratios, such as the capitalization of development costs, asset impairment accounting, inventory costing methods and numerous other factors.

These developments mark a potentially significant shift in accounting standards, with implications to financial measures and covenants such as debt-to-equity, EBITDA, interest coverage, fixed charge coverage and tangible net worth.

What should CFOs do?

CFOs will need to adopt provisions in new bank loan documents to consider potential changes to accounting rules. Many bank loan credit agreements, especially for larger, higher-rated borrowers, now take into account the anticipated accounting changes. CFOs should seek legal counsel and where deemed appropriate consider adding specific language to address these potential changes to new or amended bank agreements. Given the expected changes in accounting standards and the possible impacts these changes may have on a company's compliance with its debt covenants, CFOs should seek legal counsel and explore with their lenders how flexibility may be built into loan agreements to manage the impact these potential changes may have on the entity's compliance with its debt covenants. Options which could be explored with legal counsel and lenders include:

- In the event of an accounting standard change, can the borrower elect to calculate covenants using the GAAP rules in effect when the loan closed?
- Is there a possibility for the borrower and lender to agree in the loan document that they will negotiate in good faith to preserve the original intent of covenants by amending covenant and definitions, and/or thresholds, to take into account the estimated impact of an accounting standard change?

Given today's uncertain economic environment, the evolving state of the capital markets, and the significant amount of pending debt maturities, CFOs with tight financial covenants or pending maturities will face many challenges. Taking steps to anticipate the impact of IFRS on financial ratios, incorporating language in all new debt agreements that contemplates accounting changes, and seeking technical amendments to existing debt agreements to address the likely impact of accounting changes on debt covenants are all prudent measures that CFOs should discuss with legal counsel, and pursue where deemed appropriate in this challenging environment.

These changes are not all negative. The upside to converging global accounting standards is the potential increase in sources of capital as financial reporting barriers are reduced around the globe and competition increases across international borders. Proactive CFO's have an opportunity to capitalize on this opportunity by considering sources of debt financing that may not have historically existed and potentially achieving more efficient means of raising capital when existing financing arrangements mature over the next several years.



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