

## **International Financial Reporting Standards (IFRS)**

### *What every private investor should know ! by Jim Shoesmith*

The new International Financial Reporting Standards (IFRS) are introducing significant changes into UK company accounts. Private investors, many of whom are not accountants, need to have some knowledge of these changes if they are to make good use of company accounts. This paper (initially presented at the SIGnet Warren Buffet Way group meeting on Tuesday 2<sup>nd</sup> August 2005) seeks to provide a very simple guide to the major changes; it is not intended to be either definitive or comprehensive.

There are, simplistically, 6 major changes:

The inclusion of pension fund deficits into liabilities on the balance sheet.

Not routinely writing goodwill off over time, but only through impairment charges.

Charging as an expense the cost of employees' share options in the Income Statement.

The spreading of more costs and income over their 'useful' life.

The 'marking to market' of financial instruments.

The charging of dividends in the year paid, rather than in the year declared.

There are other changes, for example in how subsidiaries / associated companies are consolidated, but these are too involved for a general paper such as this.

### *Pension Fund Deficits*

UK companies currently quantify deficits on their pension funds and have include them in a note to the accounts. Recent UK legislation has firmed up the requirements on companies to make good these deficits and the depressed state of the stock market (and other factors) means that often these deficits are substantial in relation to the other assets and liabilities; the deficit is therefore a matter than requires serious consideration by investors. IFRS requires such a deficit to be included on the Balance Sheet as a liability.

A natural consequence of this is that shareholders' cumulative retained profits are reduced by the amount of the deficit; this may impact a few companies ability to pay dividends, as dividends can only be paid out of retained profits. A further consequence is that the gearing ratio (shareholders funds against borrowings) will be higher; with some companies this could affect their ability to borrow.

### *Goodwill Impairment*

Goodwill arising on an acquisition is now a major intangible 'asset' on the balance sheet of many UK companies; being amortised over its useful life, generally with 20 years as a maximum life but subject to impairment charges if the balance sheet valuation cannot be justified by the profits generated. IFRS does away with the regular amortisation and only requires goodwill to be written off through impairment charges.

This will significantly affect the reported profits of many UK companies, but most companies and analysts already talk of 'headline' or 'normal' profits which exclude any amortisation write-offs.

Impairment charges should occur when the profitability of an acquisition deteriorates, but this may well in practice 'occur' at times suitable to management (such as new management

taking over and a clearing out the balance sheet); management could also try to play-down the significance of these by using words such as ‘one-off’, ‘historical’ or ‘accounting matter’.

#### *Expensing Share Options*

The cost of share options to directors and executives will have to be charged to profit at the time they are granted. Warren Buffet has for a long time said that such options must be remuneration and as such should be charged against profit.

This is not likely to be a major issue with large UK companies as the level of options is generally not significant; it could however be important for some smaller companies where the management (often with large shareholdings) have significant options.

This change could well lead to some companies moving away from options are part of their remuneration package, as the cost of those options will now become very visible and fuel debates about the level of executive remuneration.

#### *Spreading of income and costs*

Income and costs have in the UK generally been spread over the period of the underlying contract or product to which they relate; though costs have tended to be written off when incurred. All such income and costs are now to be spread forward. The change is therefore not likely to have significant effects on reported profits for most companies. It could however be significant in engineering companies where product-specific engineering costs are to be spread over the life of the product. It is difficult, if not impossible, to anticipate which companies this change will affect ahead of company announcements on the subject. Many companies will argue, with some justification, that this will not alter the fundamentals of their business and it is just a change in when income and costs are reported.

#### *Marking to Market*

Financial instruments, mainly on foreign exchange and commodities, will have to be marked to market prices at the end of half and full years and any profit or loss taken to the income statement. This seems a sensible approach forcing management to take account of unrealized profits and losses, though there could be more volatility in reported earnings as profits or losses reported in one year could be reversed in the following year. Banks and other financial institutions are likely to be particularly sensitive to this matter.

#### *Charging of Dividends*

In the UK dividends are currently charged against the profits of the year for which they are declared, even though the declaration and the payment occurs some months after the end of that year. IFRS will require dividends to be charged when they are declared, generally, for final dividends, one year later. This is largely cosmetic though the current practice is so deeply ingrained into UK thought that it will require some substantial change of thinking. Dividend cover is therefore likely to be increased in companies with increasing profits, as dividends will be related to the next years (higher) profits.

#### *Conclusions*

Overall, the change to IFRS is likely to have minimal effect on most UK companies, though there will be significant exceptions. Individual investors need to carefully watch the companies in which they are interested.

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