

Special Comment

Moody's Global Corporate Finance

November 2008

Are We Better Off Under IFRS?

Summary

Following the recent decision by the US Securities and Exchange Commission ('SEC') to publish a "roadmap" that could lead to the adoption of International Financial Reporting Standards ('IFRS') by US issuers, this report considers whether the conversion to IFRS in the European Union ('EU') has made the financial statements of corporates¹ easier to compare and more useful from a credit analysis perspective. In particular, we point out that:

- Compared with local GAAP, profits were generally higher when restated under IFRS. However, the improvement in net income was largely due to the discontinuance of goodwill amortisation. EBITDA was boosted by the capitalisation of certain operating expenses and the bifurcation of others into "interest" and "operating" components, as well as by the ability to account for pension deficits as a reduction in equity. Balance sheets deteriorated, but this was largely anticipated by our adjustments.
- IFRS generally requires more comprehensive reporting than was previously the case under local GAAP, particularly in relation to cash flows, pension obligations, leases and liabilities of uncertain timing and amount. IFRS also better portrays the underlying economic reality in many instances.
- The financial statements currently prepared under IFRS are not necessarily any easier to compare. This is due to a lack of standardisation in certain areas, but we have also come across several instances of seemingly inconsistent interpretations by companies and their auditors. The usefulness of the IFRS financial statements can also be compromised by false volatility and undue complexity. For example, the amounts reported as "financial expenses" are too often simply unintelligible, and finding the "true" level of debt can be like searching for a black cat in a dark room.

While we have certainly benefited from the adoption of a single set of accounting standards in the EU, the downside of IFRS is that significant accounting expertise is often required in order to "work around" some of its less helpful features.

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¹ Moody's uses the term "corporates" to mean non-financial companies.



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Overview of the changes brought about by IFRS

In 2002, the EU adopted a regulation requiring listed companies in the Member States to prepare their consolidated financial statements in accordance with endorsed IFRS.² The regulation became applicable for financial years commencing on or after 1 January 2005. However, implementation was deferred until 2007 for certain categories of companies, including those in Germany reporting under US GAAP.

To illustrate the practical effect of the EU regulation, we selected the 30 largest³ corporates in our rated universe, and examined how their income statements, balance sheets and cash flow statements changed when restated under IFRS. The detailed findings of our study are set out in the Appendix to this report. In analysing the results, we regarded the outcome under IFRS as “unchanged” if it was within 5% (higher or lower) of the figure previously reported under local GAAP.

The featured companies represent 13 different industry sectors, and they converted to IFRS from diverse starting points, namely French GAAP (ten companies), German GAAP (two), Italian GAAP (four), Spanish GAAP (two), Swedish GAAP (one), UK GAAP (five) and US GAAP (six). Despite these differences, it is possible to make the general observations set out below.

Profit came out higher under IFRS...

For the 30 corporates in aggregate, net income⁴ increased by 25% to €114.7 billion when restated under IFRS. 53% of the companies we studied reported a materially improved result at the net income level, and EBITDA came out either higher (for 30%) or broadly unchanged (for nearly all the others).

...but the improvement in net income was largely illusory...

Although aggregate net income increased by €23 billion, a single factor – the discontinuance of goodwill amortisation – added approximately €32 billion to the “bottom line”. Amortising the premium arising on the acquisition of another company implicitly assumes that the acquirer suffers a loss in equal annual instalments due to the passage of time. This has insightfully been described as good arithmetic rather than good accounting. When the discontinuance of goodwill amortisation is stripped out, the 25% increase becomes an aggregate decline of approximately 7%, and the number of companies reporting materially higher net income falls from 16 to 7 (23% of the total).

However, the 7% decline in net income is itself deceptive. When three items⁵ are stripped out, the aggregate “bottom-line” result under IFRS was only 2% lower than previously reported under local GAAP. This is broadly consistent with aggregate “top-line” revenue being virtually unchanged, as highlighted later in this report.

² Although EU companies are required to prepare their consolidated financial statements in accordance with “endorsed IFRS” rather than “IFRS as issued by the International Accounting Standards Board”, the distinction has thus far not proved to be significant for non-financial entities.

³ Ranked by revenue, using the most recently issued Annual Reports.

⁴ After deducting the portion attributable to minority shareholders in subsidiaries.

⁵ Impairment charges net of reversals recorded by Deutsche Telekom, changes to Electricité de France's pension arrangements and the manner in which they are accounted for, and changes to France Télécom's accounting for deferred tax under IFRS.

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...and higher EBITDA was also somewhat misleading

Although 30% of the companies in our sample reported significantly higher EBITDA under IFRS, this was largely due to the capitalisation of certain operating expenses and the bifurcation of others into “interest” and “operating” components. EBITDA was also boosted by the ability to account for pension deficits as a reduction in equity.

For the 30 firms in aggregate, EBITDA increased by €7.1 billion to €347.5 billion but nearly €10 billion was added via a reduction of close to 40% in the expense for pensions⁶ and the reclassification of operating expenditure to capex and “interest”.

The reduction in pension expense totalling more than €5.3 billion was achieved by:

- Eliminating unrecognised actuarial losses against equity in the opening IFRS balance sheet thereby avoiding the need to amortise deficits against EBITDA; and
- Bifurcating part of the expense into an “interest” component thereby removing it from EBITDA.

The reclassification of operating expenditure added another €4.4 billion to EBITDA because:

- Provided that certain conditions are met, the cost of developing new products must now be capitalised as an intangible asset and reported as capex; and
- Whenever there is a significant delay between the incurrence of a long-term liability and its settlement in cash, the related expense (for items such as lawsuits, warranty claims and environmental obligations) now appears partly as “interest” in the income statement.

Examples of higher EBITDA under IFRS

The companies included in our study that reported the largest increases in EBITDA on conversion to IFRS were Fiat (42% higher), PSA Peugeot Citroën (21%) and Daimler (20%).

Fiat's EBITDA increased by approximately €600 million, but more than €700 million of product development expenditure was reclassified as capex, and the cost of post-employment benefits included in EBITDA declined by over €200 million.

PSA Peugeot Citroën's EBITDA was nearly €1 billion higher, but roughly €800 million of product development expenditure had to be capitalised under IFRS, and the pension expense declined by about €80 million.

The €3.4 billion increase in Daimler's EBITDA would be reduced to about €200 million if an estimated €1 billion worth of capitalised development costs and €600 million of “interest” on liabilities for exposures such as product guarantees had still been treated as operating expenditure, and if the cost of pension and other post employment benefits included in EBITDA had not declined by nearly €1.6 billion.

Source: Company Annual Reports.

Moody's “looked through” the higher EBITDA figures reported under IFRS

Moody's treats the cost of developing new products and settling long-term liabilities other than debt as operating expenditure. We also routinely remove the pension expense in order to replace it with the service cost⁷ (which was broadly unchanged on conversion to IFRS). Adjusting for these factors reduces the number of companies reporting materially higher EBITDA under IFRS from nine to one. Consequently, despite the better-looking headline EBITDA figures which appeared under IFRS, we did not revise our assessment of the cash generating capability of any of the 30 companies.

⁶ Including other post employment benefits such as medical. Research into the reduction in pension expense is complicated by the patchy disclosures made by some companies, the reclassification of operations between “continuing” and “discontinued”, and the capitalisation of staff costs.

⁷ The service cost represents the increase in the present value of the pension obligation resulting from employee service in the current period.

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Balance sheets deteriorated under IFRS...

For the 30 companies in aggregate, our study shows that the ratio of net debt to equity deteriorated from 59% to 69%. Gross debt increased by €72 billion to €651 billion, with 12 firms (40%) reporting a materially higher outcome. Net debt increased by 18% to €504.2 billion.

...but this was largely anticipated by Moody's methodologies

Most of the changes to debt brought about by IFRS are helpful because they reduce the gap between debt as reported by the company, and debt as historically adjusted by Moody's for credit analysis purposes. For example, we typically treat receivables securitisation transactions as collateralised borrowings and adjust debt accordingly. We also routinely capitalise all operating leases and recognise a related debt obligation, and, we classify hybrid securities with characteristics of both debt and equity using our own classification scheme. Although our classification sometimes differs from the treatment under IFRS, several instruments previously excluded from debt under local GAAP were fully or partly included in Moody's adjusted debt. The three aforementioned factors typically lie behind the higher debt figures reported under IFRS.

Examples of higher debt under IFRS

Of the companies included in our study, the largest absolute increases in gross debt (excluding derivatives) were reported by Daimler (€21.0 billion), Fiat (€13.5 billion), Deutsche Telekom (€7.3 billion) and France Télécom (€6.0 billion). However, three factors explain nearly 90% of the €47.8 billion increase in debt reported by the four companies:

- The consolidation of previously off-balance-sheet borrowings linked to securitised and factored receivables (€35.0 billion);
- Liabilities related to leased assets (€2.5 billion); and
- The reclassification of certain hybrid financing instruments (€3.9 billion).

Source: Company Annual Reports.

While cash flows were unaffected, many cash flow statements were restated under IFRS...

Of the 30 companies we studied, 20% reported that their free cash flow⁸ before dividends paid improved to a material extent, 17% showed a decline and only 63% confirmed the outcome previously reported under local GAAP. Although the choice of reporting method has no effect on the underlying cash flows which are determined by transactions entered into with third parties, how the transactions are classified and reported (and whether they are reported at all) clearly depends on the accounting method selected.

...but the more significant changes were largely due to special factors

Although 11 companies (37% of the sample) reported a materially different outcome for free cash flow before dividends paid under IFRS, it is notable that all five automobile manufacturers are part of this group. Furthermore, half of the remaining six entities were not required to prepare cash flow statements under their local GAAP. The three entities concerned had previously included a cash flow statement in their Form 20-F filings with the SEC, but free cash flow before dividends paid turned out to be materially different when restated under IFRS.

⁸ CFO (cash flow from operating activities, including interest received and paid, dividends received and income taxes paid) less capex (including the cash outflow for intangible non-current assets).

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It is not surprising that the automobile manufacturers' cash flow statements changed on conversion to IFRS. The consolidation of previously off-balance-sheet receivables, the capitalisation of product development costs (which increases CFO and capex by the same amount), and the reversal of certain sales with buy-back commitments (where the vehicles concerned are now treated as assets leased to customers under operating leases) were all bound to have a significant effect on the numbers previously reported under local GAAP. Furthermore, Daimler's decision to change the treatment of inventory-related operating leases, and Volvo's reclassification of customer finance receivables, also had a very significant effect on free cash flow as we have defined it for purposes of our study.

As further explained later in this report, there is little consistency in the way that the automobile manufacturers have prepared their cash flow statements under IFRS. When they are excluded from the sample of 30 companies, CFO for the remaining 25 firms totals €217.7 billion under IFRS versus €217.5 billion under local GAAP, capex increases very slightly to €111.3 billion from €110.6 billion, and free cash flow before dividends paid declines only marginally to €106.4 billion from €106.9 billion.

The accounting changes brought about by IFRS had only a minor effect on Moody's credit metrics

By adjusting⁹ the figures originally reported under local GAAP, as well as the restated numbers released for the same year under IFRS, we were able both to anticipate many of the changes brought about by IFRS and also to reverse some of the less helpful consequences of the new rules. The former category includes the discontinuance of goodwill amortisation, and the consolidation of special purpose vehicles used for the securitisation of receivables. As these changes were already reflected in our "adjusted local GAAP" metrics, the consequence of switching to IFRS is that our adjustment is no longer required. However, the separate reporting of debt and related hedging derivatives, and the reclassification and bifurcation of certain transactions, has created the need for additional adjustments to the figures now reported under IFRS.

What is particularly helpful about IFRS

In 2004, Moody's analysts monitored the financial performance of companies based in many different jurisdictions, including 17 EU Member States each of which had its own accounting requirements. Some of the 500-odd firms that we rated in EMEA¹⁰ were permitted to use IFRS or US GAAP, but the vast majority presented their financial statements under local GAAP. IFRS reporters represented less than 10% of the total.

Today around 75% of the corporates rated by us in EMEA prepare their financial statements under a single set of accounting standards. In addition, what is particularly helpful about IFRS is that it generally requires more comprehensive reporting, particularly in relation to debt-like obligations. It also better portrays the underlying economic reality in many instances. Examples of the improvements brought about by IFRS under these two headings are set out below.

More comprehensive reporting

Cash flow statements are now mandatory

Cash flow statements can be helpful in assessing whether the reporting entity is generating sufficient cash from its operations to service its debts, and a number of Moody's financial ratios are derived from the cash flow statement. However, prior to the adoption of IFRS, companies in Italy and Spain were not required to include a cash flow statement in their annual reports.

⁹ Moody's adjustments are available to subscribers via *Moody's Financial Metrics*TM our external data and analytics platform.

¹⁰ Europe (including Russia), the Middle East and Africa.

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Unhelpful cash flow statements under local GAAP

In the pre-IFRS period, some of the larger Italian and Spanish companies included a cash flow statement in their Form 20-F filings with the SEC. However, these statements did not always provide a reliable basis for the calculation of credit metrics. For example:

- The cash flow statement included in the Form 20-F filed for 2002 by Endesa showed that cash generated by operating activities totalled €6.7 billion. In the filing for the following year, this figure was restated downwards by €3.2 billion (48%) to €3.5 billion. The company explained that the cash flow 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."
- Repsol YPF's Form 20-F for 2004 included a cash flow statement which showed that cash generated by operating activities totalled €4.2 billion. Under IFRS, this was restated as €3.7 billion, partly because dividends on preference shares (€156 million) were required to be reclassified as interest paid. Other changes made on adoption of IFRS (such as the reclassification of the cash outflow for provisions) have also improved the comparability of Repsol YPF's credit metrics.

Source: Company Annual Reports and Filings with the SEC.

Pension obligations are now more comprehensively disclosed

Under IFRS, companies are required to provide significantly more information about their pension obligations than was often the case under local GAAP. This helps Moody's assessment of the debt-like obligation for pensions which can be an important factor in judging the relative creditworthiness of companies.

Limited disclosure about pension obligations under local GAAP

In the 2002 financial statements of EnBW Energie Baden-Württemberg ('EnBW') prepared under German GAAP, the company explained that "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." There was no additional explanatory disclosure apart from confirmation that "the accruals for pensions and similar obligations are determined according to actuarial principles at the net present value defined by sec. 6a EStG applying an interest rate of 6%" and "the effects of the Heubeck mortality tables from 1998 have been fully considered."

On conversion to IFRS, the pension liability reported under German GAAP at the end of 2001 was uplifted by €1.0 billion (41%) to €3.5 billion, and the company now provides more than two pages of supporting disclosures.

Source: Company Annual Report.

Obligations relating to leased assets are now more easily assessed

The additional information provided under IFRS in relation to leased assets provides new insight into the scale and extent of the off-balance-sheet obligation.

Limited disclosure about lease obligations under local GAAP

In its last financial statements prepared under UK GAAP (covering the financial year which ended on 26 February 2005), Tesco disclosed that the annual cost of leasing stores and other assets totalled £283 million. In accordance with local accounting requirements, the relevant note added that the lease agreements in place at the year-end required payments to be made over "a number" of years. In contrast, Carrefour incurred a cost of €688 million for the rental of stores in its financial year which ended on 31 December 2004, but the company was required by French GAAP to disclose that the future commitment at that date amounted to €4.3 billion (undiscounted).

When Tesco converted to IFRS, the relevant note was expanded to reveal that the future minimum rentals payable under operating lease agreements in place at 26 February 2005 totalled £3.8 billion.

Source: Company Annual Reports.

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Changes in the judgmental amounts set aside for uncertain liabilities are now more apparent

Under IFRS, companies are required to disclose additional information about changes in the amounts they have set aside for liabilities of uncertain timing or amount. This can provide valuable insight into the judgments and estimates that underpin the accounting in this area.

Limited disclosure about provisions under local GAAP

According to its financial statements prepared under US GAAP, Daimler's accrued liabilities (excluding those related to income and other taxes, and pension and similar obligations) declined by 14% in 2006 to approximately €24 billion. Included here are amounts set aside for product guarantees and sales incentives.

The "provision for other risks" note in Daimler's IFRS financial statements provides additional information not previously available under US GAAP about the decline in accrued liabilities. It reveals that €1.9 billion was added to pre-tax income because certain provisions had proved to be unnecessary, including nearly €1 billion for product guarantees and sales incentives. This note also provides an indication of the scale of the amounts involved: more than €15 billion (approximately 10% of total revenue) was added to, and utilised against, these provisions in 2006.

Source: Company Annual Report and IFRS Consolidated Financial Statements for 2006.

Better portrayal of the underlying reality

Balance sheets are now less likely to include questionable pension assets

Although the "smoothing mechanism" has not yet been abolished by IAS 19, balance sheets prepared under IFRS are less likely to include assets resulting from the delayed recognition of actuarial losses related to pensions.

Questionable pension asset removed under IFRS

At the end of 2004, the aggregate shortfall in the pension plans operated by GlaxoSmithKline ('GSK') was nearly £1.5 billion. However, there was a net pension asset amounting to approximately £500 million (2003: approximately £200 million) in the balance sheet prepared under UK GAAP. To address the shortfall, GSK had made special funding contributions to the UK and US pension schemes totalling £256 million in 2004.

On conversion to IFRS, the net pension asset (apart from a residual £14 million) was removed from the balance sheet at 31 December 2004 and the liability was uplifted to £1.5 billion.

Source: Company Annual Report.

Financing transactions are now more likely to be reported as borrowings

Under IFRS, special purpose entities used for securitisation transactions are consolidated when the substance of the relationship indicates that they are controlled by the transferor of the asset. In addition, whenever the sale of a financial asset leaves substantially all the risks and rewards of ownership with the seller, it must continue to recognise the asset on its balance sheet with the sale proceeds being reported as a liability.

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Sales of receivables treated as financing transactions under IFRS

Under Italian GAAP, receivables sold by Fiat through securitisation and factoring transactions were removed from the balance sheet. On conversion to IFRS, all the securitisation transactions were reversed and all the portfolios of receivables sold with recourse under factoring transactions, as well as the majority of those sold without recourse, were reinstated on the balance sheet. This added €10.2 billion to debt at the end of 2004.

On conversion to IFRS from US GAAP, Daimler, like Fiat, reinstated previously derecognised receivables and this added €21.7 billion to debt at the end of 2006.

Source: Fiat's Annual Report and Daimler's IFRS Consolidated Financial Statements.

Another example of a financing transaction appearing as a liability under IFRS is set out below. When distributions on preferred shares are not at the discretion of the issuing company, the shares must be reported as a liability.

Minority interest reclassified as a financial liability under IFRS

In December 2002, a subsidiary of Telefónica raised €2 billion via the issue of preferred shares. Under Spanish GAAP, the €2 billion was reported under the caption "minority interests".

On conversion to IFRS, the preferred shares were reclassified as a financial liability. Although there is no obligation to repay the principal amount, the payment of dividends cannot be avoided as long as there are distributable earnings. Telefónica has an option to totally or partially redeem the preferred shares at face value from 30 December 2012 onwards. If the shares are not redeemed, the payment of non-cumulative dividends will be stepped up from 3-month Euribor (subject to a minimum of 4.25% APR and a maximum of 7% APR) to include a spread of 400 basis points APR above 3-month Euribor.

Source: Company Annual Report.

Put options held by minority shareholders are no longer off balance sheet

Under local GAAP, when minority shareholders in a subsidiary had a put option or similar right to sell their interest to the majority shareholder, the possible future outflow of cash was typically disclosed in a footnote dealing with off-balance-sheet commitments. Under IFRS, these instruments are regarded as financial liabilities and they are reported on the balance sheet.

Put options reported as liabilities under IFRS

The "Contingencies and Commitments" note in E.ON's financial statements for 2006 prepared under US GAAP explained that a put option agreement had been in place since 2001 allowing a minority shareholder in E.ON Sverige (a subsidiary company) to sell its remaining stake for approximately €2 billion.

On restating the balance sheet under IFRS, E.ON included the rights held by the minority shareholder under "other operating liabilities" at an amount equal to the present value of the future exercise price.

Source: Company Annual Report.

Distortions caused by overly prudent accounting are now less likely

Prior to the adoption of IFRS, it was not uncommon for certain companies to use overly conservative depreciation rates set by the tax authorities. Using an artificially short useful life appears to be a prudent approach at first, but profits are flattered in subsequent periods when the assets are still in use without a related expense being reported in the income statement.

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More realistic depreciation rates under IFRS

On conversion to IFRS, ENI added €2.6 billion to property, plant and equipment as previously reported in the balance sheet prepared under Italian GAAP at 31 December 2003. This was mainly because gas pipelines, compression stations and distribution networks had, until 1999, been depreciated using overly prudent rates established by the tax authorities, namely 10%, 10% and 8%, respectively. Under IFRS, the 4% depreciation charge used by ENI for these assets under US GAAP had to be applied instead, and the excessive depreciation recorded in prior periods was consequently reversed.

Source: Company Annual Report.

Other examples of overly prudent accounting not permitted under IFRS include the removal of amortisation charges made by Deutsche Telekom and Unilever in relation to intangible assets with indefinite lives, and Telecom Italia's cautious provisioning for risks and charges.

Although Deutsche Telekom's FCC mobile communications licences are independent of future technological developments and renewable indefinitely at little cost, they were being amortised over 20 years in the German GAAP financial statements. Unilever was also using a 20 year maximum life for certain indefinite lived intangible assets in its local GAAP financial statements. Telecom Italia removed €318 million from profit before tax previously reported under Italian GAAP for 2004 because it was not possible to report a gain from reversing a provision that was not permitted in the first place.

Certain revenues are more appropriately no longer recognised upfront

Our research shows that the vast majority of companies (90%) were able to report essentially unchanged revenue on adopting IFRS, probably because the principles-based IAS 18 allowed the existing accounting to be retained. After stripping out the adjustment required by IFRS for previously grossed-up revenue,¹¹ the aggregate "top-line" reported under local GAAP by the 30 companies in our study declined by a mere 0.25% from €1,882.17 billion to €1,877.40 billion. Nevertheless, as illustrated below, there were several instances where the accounting adopted under local GAAP was not permitted under IFRS.

Delayed recognition of revenue under IFRS

On converting to IFRS, Telecom Italia announced that pre-tax income for 2004 would be reduced by €210 million because revenues from the activation of telephone services and the recharge of prepaid cards, as well as the related costs, had to be deferred over the expected duration of the relationship with the customer (principally eight years for retail customers and three years for wholesale customers).

The auto manufacturers Fiat, PSA Peugeot Citroën and Renault explained that vehicles transferred to customers with a buy-back commitment at a specified price would generally no longer be reported as having been sold. Under IAS 18, these arrangements do not meet the criteria for revenue recognition because the significant risks and rewards of ownership are not necessarily transferred to the buyer. The initial "selling" price received is instead accounted for as a liability, with the difference between the proceeds and the buy-back price recognised as rental revenue over the duration of the buy-back commitment. Renault had previously adopted this treatment when the buy-back commitment took place within 36 months, but it is now extended to all sales with buy-back commitments when the term of the contract covered an insufficient portion of the vehicle's useful life. The revised accounting adopted by the Italian and French auto companies helps to make their revenue more comparable with Daimler's. Prior to adopting IFRS, the German company had already treated transactions whereby it guaranteed the minimum resale value of the product sold (via an obligation either to reacquire the vehicle at a set price or to make good any deficiency on its resale by the customer) as giving rise to rental revenues over the lease term. Daimler's "top-line" revenue did not change significantly on conversion to IFRS from US GAAP.

Source: Company Annual Reports.

¹¹ Under French GAAP, Suez and Veolia Environnement included €1.00 billion and €2.13 billion, respectively, collected on behalf of third parties in both revenue and expenses. On conversion to IFRS, the previously reported revenue and expenses were reduced by the same amount. TOTAL made a similar adjustment (totalling €22.22 billion) because certain trading transactions were previously reported under both sales and purchases instead of at their net value in sales.

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Full consolidation is no longer permitted when other shareholders have important veto rights

IFRS draws a distinction between entities that are under the exclusive control of the parent company, and others ("jointly controlled entities") where control is shared because strategic financial and operating decisions require the unanimous consent of the shareholders. Full consolidation is permitted only for entities in the former category.

Stricter definition of control under IFRS

Under UK GAAP, Vodafone fully consolidated its 77% owned subsidiary in Italy whose large cash resources had been on-lent to the parent company. However, as a result of the significant participating rights held by the other shareholder (Verizon Communications), the Italian subsidiary had to be accounted for as a joint venture under IFRS.

Source: Company Annual Report.

Treasury shares are no longer presented as cash-like assets

Under local GAAP, French companies including Carrefour, PSA Peugeot Citroën, Renault, TOTAL and Veolia Environnement presented treasury shares held for share price stabilisation purposes and employee share plans as an asset in the balance sheet under a caption such as "marketable securities" or "short-term investments". These assets were typically included in the company's calculation of net debt. However, all treasury shares must be deducted from shareholders' equity under IFRS, and this reduced the cash-like assets of the five companies referred to above by approximately €2.5 billion at the end of 2004.

What is less helpful about IFRS

While companies are typically required to disclose significantly more and generally better financial information under IFRS than was previously the case under local GAAP, certain features of the new financial statements are not particularly helpful from our point of view. These include a lack of standardisation, inconsistent interpretations, false volatility and undue complexity. Examples of the difficulties that we have experienced in these four areas are set out below.

Lack of standardisation

French and Spanish companies favour proportionate consolidation, but others are less keen

When accounting for jointly controlled entities, IFRS currently permits companies to choose between proportionate consolidation and the "one-line" equity method. Our study revealed that 14 companies selected the former treatment whereas 16 preferred the latter. Of the 12 French and Spanish companies included in our sample, 10 chose proportionate consolidation, whereas BASF, ENEL and Vodafone were the only German, Italian and UK entities, respectively, that favoured this method. Although jointly controlled entities are rarely material in relation to the reporting entity, there are some notable exceptions such as TNK-BP (which accounts for more than 20% of BP's total oil and gas production), and Vodafone's 77% owned business in Italy (which, as noted above, was not permitted to be fully consolidated as a subsidiary under IFRS).

The International Accounting Standards Board ('IASB') has recognised that offering a choice of accounting methods makes it difficult to compare financial statements and a proposal to eliminate proportionate consolidation was published in September 2007. A revised accounting standard is expected to be issued in 2009.

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Some companies currently capitalise interest, but others expense it in full as incurred

An accounting change that will definitely take effect from 2009 onwards is the capitalisation of borrowing costs to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The alternative treatment, whereby interest is expensed in full as it is incurred, will no longer be permitted. Of the 30 companies included in our study, 15 selected the capitalisation method and they will be able to continue using it in 2009.

Unlike the choice of accounting method for jointly controlled entities where the information needed to standardise the credit metrics is rarely available in the published financial statements, Moody's has been able to "work around" the different accounting treatments permitted for borrowing costs. From a credit analysis perspective, we prefer to include the entire interest expense in coverage ratios even if (as will henceforth be the case) part of it is deferred and recognised as an asset on the balance sheet.

The same cash flows can be presented under different headings in the cash flow statement

Another time consuming obstacle to obtaining comparable information from financial statements prepared under IFRS is that interest received and paid, dividends received and income taxes paid can be reported under different headings in the cash flow statement. Our study revealed 10 different permutations. The majority of companies (19 out of 30) chose the US GAAP approach, favoured by Moody's, of including all four items in the operating activities section. However, the cash flow statements of the other 11 entities have to be adjusted to ensure that credit metrics are calculated on a comparable basis. This is usually a fairly straightforward exercise although it is sometimes not entirely clear whether the amount reported as "interest paid" is inclusive or exclusive of interest that has been capitalised.

Inconsistent interpretations

When comparing financial statements prepared under IFRS, we have come across several instances where the same underlying accounting principle appears to have been applied differently. This could be due to a lack of interpretative guidance in the standards themselves, misunderstandings, translation difficulties or a desire to retain familiar practices.

The "control" principle can be difficult to implement in practice

IAS 27 is based on the principle that consolidated financial statements should include all the entities that are controlled by the parent company. However, our study revealed that achieving this outcome in practice has turned out to be quite difficult. One French company explained that, because IAS 27 does not recognise *de facto* control, an entity fully consolidated under French GAAP could not be accounted for in this manner under IFRS. This view is at odds with the statement made by another French company (audited by the same firm) that companies over which *de facto* control was exercised could be fully consolidated under IFRS even if they were less than 50%-owned.

The Italian oil and gas company ENI also struggled with *de facto* control. After stating in the report for Q1 2005 that the 43% owned Saipem could not be consolidated under IAS 27, it was eventually included as a subsidiary in the full year financial statements following a statement made by the IASB in October 2005 that the control concept in IAS 27 did allow for *de facto* control. The standard setter accepted that it would have been helpful if IAS 27 had included guidance to assist preparers in exercising the judgment required to apply the control concept.

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Deciding what constitutes a lease is also proving to be problematic

The largest adjustment made to debt by Moody's is typically the capitalisation of off-balance-sheet assets made available to the reporting entity under operating lease agreements. Our adjustment is based on the disclosures made under IAS 17. The supporting guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* requires that the outcome should be based on an assessment of the substance of the arrangement. As this requires the exercise of judgment based on the specific facts and circumstances of each case, some arrangements that appear to be broadly similar will be dealt with differently.

Differences in how leases are reported under IFRS

IAS 17 defines a lease as "an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time."

- In its most recent financial statements, France Télécom explains that the IAS 17 disclosures include "lease payments in the form of overheads (land, buildings, equipment, vehicles and other assets)." Contracts with operators of telecommunication lines and arrangements related to the provision of satellite transmission capacity are excluded. The relevant accounting policy note clarifies that "contracts relating to satellite capacity have been reviewed in light of the criteria set out in IFRIC 4. As no specific assets have been identified, these contracts have been classified as services." In contrast, Telecom Italia (which is audited by the same firm) reports that the IAS 17 lease expense includes "TLC circuit lease rents and rents for use of satellite systems."
- The 2007 financial statements of Scottish and Southern Energy state that "included in ... operating leases are obligations under power purchase agreements with various power generating companies." Centrica adopted a similar approach in relation to long-term arrangements with renewable providers to purchase physical power. In the most recent annual report, the company explains that "payments made for physical power are charged to the Income Statement as incurred and disclosed as contingent rents." In contrast, the IAS 17 lease disclosures made by RWE (which is audited by the same firm as Centrica) do not include "electricity procured from power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements".
- In the 2006 financial year, BP expanded its disclosure under IAS 17 to include the total amounts payable under leases entered into solely by the group as the operator of a jointly controlled asset, irrespective of any amounts that have been or will be reimbursed by the joint venture partners. The company also clarified that, in cases where BP was not the operator, any amounts due to be reimbursed by BP to the operator were not included in the IAS 17 disclosures. This issue is not addressed at all in the equivalent footnotes published by ENI, Repsol YPF, Shell, StatoilHydro or TOTAL.
- BP's disclosure clarifies that bareboat charters, time charters and spot charters for ships are also included as operating leases. However, other IFRS reporters such as BHP Billiton appear to have concluded that ship charters are "other expenditure commitments" that do not form part of the disclosures required for operating leases under IAS 17.

Source: Company Annual Reports.

There are different views on the categorisation of certain cash flows

The five automobile manufacturers included in our sample were part of the group of 19 companies that chose the US GAAP layout for the cash flow statement. However, their statements are nevertheless not directly comparable due to differences in the categorisation of certain cash flows. An example illustrating two important differences is set out below.

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Different views as to what constitutes an "operating" activity under IFRS

Daimler and Volvo both made significant changes to their cash flow statements when they converted to IFRS from US GAAP and Swedish GAAP, respectively.

- Vehicles leased out to customers under operating leases by Daimler comprise those manufactured in-house (termed "inventory related" assets) and others purchased from third parties. On converting to IFRS, Daimler decided that all cash flows relating to inventory related leased assets (including the costs of manufacture, the rentals received and the proceeds from selling the vehicle at the end of the lease) should be reported in the operating activities section of the cash flow statement. We estimate that this involved transferring nearly €8.7 billion of manufacturing cash outflows, together with approximately €7.7 billion worth of vehicle sale proceeds, from investing activities to operating activities. However, other automobile manufacturers such as PSA Peugeot Citroën and Volvo report cash flows of the type reclassified by Daimler in the investing activities section of their cash flow statements.
- Volvo decided that customer finance receivables should be included in the operating activities section under IFRS. This reduced the Swedish company's CFO by 33% compared with the outcome previously reported under Swedish GAAP for 2004. This interpretation of IFRS is similar to the approach adopted by the two French companies PSA Peugeot Citroën and Renault. Daimler has continued its practice under US GAAP of reporting these receivables in the investing activities section.

Source: Company Annual Reports and IFRS Financial Statements.

Another example illustrating why "cash flow from operating activities" as reported under IFRS may not be directly comparable is outlined below.

Different views as to what constitutes an "operating" activity under IFRS (continued)

In 2005, the cash flows of Iberdrola and Unión Fenosa (and the other electricity producers in Spain) were adversely affected by an inability to fully recover the increase in the cost of producing power. Both companies are audited by the same firm, but their cash flow statements showed distinctly different outcomes for that year:

- Iberdrola reported that the cash generated by operating activities *declined* by 38% (€1.17 billion) compared with 2004. The company's revenue shortfall in 2005 was €1.26 billion and the Spanish government passed a decree allowing this amount to be reimbursed in subsequent years independently of future billings.
- Unión Fenosa reported that the cash generated by operating activities *increased* by 14% (€183 million) compared with 2004. The company's revenue shortfall in 2005 was €484 million, reflecting its smaller 12.84% share of the industry compared with Iberdrola.

Closer examination of Unión Fenosa's cash flow statement reveals that the cash shortfall caused by the tariff deficit was largely reported under investing activities, thereby mitigating the adverse effect on cash generated by operating activities.

Source: Company Annual Reports.

The taxation expense is presented differently in certain countries

Unlike the *deferred* tax component of the tax expense (which is essentially an accounting smoothing device), the *current* tax component represents the amount payable to, or recoverable from, the tax authorities in relation to the taxable profit or loss for the period under review. Moody's uses current tax expense in calculating important measures of cash generation such as FFO and RCF. We disregard the deferred tax component of the expense because an obligation to make a payment will often fail to crystallise.

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In recent years, France Télécom and Telefónica have both been able to reduce their income tax payments by utilising tax losses incurred in previous periods. In the French company's financial statements this manifests itself in a reduction of the amount reported as current tax. Our credit metrics for France Télécom consequently reflect the benefit of the tax losses brought forward. However, we get a different outcome for Telefónica (which is audited by the same firm as France Télécom) because the current tax expense reported by the Spanish company is completely disconnected from the tax paid in cash and appears to exclude the benefit of the tax losses, as shown in the table below.

Different presentation of income tax expense under IFRS

€ billion

Aggregate for 2004-2007 (note 1)	France Télécom	Telefónica
Profit before tax from continuing operations	25.50	29.11
Tax expense attributable to continuing operations	7.56	6.83
Deferred tax component of the tax expense	4.81	-2.84
Current tax component of the tax expense (note 2)	2.75	9.67
Tax paid in cash, including discontinued operations (note 2)	2.97	4.12
Tax paid in cash as a % of current tax	108%	43%

Note 1: This represents the sum of the amounts originally reported for 2004, 2005, 2006 and 2007 in the Annual Reports for 2005, 2006 and 2007.

Note 2: In calculating key credit metrics such as FFO and RCF, Moody's uses the current tax component of the tax expense. The difference between this amount and the tax paid in cash is regarded as a working capital movement which usually nets out to zero over time. When they are significant, differences attributable to discontinued operations are stripped out (adequate disclosure permitting).

Source: Company Annual Reports.

It would seem that the two companies' accountants have interpreted IAS 12 differently. Telefónica's appear to be of the view that current tax represents the theoretical amount of tax that would have been payable for the period if the entity did not have the benefit of factors brought forward from prior periods such as tax losses. France Télécom's accountants seem to have taken current tax to mean the tax actually payable for the period, after all relevant facts and circumstances have been taken into account. Although we have come across instances of Telefónica's approach being used elsewhere (notably in Portugal), Moody's methodology is based on France Télécom's interpretation of IAS 12.

Revenue sometimes includes excise and other taxes

IAS 18 explains that "amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue." Although the underlying accounting principle appears to be pretty clear, it would seem that there is disagreement when it comes to implementing it in practice.

Differences in the presentation of revenue under IFRS

Under Spanish GAAP, sales revenue as reported by Repsol YPF for 2004 (€40.6 billion) included excise taxes on oil and gas products totalling €5.5 billion. In the Form 20-F filing for that year the company explained that the excise taxes are not included in revenue under US GAAP because they are netted off against an identical amount reported under operating expenses.

On converting to IFRS from Spanish GAAP, Repsol YPF did not remove the excise taxes from revenue. Instead the company explained that the €5.5 billion referred to above would in fact be added to the revenue and expenses previously reported under US GAAP since "U.S. GAAP allows for various ways of reporting these revenues." By making this adjustment, Repsol YPF successfully harmonised the outcome between IFRS and US GAAP. However, the other five oil and gas companies included in our survey (BP, ENI, Shell, StatoilHydro and TOTAL), have excluded sales taxes, excise duties and similar levies from the revenue figure that they report under IFRS.

Source: Company Annual Reports.

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A similar issue to that described above arises when comparing the IFRS financial statements of three large electric and gas utilities in Germany. Electricity and natural gas taxes levied on sales are presented (in aggregate) as a deduction from revenue on the face of the income statement by EnBW, E.ON and RWE. However, these taxes (€1.45 billion) are included in a "grossed-up" revenue figure (€42.51 billion) used by RWE for segmental analysis purposes under IFRS 8 which requires the segmental data to be consistent with management's internal measures of performance. In contrast to RWE, the other two companies' segmental analyses permit divisional margins to be calculated based on the net figure exclusive of the taxes paid over to the relevant authorities.

False volatility clouding underlying performance

The usefulness of financial statements prepared under IFRS can sometimes be compromised by the introduction of false volatility. This typically happens when an underlying exposure hedged by a derivative is not accounted for in the same way as the derivative itself, as explained in the example below.

Asymmetrical accounting under IFRS

"BP uses derivative instruments to manage the economic exposure relating to inventories above normal operating requirements of crude oil, natural gas and petroleum products as well as certain contracts to supply physical volumes at future dates. Under IFRS, these inventories and contracts are recorded at historic cost and on an accruals basis respectively. The related derivative instruments, however, are required to be recorded at fair value with gains and losses recognized in income because hedge accounting is either not permitted or not followed, principally due to the impracticality of effectiveness testing requirements."

Source: Company Annual Report.

False volatility can also be introduced into the financial statements when supply contracts are deemed to be derivatives. This means that the contracts have to be recorded at fair value in the income statement, irrespective of why they were entered into in the first place, as illustrated in the following example:

Unhelpfully broad definition of derivatives under IFRS

When E.ON converted to IFRS, the company explained that "under U.S. GAAP, there are industry-specific exceptions for power-plant-related supply contracts that are unknown under IFRS. This means that the definition of a derivative encompasses more contracts under IFRS. In the case of embedded derivatives in certain supply and sale contracts, IFRS provides for the possibility of measuring only the embedded derivative, while reporting the non-derivative portion as a pending transaction. Under U.S. GAAP, the existence of an embedded derivative in these contracts gives rise to fair value reporting through income for the contract as a whole. Further effects arise from the definition of a derivative with regard to net settlement and market liquidity."

The differences described above were the main reason for the better-looking result under IFRS in 2006 (see Figure A1 in the Appendix).

Source: Company Annual Report.

For a company like Centrica, accounting for certain procurement contracts as if they were trading instruments can have a significant effect on the income statement, as shown in the extract below.

Volatility diverting attention away from underlying performance

"Many of the energy procurement contracts are held for the purpose of receipt or delivery of commodities in accordance with the Group's purchase, sale or usage requirements and are therefore out of scope of IAS 39, Financial Instruments: Recognition and Measurement. However, a number of contracts are considered to be derivative financial instruments and are required to be fair valued under IAS 39, primarily because their terms include the ability to trade elements of the contracted volumes on a net-settled basis.

The Group has shown the fair value adjustments arising on these contracts separately ... because the intention of management is, subject to short-term demand balancing, to use these energy supplies to meet customer demand. Accordingly, management believe the ultimate net charge to cost of sales will be consistent with the price of energy agreed in these contracts and that the fair value adjustments will reverse as the energy is supplied over the life of the contract."

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Volatility diverting attention away from underlying performance (continued)

Centrica plc £ million	*Profit before tax under IFRS	**Fair value adjustments	Profit before tax excluding fair value adjustments
2005	1,812	438	1,374
2006	34	-925	959
2007	2,111	248	1,863

* From continuing operations, as originally reported for the year in question.

** Arising from the net re-measurement of energy contracts excluding losses and gains on proprietary trades in relation to cross-border transportation or capacity contracts.

Source: Company Annual Report.

Undue complexity*The "true" level of debt is not always readily apparent*

In some cases, finding the "true" level of debt in an IFRS balance sheet is rather like searching for a black cat in a dark room. You have a strong sense that it is there, but you are unable to actually locate it. There are two main problem areas, as explained below.

Problem 1: Debt is reported independently of related currency swaps

The last balance sheet prepared by TOTAL under French GAAP showed that long-term debt, short-term borrowings and bank overdrafts amounted to €13.26 billion at the end of 2004. On conversion to IFRS, this was uplifted by 12% to €14.90 billion. However, a derivative asset totalling €1.52 billion appeared on the other side of the balance sheet.

In common with other oil and gas producers whose revenue is denominated mainly in US dollars, TOTAL has most of its borrowings in the US currency. At the end of 2004, 81% of the company's long-term debt was effectively payable in US dollars. However, because a significant proportion of the debt was originally issued in other currencies, the desired end result was achieved by entering into a series of currency swaps. In the French GAAP financial statements, TOTAL was able to reflect as "debt" the net amount it expected to pay out, having converted a proportion of its borrowings into a currency that had weakened against the reporting currency. The financial ratios calculated by Moody's under French GAAP were consequently "balanced" in the sense that the downward effect of a weaker dollar on the company's cash generation went hand in hand with a decline in debt as shown in the balance sheet. However, the same ratio based on the IFRS balance sheet captures the decline in cash generation but not the benefit of having swapped some of the debt into a weaker currency.

Although TOTAL has helpfully provided additional information which allows the ratio to be corrected, ascertaining the "true" level of debt from the IFRS balance sheets of other companies (such as StatoilHydro) is considerably more difficult.

Source: Company Annual Reports.

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Problem 2: Debt can be distorted by the fair value of interest rate swaps

Bonds with fixed interest coupons are sometimes converted into a floating rate via a fixed-to-floating interest rate swap. Provided that the swap achieves its objective, the end result is economically similar to having issued the same bond at a floating interest rate in the first place. Under local GAAP, most European companies were able to report the same amount as debt under both scenarios, say €1 billion.* However, the accounting required by IFRS treats the two scenarios differently.

- If the bond was originally issued at floating rates, the amount reported as debt will remain largely unchanged at €1 billion;* whereas
- If the bond was originally issued at a fixed interest rate, it will typically be adjusted every year by an amount broadly equivalent to the fair value of the fixed-to-floating interest rate swap. For example, if floating rates have risen and are expected to remain higher than the original fixed rate for the duration of the interest rate swap, the swap will have a negative fair value (say €100 million). When “fair value hedge accounting” is used, the amount reported as debt will be reduced by approximately €100 million to €900 million.* To obtain the “true” level of debt from the IFRS balance sheet, it is necessary to identify the related derivative liability (€100 million). The task is complicated by the need to distinguish fixed-to-floating interest rate swaps from floating-to-fixed swaps because the amount reported as debt is never distorted by the latter.

However, the company may decide not to use “fair value hedge accounting” in which case the bond will be reported at broadly the “right” amount (€1 billion*) in the second scenario above.

**Unamortised issue costs (which are deducted from debt under IFRS) are assumed to be immaterial.*

One way of possibly finding the “true” level of debt is to rely on the company's help in navigating the complexity surrounding the reporting of debt and derivatives in the IFRS balance sheet. However, this does not always achieve the desired outcome. Although nearly every company provides a figure for “debt” in the management commentary, the approach adopted tends to vary by country. Our study showed that, in France and Spain, the tendency is to include all so-called “financial” derivatives in the headline figure for “debt”, whereas derivatives (financial and otherwise) are usually left out altogether in Germany, Scandinavia and the UK. Practice in Italy is mixed. In our sample, Fiat and Telecom Italia went with the French and the Spanish, but ENEL and ENI followed the practice prevalent elsewhere in Europe.

Amounts reported as “interest expense” or “financial expense” can be unintelligible

It can sometimes be extremely difficult to determine the effective (or “all-in”) cost of a company's debt from its financial statements prepared under IFRS. The disclosures we typically come across in practice vary from minimalist (see Telefónica below), to very extensive but difficult to interpret (Telecom Italia) to helpful but ultimately incomplete from a credit analysis perspective (Deutsche Telekom). Too often, the end result is that the actual cost of the company's debt is unknown and a meaningful interest coverage ratio can only be calculated after further discussion with the company.

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Inconsistent and not always helpful disclosure of interest expense under IFRS

On converting to IFRS, Telefónica and Telecom Italia both made significant changes to the amounts they had previously reported for 2004 under the caption "financial expenses":

- Telefónica added €1 billion (62%) to the €1.6 billion reported under Spanish GAAP even though gross debt was only 4% higher under IFRS at the end of 2004. No further details were provided in the IFRS financial statements, and the term "interest expense" was not used.
- Telecom Italia also added nearly €1 billion (31%) to the €3.2 billion reported under Italian GAAP even though gross debt was only 7% higher under IFRS at the end of 2004. A supporting note revealed that the higher amount included €771 million of "negative fair value adjustments to fair value hedge derivatives, underlying financial assets and liabilities of fair value hedges, and non-hedging derivative financial instruments". The company also reported that "financial income" (which was €0.8 billion higher under IFRS) included €768 million of "positive fair value adjustments to fair value hedge derivatives, underlying financial assets and liabilities of fair value hedges, and non-hedging derivative financial instruments". The relevant notes also included (i) "charges from fair value hedge derivatives" totalling €152 million, (ii) "income from fair value hedge derivatives" (€290 million), (iii) "charges from non-hedging derivative financial instruments" (€114 million) and (iv) the "reversal of the Reserve for fair value adjustments of cash flow hedge derivatives (interest rate component) to the statement of operations" (€155 million under "financial expenses" and €56 million under "financial income").

In contrast to the two companies above, Deutsche Telekom reported that "interest expense" for 2004 was virtually unchanged on conversion to IFRS at €3.7 billion compared with €3.6 billion under German GAAP even though gross debt was 17% higher under the new standards at the end of that year. A footnote clarified that "accrued interest payments from derivatives (interest rate swaps) that were designated as hedging instruments in a fair value hedge in accordance with IAS 39 are netted per swap contract and recognized as interest income or interest expense depending on the net amount." As Deutsche Telekom did not reveal the net amount, or whether it was positive or negative, it is not possible to ascertain whether the interest rate swaps had the effect of increasing or reducing the interest due to the holders of the debt. The "all-in" cost of the company's borrowings is therefore not determinable from the published financial statements.

Source: Company Annual Reports.

Conclusion

While we have certainly benefited from the adoption of a single set of accounting standards in the EU, the financial statements currently prepared under IFRS are not necessarily any easier to compare. In some cases, we have found that it was a more straightforward exercise to extract the information that is most useful to us from the financial statements previously prepared under local GAAP. The downside of IFRS is that significant accounting expertise is often required in order to "work around" some of its less helpful features.

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Appendix

Explanatory notes

Figures A1, A2 and A3 contain extracts from the income statements, balance sheets and cash flow statements of the 30 largest EU companies rated by Moody's in EMEA that converted from local GAAP to IFRS in 2005 (or subsequently). For the last year that the company reported under local GAAP, we have shown for each metric the figure as reported under local GAAP and as subsequently restated under IFRS. Changes in accounting policies not required by the conversion to IFRS have been stripped out. The following definitions have been used to calculate the nine metrics:

- (i) Revenue represents income from the sale of goods and services, excluding taxes.¹² Discontinued operations are included to the extent that this is practicable.
- (ii) EBITDA represents net income (before minority interests and the cumulative effect of changes in accounting principles) after removing the income tax expense, financial income and expense, equity-accounted income, and depreciation and amortisation (including impairment charges made against intangible assets and PPE). Disposal gains and losses, and other potentially one-off items have not been removed. Discontinued operations are included to the extent that this is practicable.
- (iii) Net income is after deducting the portion attributable to minority interests and (where applicable) after excluding the cumulative effect of changes in accounting principles.¹³ Discontinued operations are included.
- (iv) Equity excludes equity attributable to minority interests.
- (v) Gross debt comprises the amounts reported under captions such as "financial liabilities", "interest-bearing debt", "debt", "borrowings", and "financial indebtedness". Derivatives with negative carrying values reported as liabilities in the balance sheet have not been included in gross debt.
- (vi) Net debt represents gross debt less the sum of cash and cash equivalents and cash-like current financial assets, excluding restricted cash. Receivables, loans and derivative assets are not treated as cash-like assets.
- (vii) CFO represents the cash inflow from operating activities, including interest received and paid, dividends received and income taxes paid. Discontinued operations are included to the extent that this is practicable.
- (viii) Capex represents the gross cash outflow relating to the acquisition of PPE and intangible assets. Disposal proceeds reported under investing activities, including those arising from the sale of assets previously leased out to customers under operating leases, are not deducted from capex. Discontinued operations are included to the extent that this is practicable.
- (ix) Free cash flow represents CFO less capex (both terms as defined above).¹⁴

Some of the amounts shown in Figures A1, A2 and A3 are affected by rounding differences.

¹² For StatoilHydro only, revenue includes an insignificant amount of "other income" because insufficient data was available to base the IFRS vs US GAAP comparison purely on revenue from the sale of goods and services. For UK GAAP reporters, revenue excludes the share of joint ventures' revenue.

¹³ For Renault, net income shown for 2004 excludes the additional quarter (Sept to Dec 2003) included in the French GAAP income statement (€432 million) but excluded under IFRS.

¹⁴ US GAAP data for CFO and capex for the merged StatoilHydro entity is not available for 2006. The IFRS amounts have been entered as "US GAAP" because the company explained that there were no significant changes to these amounts on conversion to IFRS.

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Figure A1

Income statement extracts

Amounts in € billion				Revenue			EBITDA			Net income		
Company	Year ended	Converted from	Exchange rate	IFRS	Local	Diff	IFRS	Local	Diff	IFRS	Local	Diff
BASF	31-Dec-04	German GAAP	N/A	37.54	37.54	0.0%	7.68	7.33	4.9%	2.00	1.88	6.4%
BP*	31-Dec-04	UK GAAP	\$1 = €0.80	227.95	228.05	0.0%	26.07	26.88	-3.0%	13.66	12.58	8.5%
Carrefour*	31-Dec-04	French GAAP	N/A	73.71	72.67	1.4%	4.80	4.75	0.9%	1.59	1.39	14.7%
Daimler	31-Dec-06	US GAAP	N/A	152.81	151.59	0.8%	20.42	16.99	20.2%	3.74	3.23	15.9%
Deutsche Telekom	31-Dec-04	German GAAP	N/A	57.35	57.88	-0.9%	19.39	19.65	-1.3%	1.59	4.63	-65.6%
Electricité de France*	31-Dec-04	French GAAP	N/A	46.79	46.93	-0.3%	13.23	11.22	17.9%	0.62	1.34	-53.5%
ENEL	31-Dec-04	Italian GAAP	N/A	36.45	36.49	-0.1%	10.69	10.88	-1.7%	2.63	2.71	-2.8%
ENI*	31-Dec-04	Italian GAAP	N/A	57.55	58.38	-1.4%	17.33	17.29	0.2%	7.06	7.27	-3.0%
E.ON	31-Dec-06	US GAAP	N/A	64.45	64.56	-0.2%	9.26	8.31	11.4%	5.59	5.06	10.5%
Fiat	31-Dec-04	Italian GAAP	N/A	45.64	46.70	-2.3%	2.07	1.46	41.7%	-1.63	-1.59	-3.0%
France Télécom	31-Dec-04	French GAAP	N/A	46.16	47.16	-2.1%	18.01	18.59	-3.1%	3.02	2.78	8.4%
GlaxoSmithKline*	31-Dec-04	UK GAAP	£1 = €1.47	29.38	29.93	-1.8%	9.99	10.51	-4.9%	5.74	6.32	-9.2%
PSA Peugeot Citroën	31-Dec-04	French GAAP	N/A	56.11	56.80	-1.2%	5.67	4.68	21.1%	1.68	1.36	23.9%
Renault	31-Dec-04	French GAAP	N/A	40.29	40.72	-1.0%	4.63	4.41	4.9%	2.84	3.12	-9.1%
Repsol YPF	31-Dec-04	Spanish GAAP	N/A	38.92	40.59	-4.1%	7.02	6.52	7.6%	2.41	1.95	23.8%
Saint-Gobain	31-Dec-04	French GAAP	N/A	32.17	32.03	0.5%	3.79	3.61	5.1%	1.24	1.08	14.4%
Shell*	31-Dec-04	US GAAP	\$1 = €0.80	213.11	214.96	-0.9%	31.25	32.42	-3.6%	14.83	14.55	2.0%
Siemens	30-Sep-06	US GAAP	N/A	89.68	87.80	2.1%	6.43	6.06	6.1%	3.13	3.03	3.0%
StatoilHydro	31-Dec-06	US GAAP	NOK 1 = €0.156	81.35	79.55	2.3%	32.08	31.41	2.1%	7.97	7.94	0.4%
Suez*	31-Dec-04	French GAAP	N/A	38.06	40.74	-6.6%	6.74	6.79	-0.7%	1.70	1.80	-6.0%
Telecom Italia	31-Dec-04	Italian GAAP	N/A	31.09	31.23	-0.5%	13.50	13.84	-2.5%	1.82	0.78	132.4%
Telefónica	31-Dec-04	Spanish GAAP	N/A	30.36	30.32	0.1%	12.36	12.02	2.9%	3.18	2.88	10.4%
Tesco*	26-Feb-05	UK GAAP	£1 = €1.47	49.94	49.94	0.0%	3.95	4.11	-3.9%	1.98	2.01	-1.6%
ThyssenKrupp	30-Sep-05	US GAAP	N/A	43.49	43.51	-0.1%	4.04	3.79	6.6%	1.04	1.02	1.5%
TOTAL	31-Dec-04	French GAAP	N/A	100.48	122.70	-18.1%	24.82	23.94	3.7%	10.87	9.61	13.1%
Unilever*	31-Dec-04	UK GAAP	N/A	39.11	39.11	0.0%	6.38	6.27	1.7%	2.76	1.88	46.9%
Veolia Environnement	31-Dec-04	French GAAP	N/A	24.87	27.04	-8.0%	2.98	3.20	-6.9%	0.39	0.13	212.2%
VINCI	31-Dec-04	French GAAP	N/A	19.52	19.52	0.0%	1.88	1.96	-4.0%	0.73	0.73	0.0%
Vodafone	31-Mar-05	UK GAAP	£1 = €1.47	50.09	50.18	-0.2%	18.46	18.95	-2.6%	9.42	-11.08	185.0%
Volvo*	31-Dec-04	Swedish GAAP	SEK 1 = €0.109	23.01	22.93	0.3%	2.60	2.58	0.7%	1.08	1.02	5.5%
				1,877.40	1,907.52	-1.6%	347.53	340.41	2.1%	114.67	91.43	25.4%

*The figures shown in the IFRS column for these companies exclude the impact of IAS 32 and IAS 39 because the company elected to defer their implementation by one year.

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Figure A2

Balance sheet extracts

Amounts in € billion				Equity			Gross debt			Net debt		
Company	Year ended	Converted from	Exchange rate	IFRS	Local	Diff	IFRS	Local	Diff	IFRS	Local	Diff
BASF	31-Dec-04	German GAAP	N/A	16.27	15.43	5.4%	3.30	3.30	-0.2%	1.01	1.05	-4.5%
BP*	31-Dec-04	UK GAAP	\$1 = €0.74	56.90	56.73	0.3%	17.09	17.09	0.0%	16.08	15.99	0.6%
Carrefour*	31-Dec-04	French GAAP	N/A	6.95	7.55	-8.0%	12.88	9.72	32.5%	9.68	6.79	42.4%
Daimler	31-Dec-06	US GAAP	N/A	37.03	34.16	8.4%	99.54	78.52	26.8%	88.04	65.40	34.6%
Deutsche Telekom	31-Dec-04	German GAAP	N/A	41.42	33.92	22.1%	49.93	42.65	17.1%	41.84	34.51	21.2%
Electricité de France*	31-Dec-04	French GAAP	N/A	8.44	17.57	-52.0%	25.79	25.79	0.0%	19.68	19.67	0.0%
ENEL	31-Dec-04	Italian GAAP	N/A	17.95	19.85	-9.5%	26.88	26.66	0.8%	26.56	26.34	0.8%
ENI*	31-Dec-04	Italian GAAP	N/A	32.37	30.34	6.7%	12.68	12.73	-0.3%	10.89	10.67	2.1%
E.ON	31-Dec-06	US GAAP	N/A	48.71	47.85	1.8%	13.47	13.40	0.5%	7.87	7.80	0.9%
Fiat	31-Dec-04	Italian GAAP	N/A	4.30	5.10	-15.6%	32.19	18.74	71.7%	26.07	13.40	94.6%
France Télécom	31-Dec-04	French GAAP	N/A	14.45	15.68	-7.8%	53.39	47.39	12.7%	50.00	43.94	13.8%
GlaxoSmithKline*	31-Dec-04	UK GAAP	£1 = €1.41	8.07	8.35	-3.4%	8.41	8.41	0.0%	2.80	2.80	0.0%
PSA Peugeot Citroën	31-Dec-04	French GAAP	N/A	12.92	12.70	1.8%	28.38	25.13	12.9%	19.64	16.72	17.4%
Renault	31-Dec-04	French GAAP	N/A	15.48	16.06	-3.6%	28.11	27.59	1.9%	21.30	19.80	7.6%
Repsol YPF	31-Dec-04	Spanish GAAP	N/A	12.81	14.55	-12.0%	13.47	9.45	42.6%	9.84	5.95	65.5%
Saint-Gobain	31-Dec-04	French GAAP	N/A	10.67	11.56	-7.6%	9.20	8.53	7.7%	6.30	5.64	11.7%
Shell*	31-Dec-04	US GAAP	\$1 = €0.74	63.69	67.00	-4.9%	10.80	10.63	1.6%	3.99	3.81	4.6%
Siemens	30-Sep-06	US GAAP	N/A	25.57	29.31	-12.7%	15.30	15.57	-1.8%	4.49	4.76	-5.8%
StatoilHydro	31-Dec-06	US GAAP	NOK 1 = €0.160	26.85	26.45	1.5%	8.76	8.81	-0.6%	7.40	7.44	-0.7%
Suez*	31-Dec-04	French GAAP	N/A	7.84	7.92	-1.1%	20.25	20.07	0.9%	11.70	11.51	1.6%
Telecom Italia	31-Dec-04	Italian GAAP	N/A	16.25	15.17	7.1%	41.67	38.84	7.3%	32.35	29.35	10.2%
Telefónica	31-Dec-04	Spanish GAAP	N/A	10.44	16.23	-35.7%	25.43	24.55	3.6%	24.52	23.22	5.6%
Tesco*	26-Feb-05	UK GAAP	£1 = €1.45	12.47	13.06	-4.5%	7.32	7.23	1.1%	5.65	5.57	1.5%
ThyssenKrupp	30-Sep-05	US GAAP	N/A	7.56	8.77	-13.9%	4.86	4.67	4.0%	0.23	-0.06	488.3%
TOTAL	31-Dec-04	French GAAP	N/A	31.61	31.26	1.1%	14.90	13.26	12.4%	11.04	8.07	36.8%
Unilever*	31-Dec-04	UK GAAP	N/A	7.26	5.53	31.3%	12.27	12.27	0.0%	9.66	9.66	0.0%
Veolia Environnement	31-Dec-04	French GAAP	N/A	3.22	3.56	-9.6%	18.00	15.92	13.1%	13.15	10.61	24.0%
VINCI	31-Dec-04	French GAAP	N/A	3.02	3.15	-4.2%	7.27	7.15	1.7%	2.75	2.60	5.5%
Vodafone	31-Mar-05	UK GAAP	£1 = €1.46	166.15	145.00	14.6%	22.18	17.53	26.6%	16.68	12.17	37.0%
Volvo*	31-Dec-04	Swedish GAAP	SEK 1 = €0.111	7.76	7.70	0.7%	6.86	6.86	0.0%	3.00	3.00	0.0%
				734.44	727.49	1.0%	650.56	578.46	12.5%	504.18	428.19	17.7%

*The figures shown in the IFRS column for these companies exclude the impact of IAS 32 and IAS 39 because the company elected to defer their implementation by one year.

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Figure A3

Cash flow statement extracts

Amounts in € billion				CFO			Capex			Free cash flow		
Company	Year ended	Converted from	Exchange rate	IFRS	Local	Diff	IFRS	Local	Diff	IFRS	Local	Diff
BASF	31-Dec-04	German GAAP	N/A	4.63	4.51	2.7%	2.06	1.93	6.4%	2.58	2.58	0.0%
BP*	31-Dec-04	UK GAAP	\$1 = €0.80	18.70	19.25	-2.9%	9.83	10.43	-5.7%	8.87	8.82	0.6%
Carrefour*	31-Dec-04	French GAAP	N/A	4.30	4.25	1.3%	2.57	2.56	0.2%	1.73	1.68	2.9%
Daimler	31-Dec-06	US GAAP	N/A	14.34	14.02	2.3%	23.01	30.76	-25.2%	-8.67	-16.75	48.2%
Deutsche Telekom	31-Dec-04	German GAAP	N/A	16.72	16.31	2.5%	6.41	6.13	4.6%	10.31	10.18	1.3%
Electricité de France*	31-Dec-04	French GAAP	N/A	8.00	7.75	3.2%	4.94	4.71	4.9%	3.06	3.04	0.6%
ENEL	31-Dec-04	Italian GAAP	N/A	4.84	4.81	0.5%	3.83	3.83	0.0%	1.00	0.98	2.2%
ENI*	31-Dec-04	Italian GAAP	N/A	12.50	12.36	1.1%	7.50	7.50	-0.1%	5.00	4.86	2.9%
E.ON	31-Dec-06	US GAAP	N/A	7.23	7.26	-0.5%	4.10	4.08	0.3%	3.13	3.18	-1.4%
Fiat	31-Dec-04	Italian GAAP	N/A	2.01	-0.36	661.7%	2.92	2.35	24.1%	-0.90	-2.71	66.6%
France Télécom	31-Dec-04	French GAAP	N/A	12.70	12.82	-0.9%	5.21	5.22	-0.1%	7.49	7.60	-1.5%
GlaxoSmithKline*	31-Dec-04	UK GAAP	£1 = €1.47	7.02	7.02	0.0%	1.53	1.53	0.0%	5.49	5.49	0.0%
PSA Peugeot Citroën	31-Dec-04	French GAAP	N/A	5.04	4.08	23.5%	3.73	2.93	27.4%	1.30	1.15	13.5%
Renault	31-Dec-04	French GAAP	N/A	5.28	4.96	6.4%	3.92	3.48	12.6%	1.35	1.47	-8.3%
Repsol YPF	31-Dec-04	Spanish GAAP	N/A	3.71	4.24	-12.4%	2.48	2.39	3.5%	1.24	1.85	-33.0%
Saint-Gobain	31-Dec-04	French GAAP	N/A	2.73	2.71	0.6%	1.56	1.54	1.2%	1.17	1.18	-0.3%
Shell*	31-Dec-04	US GAAP	\$1 = €0.80	20.83	20.48	1.7%	10.85	10.19	6.5%	9.98	10.29	-3.1%
Siemens	30-Sep-06	US GAAP	N/A	5.06	4.98	1.6%	4.05	3.97	2.1%	1.01	1.01	0.0%
StatoilHydro	31-Dec-06	US GAAP	NOK 1 = €0.156	13.82	13.82	0.0%	9.34	9.34	0.0%	4.48	4.48	0.0%
Suez*	31-Dec-04	French GAAP	N/A	4.12	4.38	-6.0%	2.04	2.17	-6.2%	2.08	2.21	-5.8%
Telecom Italia	31-Dec-04	Italian GAAP	N/A	10.77	11.44	-5.9%	5.34	5.34	0.1%	5.43	6.11	-11.1%
Telefónica	31-Dec-04	Spanish GAAP	N/A	11.27	10.19	10.6%	3.49	3.49	0.0%	7.78	6.70	16.2%
Tesco*	26-Feb-05	UK GAAP	£1 = €1.47	3.52	3.52	0.0%	3.39	3.39	0.0%	0.13	0.13	0.0%
ThyssenKrupp	30-Sep-05	US GAAP	N/A	2.35	2.18	7.7%	1.57	1.52	3.0%	0.78	0.66	18.6%
TOTAL	31-Dec-04	French GAAP	N/A	14.66	14.43	1.6%	7.78	7.54	3.1%	6.89	6.89	0.0%
Unilever*	31-Dec-04	UK GAAP	N/A	5.05	4.96	1.8%	1.07	0.98	8.9%	3.98	3.98	0.0%
Veolia Environnement	31-Dec-04	French GAAP	N/A	2.90	3.04	-4.5%	1.96	2.32	-15.2%	0.94	0.72	29.8%
VINCI	31-Dec-04	French GAAP	N/A	1.89	2.01	-5.9%	1.12	1.22	-7.5%	0.76	0.79	-3.3%
Vodafone	31-Mar-05	UK GAAP	£1 = €1.47	18.36	18.82	-2.4%	7.32	7.28	0.6%	11.04	11.54	-4.3%
Volvo*	31-Dec-04	Swedish GAAP	SEK 1 = €0.109	1.67	2.47	-32.5%	1.28	1.28	0.0%	0.39	1.19	-67.6%
				246.00	242.69	1.4%	146.18	151.39	-3.4%	99.82	91.30	9.3%

*The figures shown in the IFRS column for these companies exclude the impact of IAS 32 and IAS 39 because the company elected to defer their implementation by one year.

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Moody's Related Research

Rating Methodology:

- Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations – Part II, February 2006 (96729)

Special Comments:

- Moody's Comments on Convergence of International Accounting Standards, May 1999 (45044)
- The Impact Of International Financial Reporting Standards ('IFRS', formerly known as IAS) On The Credit Ratings Of European Corporates, October 2004 (89389)

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.

Report Number: 111906

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