

Chapter 7

HOW TO COPE WITH THE MOST COMPLEX POINTS IN FINANCIAL ACCOUNTS

Everything you always wanted to know but never dared to ask!

This chapter is rather different from the others. It is not intended to be read from start to finish, but consulted from time to time, whenever readers experience problems interpreting, analysing or processing a particular accounting item.

Each of these complex points will be analysed from these angles:

- **from an economic standpoint** so that readers gain a thorough understanding of its real substance;
- **from an accounting standpoint** to help readers understand the accounting treatment applied and how this treatment affects the published accounts;
- **from a financial standpoint** to draw a conclusion as to how best to deal with this problem.

Our experience tells us that this is the best way of getting to grips with and solving problems. The key point to understand in this chapter is the method we use to deal with complex issues since we cannot look at every single point here. When faced with a different problem, readers will have to come up with their own solutions using our methodology – unless they contact us through the vernimmen.com web site.

The following bullet list shows, in alphabetical order, the main line items and principal problems that readers are likely to face.

- | | |
|---------------------------------------|---|
| ● accruals | ● leases |
| ● construction contracts | ● mandatory convertible bonds |
| ● convertible bonds or loans | ● off-balance sheet commitments |
| ● currency translation adjustments | ● pensions and other employee benefits |
| ● deferred tax assets and liabilities | ● perpetual subordinated loans or notes |
| ● dilution profits or losses | ● preference shares |
| ● exchangeable bonds | ● provisions |
| ● goodwill | ● stock options |
| ● impairment losses | ● tangible fixed assets |
| ● intangible fixed assets | ● treasury shares |
| ● inventories | |

Section 7.1

ACCRUALS

1/WHAT ARE ACCRUALS?

Accruals are used to recognise revenue and costs booked in one period but relating to another period. To accrue basically means to transfer revenue or costs from the P&L to the balance sheet.

2/HOW ARE THEY ACCOUNTED FOR?

The main categories of accruals are:

- **prepaid costs**, i.e. charges relating to goods or services to be supplied later. For instance, three-quarters of a rental charge payable in advance for a 12-month period on 1 October each year will be recorded under prepaid costs on the asset side of the balance sheet at 31 December;¹
- **deferred income**, i.e. income accounted for before the corresponding goods or services have been delivered or carried out. For instance, a cable company records three-quarters of the annual subscription payments it receives on 1 October under deferred income on the liabilities side of its balance sheet at 31 December.¹

¹ If the company's financial year starts as of January 1st.

We should also mention accrued income and cost, which work in the same way as deferred income and prepaid cost, only in reverse. For example, a company can accrue R&D costs, i.e. consider that it should not appear in the P&L but as an intangible asset that will be amortised.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Deferred income and prepaid cost form part of operating working capital.

Accrued costs are either part of the working capital if short term or of fixed assets if they correspond to a long-term asset (e.g. R&D costs).

Section 7.2

CONSTRUCTION CONTRACTS

1/WHAT ARE CONSTRUCTION CONTRACTS?

In some cases, it may take more than a year for a company to complete a project. For instance, a group that builds dams or ships may work for several years on a single project.

2/HOW ARE THEY ACCOUNTED FOR?

Construction contracts are accounted for using the percentage of completion method, which consists in recognising at the end of each financial year the sales and profit/loss

anticipated on the project in proportion to the percentage of the work completed at that time. US accounting rules recognise both the percentage of completion method and the completed contract method where revenue recognition is deferred until completion of the contract.²

² *The completed contract method consists of recognising the sales and earnings on a project only when the project has been completed or the last batch delivered. Nonetheless, by virtue of the conservatism principle, any losses anticipated are fully provisioned. This method is thus equivalent to recognising only unrealised losses while the project is under way. It may be used in the US where the recommended method is the percentage of completion method.*

³ *See Chapter 29.*

⁴ *This is known as “split accounting”.*

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Construction projects in progress are part of the operating working capital. The percentage of completion method results in less volatile profits as they are spread over several fiscal years even if the completed contract method may seem more prudent. Analysts should be aware of changes in accounting methods for construction contracts (which are not possible under IFRS) as such change may indicate an attempt to improve artificially the published net income for a given year.

Section 7.3

CONVERTIBLE BONDS AND LOANS

1/ WHAT ARE CONVERTIBLE BONDS AND LOANS?

Convertible bonds are bonds that may be converted at the request of their holders into shares in the issuing company. Conversion is thus initiated by the investor³.

2/ HOW ARE THEY ACCOUNTED FOR?

When they are issued, convertible bonds and loans are allocated between debt and equity accounts⁴ since they are analysed under IFRS standards as compound financial instruments made up of a straight bond and a call option (see Chapter 29). The present value of the coupons and reimbursement amount discounted at fair borrowing rate of the firm is accounted as debt. The remainder is accounted as equity. In addition, each year the company will account for the interest as it would be paid for a standard bond (part of this amount corresponding to the actual amount paid, the rest being a notional amount).

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Some analysts take the view that convertible bonds lie halfway between equity and debt, so treat them as 50% shareholders' equity and 50% debt. We believe this to be a totally arbitrary and unjustified approach. The approach we recommend is to examine the conditions governing conversion of the bonds and to make the equity/debt classification based on the results of this analysis. For instance, if the share price already lies well above the conversion price, the bonds are very likely indeed to be converted, so it should be treated as equity. For valuation purposes, the related interest expense net of tax should be reversed out of the income statement, leading to an increase in net income. The number of shares should also be increased by those to be issued through the conversion of the convertible bonds.

On the other hand, if the share price is below the conversion price, convertible bonds should be treated as conventional bonds and stay classified as borrowings.

Section 7.4**CURRENCY TRANSLATION ADJUSTMENTS**

See Chapter 6.

Section 7.5**DEFERRED TAX ASSETS AND LIABILITIES**

1/WHAT ARE DEFERRED TAX ASSETS AND LIABILITIES?

Deferred taxation giving rise to deferred tax assets or liabilities stems:

- either from differences in periods in which the income or cost is recognised for tax and accounting purposes;
- or from differences between the taxable and book values of assets and liabilities.

On the income statement, certain revenue and charges are recognised in different periods for the purpose of calculating pre-tax accounting profit and taxable profit.

In some cases, the difference may be temporary due to the method used to derive taxable profit from pre-tax accounting profit. For instance, a charge has been recognised in the accounts, but is not yet deductible for tax purposes (e.g. employee profit-sharing in some countries); or vice versa. The same may apply to certain types of revenue. Such differences are known as **timing differences**.

In other circumstances, the differences may be definitive or permanent, i.e. for revenue or charges that will never be taken into account in the computation of taxable profit (e.g. tax penalties or fines that are not deductible for tax purposes). Consequently, there is no deferred tax recognition.

On the balance sheet, the historical cost of an asset or liability may not be the same as its tax base, which creates a **temporary difference**. Depending on the situation, temporary differences may give rise to a future tax charge and thus deferred tax liabilities, while others may lead to future tax deductions and thus deferred tax assets. For instance, deferred tax liabilities may arise from:

- assets that give rise to tax deductions that are lower than their book value when sold or used. The most common example of this derives from the revaluation of assets upon the first-time consolidation of a subsidiary. Their value on the consolidated balance sheet is higher than the tax base used to calculate depreciation and amortisation or capital gains and losses;
- capitalised financial costs that are deductible immediately for tax purposes, but that are accounted for on the income statement over several years or deferred;
- revenue, the taxation of which is deferred, such as accrued financial income that becomes taxable only once it has been actually received.

Deferred tax assets may arise in various situations including charges that are expensed in the accounts but are deductible for tax purposes in later years only, such as:

- provisions that are deductible only when the stated risk or liability materialises (for retirement indemnities in certain countries);

- certain tax losses that may be offset against tax expense in the future (i.e. tax loss carryforwards, long-term capital losses).

Finally, if the company were to take certain decisions, it would have to pay additional tax. These taxes represent **contingent tax liabilities**, e.g. stemming from the distribution of reserves on which tax has not been paid at the standard rate.

2/ HOW ARE THEY ACCOUNTED FOR?

It is mandatory for companies to recognise all their deferred tax liabilities in consolidated accounts. Deferred tax assets arising from tax losses should be recognised when it is probable that the deferred tax asset can be used to reduce tax to be paid.

Deferred tax liabilities are not recognised on goodwill where goodwill depreciation is not deductible for tax purposes, as is the case in the UK, Italy or France. Likewise, they are not recorded in respect of tax payable by the consolidating company on distributions (e.g. dividend withholding tax) since they are taken directly to shareholders' equity.

In some more unusual circumstances, the temporary difference relates to a transaction that directly affects shareholders' equity (e.g. a change in accounting method), in which case the temporary difference will also be set off against the company's shareholders' equity.

IFRS do not permit the discounting of deferred tax assets and liabilities to net present value.

Deferred tax is not the same as **contingent taxation**, which reflects the tax payable by the company if it takes certain decisions. For instance, tax charges payable if certain reserves are distributed (i.e. dividend withholding tax), or if assets are sold and a capital gain is registered, revenue qualifying for a lower rate of tax provided they are not distributed to shareholders (long-term capital gains in some countries, etc.). The principle governing contingent taxation is straightforward: it is not recorded on the balance sheet and no charge appears on the income statement.

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

It is important to recognise that deferred taxation does not represent an amount of tax currently due to or from the tax authorities, but consists of accounting entries with, most of the time, no economic underpinnings and with no corresponding cash flows.

Deferred taxation is the product of accounting entries triggered by differences between accounting values and tax bases (on the balance sheet) or between accounting and tax treatments (on the income statement). The corresponding double entry is made either on the income statement or to shareholders' equity.

A company that posts a loss for a given period owing to exceptional circumstances will recognise a deferred tax asset in its consolidated accounts, the double entry to which will be a tax benefit that reduces the amount of the after-tax reported loss. Please note that the deferred tax asset does not represent an amount due from the State, but only a future tax saving assuming positive net income in the near future.

Accordingly, we would advise treating deferred tax assets due to past losses as an intangible asset or to deduct it from shareholders' equity to come back to the original amount of the nonrecurrent loss for the year. The choice between the two will be in particular driven by the assessment of when the tax asset will be used and the willingness to be conservative or not with the reading of the balance sheet.

For deferred tax assets linked to non-tax deductible provisions, we would advise deducting the related deferred tax asset from the provision (which will appear after tax on the balance sheet) or deducting it from shareholders' equity.

We recommend adding the deferred tax assets linked to assets with a different tax and accounting base (a frequent case after an acquisition booked under purchase accounting)⁵ to goodwill (as goodwill was initially reduced by accounting for their deferred tax assets which has no real value). We advise adding deferred tax liabilities created by differences between tax and accounting base to shareholders' equity.

⁵ See Chapter 6.

Lastly, contingent tax liabilities, which do not appear in company accounts, are of interest only for the computation of the net asset value of the company (see Chapter 32).

Section 7.6

DILUTION PROFIT AND LOSSES

1/WHAT ARE DILUTION PROFIT AND LOSSES?

Where a parent company does not subscribe either at all or only partially to a capital increase by one of its subsidiaries that takes place above the subsidiary's book value, the parent company records a **dilution profit**.

Likewise, if the valuation of the subsidiary for the purpose of the capital increase is less than its book value, the parent company records a **dilution loss**.

2/HOW ARE THEY ACCOUNTED FOR?

For instance, let us consider the case of a parent company that has paid 200 for a 50% shareholding in a subsidiary with shareholders' equity of 100. A capital increase of 80 then takes place, valuing the subsidiary at a total of 400. Since the parent company does not take up its allocation, its shareholding is diluted from 50% to 41.67%.

The parent company's share of the subsidiary's equity decreases from $50\% \times 100 = 50$ to $41.67\% \times (100 + 80) = 75$, which generates a nonrecurrent gain of $75 - 50 = 25$. This profit of 25 corresponds exactly to the profit that the parent company would have made by selling an interest of $50\% - 41.67\% = 8.33\%$ based on a valuation of 400 and a cost price of 100 for 100%, since $25 = 8.33\% \times (400 - 100)$.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Dilution gains and losses generate an accounting profit, whereas the parent company has not received any cash payments. They are by their very nature nonrecurring. Otherwise, the group would soon not have any subsidiaries left. Naturally, they do not form part of a company's normal earnings power and so they should be totally disregarded.

Section 7.7

EXCHANGEABLE BONDS

1/WHAT ARE EXCHANGEABLE BONDS?

Exchangeable bonds are bonds issued by a company that may be redeemed at the request of their holders into shares of a company other than the issuer of the bonds or in cash (see Chapter 30).

2/HOW ARE THEY ACCOUNTED FOR?

Exchangeable bonds are accounted for as financial debt.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Financial analysts must treat exchangeable bonds as financial debt as they will be redeemed either in cash or in shares of a company other than the issuer, and never in shares of the issuer. They have no equity component at all.

Section 7.8

GOODWILL

See Chapter 6.

Section 7.9

IMPAIRMENT LOSSES

1/WHAT ARE IMPAIRMENT LOSSES?

Impairment losses are set aside to cover capital losses or those that may be reasonably anticipated on assets. They can be incurred on goodwill, other intangible assets and tangible assets.

2/HOW ARE THEY ACCOUNTED FOR?

Impairment losses are computed based on the value of Cash Generating Units (CGU). The firm needs to define a maximum number of largely independent CGUs and allocates assets for each one. Each year, the recoverable value of the CGU is computed if there is indication that there might be a decrease in value or if it includes goodwill.⁶ If the recoverable value of the CGU is lower than the carrying amount, an impairment loss needs to be recognised. Impairment is first allocated to goodwill (if any) and then between the other assets.

⁶ *An intangible asset with indefinite useful life to be precise.*

The recoverable value is defined as the highest of:

- the value in use, i.e. the present value of the cash flows expected to be realised from the asset;
- the net selling price, i.e. the amount obtainable from the sale of an asset in an arm's length transaction, less the costs of disposal.

If the value of the CGU increases again, the impairment can be reversed on all assets but goodwill.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Impairment losses are netted off directly against assets, and provided that these losses are justified, there is no need for any restatements. Conversely, we regard impairment losses on tangible assets as nonrecurring items. As discussed on page 168, we consider impairment losses on intangible fixed assets (including goodwill) as nonoperating items to be excluded from EBITDA and EBIT.⁷

7 Earnings Before Interest and Taxes.

Section 7.10

INTANGIBLE FIXED ASSETS

These primarily encompass startup costs, capitalised development costs, patents, licences, concessions and similar rights, leasehold rights, brands, market share, software and goodwill arising on acquisitions (see Chapter 6).

Under IFRS, a company is required to recognise an intangible asset (at cost) if and only if:

- it is probable that the future economic benefits that are attributable to the asset will flow to the company; and if
- the cost of the asset can be reliably measured.

Internally generated goodwill, brands, mastheads, publishing titles and customer lists should not be recognised as intangible assets. Internally generated goodwill is expensed as incurred. Costs on starting up a business, on training, on advertising, on relocating or reorganising a company receive the same treatment.

This line item requires special attention since companies have some degree of latitude in treating these items that now represent a significant portion of companies' balance sheets.

1/STARTUP COSTS

(a) What are startup costs?

Startup costs are costs incurred in relation to the creation and the development of a company, such as incorporation, customer canvassing and advertising costs incurred when the business first starts operating, together with capital increase, merger and conversion fees.

(b) How are they accounted for?

Startup costs are to be expensed as incurred under IFRS. In the US, pre-operating costs may be included in “Other noncurrent assets” and are generally amortised over 3–5 years.

(c) How should financial analysts treat them?

It is easy to analyse such costs from a financial perspective. They have no value and should thus be deducted from the company’s shareholders’ equity.

2/ RESEARCH AND DEVELOPMENT COSTS**(a) What are research and development costs?**

These costs are those incurred by a company on research and development **for its own benefit**.

(b) How are they accounted for?

Under IFRS, research costs are expensed as incurred in line with the conservatism principle governing the unpredictable nature of such activities.

Development costs should be capitalised on the balance sheet if the following conditions are met:

- the project or product is clearly identifiable and its costs measurable;
- the product’s feasibility can be demonstrated;
- the company intends to produce, market or use the product or project;
- the existence of a market for the project or product can be demonstrated;
- the utility of the product for the company, where it is intended for internal use, can be demonstrated;
- the company has or will have the resources to see the project through to completion and use or market the end product.

Under US GAAP, research and development costs generally cannot be capitalised (except specific web developments).

(c) Financial analysis

We recommend leaving development costs in intangible fixed assets, while monitoring closely any increases in this category, since those could represent an attempt to hide losses.

3/ BRANDS AND MARKET SHARE**(a) What are brands and market share?**

These are brands or market share purchased from third parties and valued upon their first-time consolidation by their new parent company.

(b) How are they accounted for?

Brands are not valued in the accounts unless they have been acquired. This gives rise to an accounting deficiency, which is especially critical in the mass consumer (e.g. food, textiles, automotive sectors) and luxury goods industries, particularly from a valuation standpoint. Brands have considerable value, so it makes no sense whatsoever not to take them into account in a company valuation. As we saw in Chapter 6, the allocation of goodwill on first-time consolidation to brands and market share leads to an accumulation of such assets on groups' balance sheets. For instance, LVMH carries brands for €6 billion on its balance sheet, which thus account for one-quarter of its capital employed. Since the amortisation of brands is not tax deductible in most countries, it has become common practice not to amortise such assets all the more so as they have an indefinite life. Brands are at most written down, where appropriate.

Under IFRS, market share cannot be carried on the balance sheet unless the company has protection enabling it to protect or control its customer relationships (which is difficult to get and demonstrate).

(c) How should financial analysts treat them?

Some analysts, especially those working for lending banks, regard brands as having nil value from a financial standpoint. Such view leads to deducting these items preemptorily from shareholders' equity. We beg to differ.

These items usually add considerably to a company's valuation, even though they may be intangible. For instance, what value would a top fashion house or a consumer goods company have without its brands?

4/ CONCLUSION

To sum up, our approach to intangible fixed items is as follows: the higher the book value of intangibles, the lower their market value is likely to be; and the lower their book value, the more valuable they are likely to be. This situation is attributable to the accounting and financial policy of a profitable company that seeks to minimise as much as possible its tax expense by expensing every possible cost. Conversely, an ailing company or one that has made a very large acquisition may seek to maximise its intangible assets in order to keep its net profit and shareholders' equity in positive territory.

From a financial standpoint, intangible fixed assets form a key part of a company's value. This said, we believe that their book value is purely formal and has little to do with financial reality.

Readers familiar with traditional accounting must understand that no difference is now made between:

- intangible fixed assets that are by nature immune to wear and tear and thus not subject to amortisation, aside from write-downs in the event of a crisis; and
- tangible assets that are depreciated.

Intangible assets with finite lives are amortised over their useful life.

The International Accounting Standards Board (IASB) also requires that intangible assets with indefinite life undergo an impairment test each year to verify that their net book

value is consistent with the recoverable value of the corresponding assets (see section on Impairment losses).

US rules are very similar to the IASB's.

Depreciation and amortisation indicate a desire to reflect the turnover in fixed assets, be they tangible or intangible, and thus recognise the ephemeral nature of all assets.

Section 7.11 INVENTORIES

1/WHAT ARE INVENTORIES?

Inventories include items used as part of the company's operating cycle. More specifically, they are:

- used up in the production process (inventories of raw materials);
- sold as they are (inventories of finished goods or goods for resale) or sold at the end of a transformation process that is either under way or will take place in the future (work in progress).

2/HOW ARE THEY ACCOUNTED FOR?

(a) Costs that should be included in inventories

The way inventories are valued varies according to their nature: supplies of raw materials and goods for resale or finished products and work in progress. Supplies are valued at acquisition cost, including the purchase price before taxes, customs duties and costs related to the purchase and the delivery. Finished products and work in progress are valued at production cost, which includes the acquisition cost of raw materials used, direct and indirect production costs insofar as the latter may reasonably be allocated to the production of an item.

Costs must be calculated based on normal levels of activity, since allocating the costs of below-par business levels would be equivalent to deferring losses to future periods and artificially inflating profit for the current year. In practice, this calculation is not always properly performed, so we would advise readers to closely follow the cost allocation.

Financial charges, research and development costs and general and administrative costs are not usually included in the valuation of inventories unless specific operating conditions justify such a decision. Interim interest payments⁸ may be included in the cost of inventories where the production cycle is very long.

⁸ Interest on capital borrowed to finance production.

In all sectors of activity where inventories account for a significant proportion of the assets, we would strongly urge readers to study closely the impact of inventory valuation methods on the company's net income.

(b) Valuation methods

Under IFRS, there are three main methods for valuing inventories:

- the weighted average cost method;
- the FIFO (first in, first out) method;
- the identified purchase cost method.

Weighted average cost consists of valuing items withdrawn from the inventory at their weighted average cost, which is equal to the total purchase cost divided by quantities purchased.

The **FIFO** (first in, first out) method values inventory withdrawals at the cost of the item that has been held in inventory for the longest.

The **identified purchase** cost is used for noninterchangeable items and goods or services produced and assigned to specific projects.

For items that are interchangeable, the IASB allows the weighted average cost and FIFO methods but no longer accepts the LIFO method (last in, first out) that values inventory withdrawals at the cost of the most recent addition to the inventory. US GAAPs permit all methods (including LIFO) but the identified cost method.

During periods of inflation, the FIFO method enables a company to post a higher profit than under the LIFO method. The FIFO method values items withdrawn from the inventory at the purchase cost of the items that were held for longest and thus at the lowest cost, hence a high net income. The LIFO method produces a smaller net income as it values items withdrawn from the inventory at the most recent and thus the highest purchase cost. The net income figure generated by the weighted average cost method lies midway between these two figures.

Analysts need to be particularly careful when a company changes its inventory valuation method. These changes, which must be disclosed and justified in the notes to the accounts, make it harder to carry out comparisons between periods and may artificially inflate net profit or help to curb a loss.

Finally, where the market value of an inventory item is less than its calculated carrying amount, the company is obliged to recognise an impairment loss for the difference (i.e. an impairment loss on current assets).

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Firstly, let us reiterate the importance of inventories from a financial standpoint. Inventories are assets booked by recognising deferred costs. Assuming quantities remain unchanged, the higher the carrying amount of inventories, the lower future profits will be. Put more precisely, assuming inventory volumes remain constant in real terms, **valuation methods do not affect net profit for a given period**. But depending on the method used, inventory receives a higher or lower valuation, making shareholders' equity higher or lower accordingly.

When inventories are being built up, the higher the carrying amount of inventories, the faster profits will appear. The reverse is true when inventories are decreasing. Overvalued inventories that are being run down generate a fall in net income.

Hence the reluctance of certain managers to scale down their production even when demand contracts. Finally, we note that tax-related effects apart, inventory valuation methods have no impact on a company's cash position.

From a financial standpoint, it is true to say that the higher the level of inventories, the greater the vulnerability and uncertainty affecting net income for the given period. We recommend adopting a cash-oriented approach if, in addition, there is no market serving as a point of reference for valuing inventories, such as in the building and public infrastructure sectors, for instance. In such circumstances, cash generated by operating activities is a much more reliable indicator than net income, which is much too heavily influenced by the application of inventory valuation methods.

Inventories are merely accruals (deferred costs), which are always slightly speculative and arbitrary in nature, even when accounting rules are applied bona fide.

Consequently, **during inflationary periods**, inventories carry unrealised capital gains that are larger when inventories are moving more slowly. In the accounts, these gains will appear only as these inventories are being sold, even though these gains are there already. When prices are falling, inventories carry real losses that will appear only gradually in the accounts, unless the company writes down inventories.

The only financial approach that makes sense would be to work on a replacement cost basis and thus to recognise gains and losses incurred on inventories each year. In some sectors of activity where inventories move very slowly, this approach seems particularly important. In 1993, Champagne houses carried inventories at prices that were well above their replacement cost. We firmly believe that had inventories been written down to their replacement cost, the ensuing crisis in the sector would have been less severe. The companies would have recognised losses in one year and then posted decent profits the next instead of resorting to all kinds of creative solutions to defer losses. The same can be argued regarding the loan portfolios carried by the Japanese banks in the early 2000s.

Section 7.12 LEASES

1/WHAT ARE LEASES?

Leases allow a company to use some of its operating fixed assets (i.e. buildings, plant and other fixed assets) under a rental system. In certain cases, the company may purchase the asset at the end of the contract for a predetermined and usually very low amount (see page 522).

Leases raise two relatively complicated problems for external financial analysts:

- Firstly, leases are used by companies to finance the assets. Even if those items may not appear on the balance sheet, they may represent a considerable part of a company's assets.
- Secondly, they represent a commitment whose extent varies depending on the type of contract:

- equipment leasing may be treated as similar to debt depending on the length of the period during which the agreement may not be terminated;
- real estate leasing for buildings may not be treated as actual debt in view of the termination clause contained in the contract. Nonetheless, the utility of the leased property usually leads the company to see out the initially determined length of the lease and the termination of a lease may then be treated as the early repayment of a borrowing (financed by the sale of the relevant asset).

2/ HOW ARE THEY ACCOUNTED FOR?

A lease is either a **finance lease** or an **operating lease**.

A finance lease⁹ according to IASB is “a lease that transfers substantially all the risk and rewards incident to ownership of an asset. Title may or may not eventually be transferred”.¹⁰ Indications of the financial nature of a lease include:

- the contract sets that the asset will be transferred at the end of the lease to the company;
- the lessee has the option to purchase the asset at an “attractive” price;
- the lease is for the major part of the economic life of the asset;
- the present value of the rents are close to the fair value of the leased asset at the beginning of the contract;
- the assets leased are so specific that only the company can use (them without major changes being made).

⁹ *Capital lease in the United States.*

¹⁰ *IAS 17.*

An operating lease is a lease that is not a finance lease.

Under IFRS, finance leases are capitalised which means they are recorded under fixed assets and a corresponding amount is booked under financial debt.

The lease payments to the lessor are treated partly as a repayment of financial debt and partly as financial expense. The capitalised asset under a finance lease is depreciated over its useful life. Accordingly, no rental costs are recorded on the income statement, merely financial and depreciation costs.

Operating leases are not capitalised and are treated as rents.

Sale and leaseback transactions, where an asset is sold only to be taken back immediately under a lease, are restated as follows: any capital gain on the disposal is deferred and recognised in income over the duration of the lease for finance leases or immediately for operating leases.

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

As the reader can see, the distinction between a finance lease and an operating lease is fairly vague; nonetheless, it remains a vital one for analysing the real level of a group’s indebtedness.

US GAAP contain precise criteria. But they may be too precise as companies wanting to avoid capitalising leases in their balance sheet may artificially structure leases in a way to avoid being qualified as a finance lease so as not to show additional liabilities.

Eventually, accountants may decide that all leases are financial leases. Such a decision is not as dramatic as it seems at first sight since, when a lessee signs a contract with

a lessor and pays him a rent, this commitment gives rise to a liability, at least from a financial point of view.

So the reader should beware of a company with large operating leases. They add fixed costs to its income statement and raise its breakeven point.

Section 7.13

MANDATORY CONVERTIBLE BONDS

1/WHAT ARE MANDATORY CONVERTIBLE BONDS?

Mandatory convertible bonds are bonds that initially pay a fixed interest rate (not linked to the company's earnings performance) and are redeemed in shares of the issuing company. For further details, please refer to Chapter 29 on hybrid securities.

2/HOW ARE THEY ACCOUNTED FOR?

Proceeds from the issue of mandatory convertible bonds are allocated between debt (present value of interest) and equity (present value of shares to be issued to redeem the bonds). Such treatment is due to IASB seeing mandatory convertible bonds as compound financial instruments made up of a straight bond and a deferred issue of shares.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

We treat mandatory convertible bonds as equity, since this is what they are **certain** to become. For valuation purposes, interest payments net of tax should be reversed. This boosts net profit, and increases the number of shares outstanding to reflect those to be issued upon redemption of the bonds.

Section 7.14

OFF-BALANCE-SHEET COMMITMENTS

1/WHAT ARE OFF-BALANCE-SHEET COMMITMENTS?

The balance sheet shows all the items resulting from transactions that were realised. But it is hard to show in company accounts transactions that have not yet been realised (e.g. the remaining payments due under an operating lease, orders placed but not yet recorded or paid for because the goods have not yet been delivered). And yet such items may have a significant impact on a company's financial position.

2/ HOW ARE THEY ACCOUNTED FOR?

These commitments may have:

- either a positive impact – they are not recorded on the balance sheet, but are stated in the notes to the accounts, hence the term “off-balance-sheet”. These are known as **contingent assets**;
- or a negative impact that causes a provision to be set aside if likely to be realised, or gives rise to a note to the accounts if it remains a possibility only. These are called **contingent liabilities**.

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Analysts should always be concerned that a company may show some items as off-balance entries while they should actually appear on the balance sheet. It is therefore very important to analyse off-balance-sheet items because they reflect:

- the degree of accounting ingenuity used by the company; this judgement provides the basis for an opinion about the quality of the published accounts;
- the subsequent arrival on the balance sheet of the effects of the commitments (purchase of fixed assets or purchase commitment that will have to be financed with debt, guarantees given to a failed third party that will lead to losses and payments with nothing received in return).

The key points to watch are as follows:

| | Item | Comments |
|-----------------------|--|--|
| Financial commitments | Pledges and guarantees granted (including representations and warranties on disposal of an asset, product warranties). Commitments given as partners, whether unlimited or not, put options written on assets. Clawback commitments. | Analyse the situation of the relevant entity to estimate the size of the commitment. Same as above. |
| Liabilities | Debts backed by tangible collateral. | Reflects bankers' confidence in the company. |
| Other | Orders to suppliers of fixed assets and other purchase commitments. | These will alter the balance sheet in the short term. |

It should be noted that from 2009, firms using IFRS will have to account for all potential liabilities and will no longer be allowed to put forward the fact that the liability is hardly measurable to avoid accounting. In addition, detailed information will have to be provided to justify the assessment of the amount.

Section 7.15

PENSIONS AND OTHER EMPLOYEE BENEFITS

1/WHAT ARE PROVISIONS FOR EMPLOYEE BENEFITS AND PENSIONS?

Pension and related commitments include severance payments, early retirement and related payments, special retirement plans, top-up plans providing guaranteed resources and healthcare benefits, life insurance and similar entitlements that, in some cases, are granted under employment contracts and collective labour agreements.

A distinction is made between:

- **defined benefit plans** where the employer commits to the amount or guarantees the level of benefits defined by the agreement. This is a commitment to a certain level of performance, usually according to the final salary and length of service of the retiring employee. These plans may be managed internally or externally;
- **defined contribution plans** where the employer commits to making regular payments to an external organisation. Those payments are paid back to employees when they retire in the form of pensions together with the corresponding investment revenue. The size of the pension payments depends on the investment performance of the external organisation managing the plan. The employer does not guarantee the level of the pension paid (a resource-related obligation). This applies to most national social security systems.

2/HOW ARE THEY ACCOUNTED FOR?

Defined contribution plans are fairly simple to account for as contributions to these plans are expensed each year as they are incurred.

Defined benefit plans require detailed specific information disclosures in accounts. A defined benefit plan gives rise to a liability corresponding to the **actuarial present value of all the pension payments due at the balance sheet closing date** (Defined benefit obligation or, in US GAAP, Projected Benefit Obligation – PBO).

In countries where independent pension funds handle the company's commitments to its workforce, the market value of the pension fund's assets are set off against the actuarial value of the liability. The method used to assess the actuarial value is the projected unit credit method that models the benefits vested with the entire workforce of the company at the assessment date. It is based on certain demographics, staff turnover and other assumptions (resignations, redundancies, mortality rates, etc.).

Each year, changes in actuarial assumptions (especially the discount rate) and changes to retirement benefit plans give rise to adjustments in the calculation of pension liabilities. These adjustments may be recognised according to one of these three methods: immediately in the income statement, or amortised on a straight-line basis over the remaining service life of employees for amounts exceeding 10% of the provision for retirement benefit plans (or 10% of assets if greater), or recorded entirely in equity (this last method has been authorised since 2004).

Consequently, the net pension costs in the income statement for a given year are mainly composed of:

- a service cost, which represents the present value of benefits earned by employees during the year;
- an interest cost, which represents the increase in the present value of the pensions payments due at the balance sheet closing date since the previous year due to the passage of time; this is generally recognised in financial expense;
- an expected return on assets, which represents what management expects to earn on the pension plan assets;
- depending on the method used to record actuarial profit or losses, an amortisation of actuarial unrecognised profit or loss on the pension plan if they exceed 10% of the projected benefit obligation or the fair value of plan assets, whichever is greater.

In a move that has broadened the debate, the IASB has stipulated that all benefits payable to employees, i.e. retirement savings, pensions, insurance and healthcare cover and severance payments should be accounted for. These standards state in detail how the employee liabilities deriving from these benefits should be calculated. US accounting standards also provide for the inclusion of retirement benefits and commitments other than just pension obligations, i.e. mainly the reimbursement of medical costs by companies during the active service life of employees.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

How therefore should we treat provisions for employees' benefits and pensions that may in some cases reach very high levels, as is often the case with German companies?

Our view is that provisions for retirement benefit plans are very similar to a financial liability *vis-à-vis* employees. This liability is adjusted each year to reflect the actuarial (and automatic) increase in employees' accrued benefits, just like a zero-coupon bond,¹¹ where the company recognises an annual financial charge that is not paid until the bond is redeemed. Consequently, we suggest treating such provisions minus the market value of the pension fund's assets as a financial debt.

¹¹ See p. 319.

In the income statement, we regard only pension service costs as operating costs and the balance of net pension costs (interest costs, notional return on pension assets, amortisation of various types, etc.) as financial charges. Consequently the balance of net pension costs must be deducted from EBITDA and EBIT and added to financial charges unless the company has already applied this rule in its accounts as sometimes happens.

Section 7.16

PERPETUAL SUBORDINATED LOANS AND NOTES

1/WHAT ARE PERPETUAL SUBORDINATED LOANS AND NOTES?

As their name suggests, these instruments are never redeemable and thus continue to pay interest as long as the borrower remains solvent.

They have no duration because there is no contractual undertaking for repayment, which may take place when the issuer so wishes. **Note that if the issuer is liquidated,**

holders rank for repayment after other creditors (as they are subordinated loans) but before shareholders.

2/ HOW ARE THEY ACCOUNTED FOR?

Perpetuals are booked under financial debt or equity depending on their characteristics (see Chapter 29).

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

We regard perpetual subordinated notes as financial debt. They do not meet one of the three criteria needed to be ranked as equity: their returns are not linked to the company's earnings.

Section 7.17

PREFERENCE SHARES¹²

¹² Also called preferred shares.

1/ WHAT ARE PREFERENCE SHARES?

Preference shares combine characteristics of shares and bonds. They may have a fixed dividend (bonds pay interest), a redemption price (bonds), and a redemption date (bonds). If the company were to be liquidated, the preference shareholders would be paid a given amount before the common shareholders would have a right to receive any of the proceeds. Sometimes the holders of preference shares may participate in earnings beyond the ordinary dividend rate, or have a cumulative feature allowing their dividends in arrears, if any, to be paid in full before shareholders can get a dividend, and so on.

Most of the time, in exchange for these financial advantages, the preference shares have no voting rights. They are known as *actions de préférence* (ADP) in France, *Vorzugsaktien* in Germany, *azioni risparmio* in Italy, preferred stock in the US, etc.¹³

¹³ For more details about preference shares, see Chapter 29.

2/ HOW ARE THEY ACCOUNTED FOR?

Under IFRS, preference shares are accounted either as equity or financial debt, depending on the results of a “substance over form” analysis. If the preference share:

- provides for mandatory redemption by the issuer at a fixed¹⁴ date in the future; or
- if the holder has the right to put the preference share to the issuer in the future; or
- if the preference share pays a fixed dividend regardless of the net income of the company,

it is a financial debt.

Under US GAAP, preference shares are treated as equity.

¹⁴ Or determinable.

3/ HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Let's call a spade a spade: if the preference share meets all our criteria for consideration as equity:

- returns linked solely to the company's earnings;
- no repayment commitment;
- claims on the company ranking last in the event of liquidation,

then it is equity. If not, it is a financial debt.

Section 7.18 PROVISIONS

Provisions are set aside in anticipation of a charge. Additions to provisions reduce net income in the year they are set aside and not in the year the corresponding charge will actually be incurred. Provisions will actually be written back the year the corresponding charge will be incurred, thereby neutralising the impact of recognising the charges in the income statement. Additions to provisions are therefore equivalent to an anticipation of costs.

1/ RESTRUCTURING PROVISIONS

(a) What are restructuring provisions?

Restructuring provisions consists of taking a heavy upfront charge against earnings in a given year to cover a restructuring programme (site closures, redundancies, etc.). The future costs of this restructuring programme are eliminated through the gradual write-back of the provision, thereby smoothing future earnings performance.

(b) How are they accounted for?

Restructuring costs represent a liability if they derive from an obligation for a company *vis-à-vis* third parties or members of its workforce. This liability must arise from a decision by the relevant authority and confirmed prior to the end of the accounting period by the announcement of this decision to third parties and the affected members of the workforce. The company must not anticipate anything more from those third parties or members of its workforce. Conversely, a relocation leading to profits further ahead in the future should not give rise to such a provision.

(c) How should financial analysts treat them?

The whole crux of the matter boils down to whether restructuring provisions should be recorded under operating or nonoperating items: the former are recurrent in nature, unlike the latter. Some groups consider productivity-enhancing restructuring charges as operating items and business shutdowns as nonrecurrent items. This may be acceptable when the external analyst is able to verify the breakdown between these two categories. Other companies tend to treat the entire restructuring charge as nonrecurrent items.

Our view is that in today's world of rapid technological change and endless restructuring in one division or another, restructuring charges are usually structural in nature, which means they should be charged against operating profit. The situation may be different for SMEs,¹⁵ where those charges are more likely to be of a nonoperating nature.

¹⁵ *Small- and Medium-sized Enterprises.*

On the liability side of balance sheet, we treat these restructuring provisions as comparable to financial debt.

Section 7.19 STOCK OPTIONS

1/WHAT ARE STOCK OPTIONS?

Stock options are options to buy existing or to subscribe to new shares at a fixed price. Their maturity is generally between 3 and 10 years after their issuance. They are granted free of charge to company employees, usually senior executives. Their purpose is to motivate executives to manage the company as efficiently as possible, thereby increasing its value and delivering them a financial gain when they exercise the stock options. As we will see in Chapter 31, they represent one of the ways of aligning the interests of managers with those of shareholders.

2/HOW ARE THEY ACCOUNTED FOR?

Under IFRS, the issuance of fully vested stock-options is presumed to relate to past service, requiring the full amount of the grant-date fair value to be expensed immediately. The issuance of stock options to employees with, say, a four-year vesting period¹⁶ is considered to relate to services over the vesting period. Therefore, the fair value of the share-base payment, determined at the grant date, should be expensed on the income statements over the vesting period. The corresponding entry is an increase in equity for the same amount.

¹⁶ Which means that stock options cannot be exercised before at least four years.

¹⁷ For more, see Chapter 28.

Stock options are usually valued using standard option pricing models¹⁷ with some alterations or discounts to take into account cancellations of stock-options during the vesting period (some holders may resign), conditions which may be attached to their exercise such as the share price reaching a minimum threshold or outperforming an index.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

We are not in favour of expensing stock options because:

- the issuance of stock options means that existing shareholders potentially transfer some of their ownership interests to employees without any impoverishment for the company;
- there is no cost for the company itself, because stock option flows do not require the company to sacrifice any cash or other assets at any point in time;
- cost recognition is inconsistent with the definition of a cost. If services are received in a stock option payment, there is no transaction or event that meets the definition of a cost: there is no outflow of assets and no liability is incurred.

If the company has expensed stock options and if the amounts are material, we recommend reversing the relevant entries.

Section 7.20

TANGIBLE ASSETS

1/WHAT ARE TANGIBLE ASSETS?

Tangible assets (or property, plant and equipment)¹⁸ comprise **land, buildings, technical assets, industrial equipment and tools, other tangible assets and tangible assets in process.**

¹⁸ Known as PPE.

Together with intangible assets, tangible assets form the backbone of a company, namely its **industrial and commercial base.**

2/HOW ARE THEY ACCOUNTED FOR?

Tangible assets are booked at acquisition costs and depreciated over time (except for land). IFRS allows them to be revalued at fair value, but this option is not widely used by companies (in particular because the annual measurement of fair values and booking of changes in fair value is complex)¹⁹ except

- at first implementation of IFRS;
- following an acquisition where it is required for the tangible assets of the purchased company.²⁰

Some tangible assets may be very substantial; they may have increased in value (e.g. a head office, a store, a plant located in an urban centre) and thus become much more valuable than their historical costs suggests. Conversely, some tangible assets have virtually no value outside the company's operations. Though it may be an exaggeration, we can say that they have no more value than certain startup costs.

¹⁹ For tangible asset (but investment property) an increase in the value of the asset will be directly impacted on equity (except if it reverses a previous loss) and a loss will be accounted through the income statement.

It is clear that showing assets at historical cost, in line with the historical cost principle, does not have any benefits for the analyst from a financial standpoint.

²⁰ See p. 82.

Note that certain companies also include interim financial expense into internally or externally produced fixed assets (provided that this cost is clearly identified). IFRS provides for the possibility of including borrowing costs related to the acquisition cost or the production of fixed assets when it is likely that they will give rise to future economic benefits for the company and that their cost be may reliably assessed. Under US GAAP, these financial costs must be included in the cost of fixed assets.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

The accounting policies applied with respect to fixed assets may have a significant impact on various parameters, including the company's or group's net income and apparent solvency level.

For instance, a decision to capitalise a charge by recording it as an asset **increases net income in the corresponding year, but depresses earnings performance in subsequent periods because it leads to higher depreciation charges.**

The way tangible fixed assets are accounted for is:

- formal in a capital-employed analysis of the balance sheet;
- partial in an analysis seeking to establish the company's value or its solvency.

Accordingly, financial analysts need to take a much closer look at changes in fixed assets rather than fixed assets at a given point in time. The advantage of movements is that they are shown at their current value.

Section 7.21 TREASURY SHARES

1/WHAT ARE TREASURY SHARES?

Treasury shares are shares that a company or its subsidiaries owns in this company. These shares may have been bought for the purpose of:

- stabilising the share price (i.e. for listed companies); or
- being granted to employees, i.e. as part of a stock option plan; or
- reinforcing a shareholder; or
- being remitted to holders of convertible bonds if they request conversion of their bonds into shares; or
- simply because they were considered at a given moment to be a good investment.

We will examine in more details how such situations arise in Chapter 38.

2/HOW ARE THEY ACCOUNTED FOR?

Under IFRS, treasury shares are systematically deducted from shareholders' equity.

3/HOW SHOULD FINANCIAL ANALYSTS TREAT THEM?

Whatever their original purpose, we recommend deducting treasury shares from assets and from shareholders' equity if this has not yet been done by the accountants. From a financial standpoint, we believe that share repurchases are equivalent to a capital reduction, regardless of the legal treatment. Likewise, if the company sells the shares, we recommend that these sales be analysed as a capital increase.

Treasury shares must thus be subtracted from the number of shares outstanding when calculating earnings per share or valuing the equity.

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APPENDIX 7A: MAIN DIFFERENCES BETWEEN INTERNATIONAL AND US ACCOUNTING STANDARDS

| | IFRS | US GAAP |
|---------------------------------------|---|---|
| Capitalisation of R&D costs | <p>Research costs must be expensed. Development costs must be treated as intangible fixed assets provided that a whole series of conditions are met related to:</p> <ul style="list-style-type: none"> • the technical feasibility of the project such that the final asset may be used or sold; • the intention of completing the project; • the ability to sell or use the asset; • the way in which the asset will generate future profits; • the ability to measure cost related to the project's development. | All R&D costs must be expensed as incurred (except some specific IT/web developments). |
| Consolidation policy for subsidiaries | Control (look to governance and risk and rewards). This difference should disappear in the mid term with revision of respective US GAAP and IFRS. | Majority voting rights. |
| Construction contracts | The percentage of completion method is the only method accepted. | The percentage of completion method is the recommended method. The completed contract method may also be used. |
| Convertible debt | Split the convertible debt into its debt and equity components at issuance. | Classified as a debt. |
| Impairment loss subsequent reversal | Required if certain criteria are met, except for goodwill | Prohibited. |
| Intangible assets revaluation | Permitted if the intangible asset trades in an active market. | Prohibited. |
| Inventory cost | LIFO is prohibited. | LIFO is permitted. |
| Joint ventures | Consolidated with the equity method or the proportionate consolidation. But the proportionate method may soon be forbidden. | Generally the equity method is used. |
| Provisions | Best estimate to settle the obligation. | Low end of the range of possible amounts. |
| Reversal of inventory write downs | Required if certain criteria met. | Prohibited. |
| Special purpose entity (SPE) | Consolidated if controlled. | Consolidated if certain criteria for qualifying SPE are not met, depends on whether the SPE has sufficient level of equity at risk. |
| Tangible assets | Valued at historical costs or fair value. | Valued at historical costs. |

Adapted from "Key Differences between IFRS and US GAAP", March 2007, Deloitte.