

## NEW RESEARCH REVEALS GAAP IN CITY ANALYSTS' KNOWLEDGE

**Research reveals the extent to which City analysts are unprepared for the introduction of international financial reporting standards. The onus is on companies to explain the implications of the transition.**

With just weeks to go before the first-quarter corporate results under IFRS, research commissioned by leading financial PR firm Citigate Dewe Rogerson predicts "volatility and confusion" in the stock market rather than enhanced disclosure, clearer accounts and a lower cost of capital.

For the survey, research group Fallon Stewart interviewed 30 analysts in early February 2005 from a dozen leading investment banks, including Goldman Sachs, CSFB and UBS. It found that only two firms have provided a 'house view' on how to reconcile UK GAAP to IFRS, and that three-quarters had provided no training at all on IFRS. "We had a day's training from external accountants," says one analyst. "It was better than nothing, but I would have wanted more." The survey suggests that giving IFRS training to analysts could provide competitive advantage.

Almost a third of the analysts had received no guidance from the companies they covered, while only a small minority were actually pleased with the companies' communications efforts to date. Half the analysts had made no changes to their forecast models. The report says that analysts are reluctant to change their models as that would affect their headline forecasts and, potentially, their valuations, without specific

guidance from the companies concerned. "We believe this is due to the lack of data sufficient to produce an 'educated' estimate," it says.

Many analysts believe that US GAAP is broadly similar to IFRS and therefore believe they are already "up with events" in relation to the companies they follow that publish reconciliations to US standards. This, however, is a dangerous assumption on their part, says the report, given the differences between the two:

- US GAAP is a rule-based system, while IFRS is principles-based and therefore may allow different interpretations.
- The two systems are very close on issues such as acquisitions, goodwill and financial instruments, but differ in relation to revenue recognition, capitalisation of costs and the use of provisions, particularly for restructuring and acquisitions.

### Cash, not earnings?

It appears from the research that analysts will be putting more emphasis on analysing cashflows in future. "It follows, therefore, that more focus will be placed on investment decisions at the expense of current trading," suggests the report. "Put simply, analysts are now likely to question companies more deeply on their investment programmes; ie, how much they are going to spend, on what operations and against which benchmarks. They will spend more time forecasting the outcome of these investment decisions, allowing them to place greater emphasis on long-term cash flows than short-term profit and loss

accounts. If analysts become more confident of the visibility of cash flows in the medium term, it is likely that companies will be valued more on discounted models than they are at the present time.

"The corollary of this view is that earnings-based valuations will diminish in importance. If IFRS increases the volatility of earnings, it is likely that price-to-earnings ratios will also become more volatile and, therefore, meaningless."

A number of the analysts already use cashflow models; some who use earnings models say they will simply "look through" the IFRS adjustments.

### Recommendations

The survey concludes that most analysts are waiting for the companies they follow to take the lead in communicating information about the impact of IFRS. In particular, analysts say they want:

- A full reconciliation of the company balance sheet going back at least three years. Analysts are particularly concerned about distributable reserves.
- Full disclosure of divisional metrics. Companies should provide historic reconciliations between the new and old disclosures.
- Guidance relating to metric trends in future. Analysts need particular help in forecasting elements such as pension fund positions, share options expensing and any switch from off balance sheet to on balance sheet financing. Companies are prohibited from offering such forecasts, but should consider offering guidance relating to the mechanics of the calculations.

There may also be changes in

behaviour. For example, as one analyst says: "The disclosure of hedging will now be more explicit, leading to more volatility on the p&l. You can imagine that companies might engage less in hedging. If the purpose of hedging was to smooth the p&l, but under IFRS it is not as effective, the question is, why should they continue to hedge?"

While analysts are expecting companies to give presentations on IFRS prior to the release of their first set of results, they have also complained that some companies have "swamped" them with detail. Companies should have consideration for the structure of analysts' models when preparing presentations and should put more emphasis on interpretation. "However, we would caution that an accountant's view of what constitutes an informative discussion on IFRS may not necessarily be that of an investment analyst," says the report.

Analysts are expecting reconciliations before publication of the results, but the indications are that this need not be done all at once. "If [analysts] are to make sense of the first set of results, their models must be 'in-line' before the results are released," the research concludes. "By maintaining a dialogue with analysts in the run-up to the results, companies can ensure that analysts are forecasting 2005 and 2006 [accurately]."

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### Useful links

- For an executive summary of *The Adoption of International Financial Reporting Standards: Who Should Lead the Way?* go to [www.citigatedr.co.uk](http://www.citigatedr.co.uk)