IFRS rules distort debt reporting

IFRS accounting rules are making it hard to assess the levels of debt reported on European companies' balance sheets, and companies should consider making additional disclosures to clarify their position, according to a report from Moody's Investors Service.

Its research highlights what it says are five critical drawbacks in debt reporting, given an environment with low interest rates and volatile currencies.

Trevor Pijper, vice president and senior credit officer at Moody's, said: 'In the current environment, there is a significant risk that the amount reported as debt will fail to represent either the amount owed to the lenders, or the future cash outflow needed to discharge the obligation.'

The report says the first concern is that the amount reported as debt does not incorporate the hedging of foreign currency risk. Debt denominated in a foreign currency is always translated at the year-end exchange rate. This rule applies even when the year-end exchange rate is of questionable relevance because the currency exposure has been hedged using a derivative instrument.

Secondly, Moody's argues that the amount reported as debt loses its meaning when fair value hedge accounting is used for interest rate swaps. The credit ratings agency argues this means fair value hedge accounting causes debt to be adjusted by an amount that is not actually payable to, or receivable from, the lender.

It also highlights that the amount reported as debt may, or may not, include accrued interest payable. Interest owed to lenders but not yet paid at the balance sheet date may, or may not, be included within the amount reported as debt.

Moody's goes on to argue that the amount reported as debt may not represent the sum owed to lenders by an acquired subsidiary. All debt issued by the acquired company must be recorded in the books of the acquirer at its fair value on the date of the acquisition. As a result, the amount reported on the balance sheet is not actually owed to the lenders, and there will be no corresponding cash outflow unless the debt is redeemed ahead of schedule.

Finally, the ratings agency says the amount reported as debt is reduced by the cost of borrowing the money. IFRS requires the cost of issuing debt to be deducted from the liability reported on the balance sheet. Although the resulting understatement diminishes systematically over the term of the borrowing, the lower amount is unhelpful because the principal owed to the lender is unaffected by the expenses incurred to borrow the money.

Pijper said: 'Companies voluntarily disclosing additional information not required under IFRS helps us to identify and address the above distortions, and factor them into our credit metrics where material.'