

Financial ratios: Lost in translation

An accountants perspective

2 September 2017

Accounting “baseline”...

▶ Legal rules

- ▶ Law – principle based
 - ▶ Case law, interpretation
- ▶ All advice is linked to the above

▶ Accounting rules

- ▶ International Accounting Standards – principle based
 - ▶ IGAAP, interpretation, judgement
 - ▶ Provides consistency of the basis for measuring and recording all assets and liabilities
- ▶ All opinions are based on the above
- ▶ Materiality

Accounting “baseline”...

- ▶ Why do accountants and auditors care about covenants...??
 - ▶ Going concern considerations
 - ▶ Impact on audit opinions

 - ▶ Differences in opinions on covenant compliance
 - ▶ Audit report
 - ▶ Review report
 - ▶ Agreed upon procedures

What are the areas of confusion....

- ▶ Many of the standard terms used in banking documents do not have meaning in accounting terms
 - ▶ Financial indebtedness
 - ▶ EBITDA
 - ▶ Exceptional items
 - ▶ Tangible net worth
- ▶ Changes in accounting policy and new accounting standards – do these impact covenant calculations
- ▶ Changes in interpretation that impact the covenant calculation

How could we avoid these...

- ▶ A closer alignment of the covenant definitions to accounting definitions may reduce inconsistency and misinterpretation of borrowing covenants
 - ▶ Makes it easier for both parties to the agreement to understand what is required under the agreement
 - ▶ Where definition or meaning is unclear the accounting definition will prevail
 - ▶ Agreed exclusions being explicitly itemised
- ▶ Ratios that are to be derived from financial statements (e.g. gearing ratios) should be consistently based upon the accounting policies in the financial statements
 - ▶ Consistency of basis of calculation, removes potential for differences between management accounts and financial statements

How could we avoid these...

- ▶ Agreed treatment of “exceptional” items, this is an inherently complex area and difficult to achieve where unambiguous definitions
 - ▶ Agreed “exclusions” should be explicitly itemised
- ▶ The timing of covenant testing – “at any time” or “at period end”
 - ▶ Consistency the phrase ‘at any time’ can be used within the ratios which might imply that these are continuously measured

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organisation and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organisation, please visit ey.com.

© 2017 Ernst & Young, Australia.

All Rights Reserved.

APAC no. AU00003106

ED none

This communication provides general information which is current at the time of production. The information contained in this communication does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Ernst & Young disclaims all responsibility and liability (including, without limitation, for any direct or indirect or consequential costs, loss or damage or loss of profits) arising from anything done or omitted to be done by any party in reliance, whether wholly or partially, on any of the information. Any party that relies on the information does so at its own risk.

Liability limited by a scheme approved under Professional Standards Legislation.

ey.com