

DBRS Canada Newsletter

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CANADA'S TRANSITION TO IFRS – NO RATING CHANGES EXPECTED BY DBRS

It is no secret that most Canadian public companies¹ are transitioning to International Financial Reporting Standards (IFRS) for fiscal years beginning on or after January 1, 2011. Users of financial statements have been faced with an ongoing wave of accounting changes over the years. As one of those users, DBRS has experience in analyzing entities under a wide range of accounting systems. DBRS's objective is to understand the accounting practices and choices of issuers, enabling it to look through the measurement system to gauge the underlying fundamental creditworthiness of the issuer. DBRS's approach means that any accounting change, including a more major shift such as IFRS, would not typically result in a material change to its credit views and should not in and of itself result in rating changes.

DBRS Considerations

While IFRS is not expected to result in rating changes, DBRS will watch for the following situations that could affect rating opinions:

- Certain beneficial shifts related to IFRS such as write-up of assets could strengthen some key ratios. DBRS will take a negative view if a company believes that this additional latitude provides an opportunity to take on higher liabilities simply because certain traditional key ratios have changed merely due to accounting.
- While we have no expectations that such will occur, there could conceivably be cases where the shift to IFRS highlights certain information that was less clear under prior GAAP accounting, which would be considered by DBRS in its rating opinion.
- DBRS believes IFRS will likely require modification to some covenant metrics to preserve adequate financial flexibility. If this does not occur satisfactorily and covenants are deemed to be more of a challenge under IFRS, it could cause rating challenges, particularly in the non-investment-grade area.

In the past, DBRS has made adjustments to a variety of areas, including leasing, securitizations and hybrids, that are reflected in key ratios. Some of these adjustments may no longer be required under IFRS. When deemed necessary, DBRS will continue to make adjustments to more accurately portray key ratios. Given the latitude of choices under IFRS, there are likely to be cases where DBRS would partially discount the strength of certain metrics for management that has made liberal choices. This has always been the case, but it is worth noting since there is more choice for companies under IFRS.

DBRS will continue to place a high weighting on cash flow related metrics and ratios for issuers where such have been our traditional focus.

Key Dates

- January 1, 2010, will be the opening balance sheet under IFRS for most companies.
- For companies with calendar year ends, March 31, 2011, will represent the first IFRS financial statements; Q1 2010 comparables will be included.
- The first annual IFRS statements will be based on the year ending December 31, 2011.
- Companies have the choice of switching to IFRS at earlier dates. To date, few have taken this option.

What Users Can Expect

To reduce surprises as IFRS is rolled out, here are some general key themes that IFRS users should be aware of:

- In general, IFRS will extend accounting choice and the number and types of disclosures. It will require more judgment and work for users to understand the choices made by management and their impact. Choices can and likely will differ between individual companies within the same industry sector, increasing the challenge of directly comparing results for companies in the same industry. Therefore, the notes to the financial statements will be even more critical to understand the choices

made by management. As a result, users should be prepared for a lot more reading. Including the notes, IFRS statements will be considerably longer than was the case with Canadian GAAP.

- A higher level of fair value measurements (for both tangible and intangible assets) will lead to higher earnings volatility.
- Do not be surprised to see amendments to debt covenants as the levels and ranges of past metrics may change, necessitating the need for covenant reviews and changes.
- Public companies that are U.S. Securities and Exchange Commission (SEC) registrants could currently choose U.S. GAAP instead of IFRS. This means that for cross-border/international companies, users must continue to understand any such accounting differences.
- Issuers should expect more accounting questions and analysis from rating analysts, who will need to fully understand the choices made and their impact. Specifically, expect more discussion on fair value, particularly in areas such as troubled assets and impairments.

To end on a positive note, historically, the change to IFRS in Europe was accompanied by significant communication efforts and did not result in any meaningful market turmoil or rating changes.

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1. Certain government, private, not-for-profit and other organizations will have other options such as U.S. GAAP and Accounting Standards for Private Enterprises.

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