THERE'S NO TIME LIKE THE PRESENT

BE PREPARED FOR IAS 39 AND YOU WON'T BE SORRY, SAY **PETER RUSSELL** (RIGHT) AND **NATHAN REEVE** OF DELOITTE & TOUCHE.

The shift towards International Accounting Standards (IAS) as the single body of internationally accepted accounting standards has been a clear trend in recent years. In June 2000, the European Commission proposed that all EU-listed companies, including banks and insurance companies, should be required to use IAS for their consolidated financial statements for periods beginning on or after 1 January 2005. The drive behind this initiative is harmonisation of accounting within the EU.

Of particular concern to treasurers is IAS 39, Financial Instruments: Recognition and Measurement, which should be considered along with IAS 32, Financial Instruments: Disclosure and Presentation. Given that there are companies already required to comply with IAS 39 and companies that have implemented FAS 133 in the UK, there are some lessons to be learned and some practical issues that merit due consideration.

IAS 39 is already effective for those companies already complying with IAS. It is broadly similar to FAS 133, FAS 115 and FAS 140, since in addition to the accounting for derivatives addressed by FAS 133, IAS 39 also deals with accounting for financial assets and liabilities, as well as derecognition. Although there are differences between IAS 39 and FAS 133, the main themes of recognition and measurement of financial instruments are more or less the same.

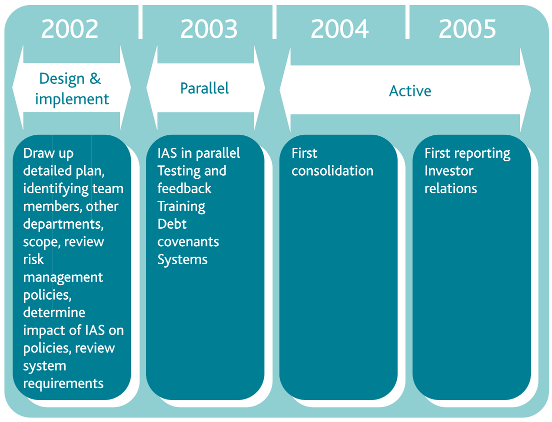
For treasurers of EU-listed companies, FAS 133 has probably not had a huge impact, even where the companies submit a Form 20-F for SEC purposes as these are not the primary financial statements. However, IAS 39 will directly affect EU treasurers and highlight their treasury and risk management activities. IAS 39 is more than just an accounting issue.

Treasurers therefore need to be aware of the impact of their risk management decisions on reported results and the subsequent tax affect, as tax rules often follow the accounting regulations.

☐ IMPLICATIONS

TIMING. For calendar year ended companies, the initial reaction may be that 1 January 2005 is the first time that IAS accounting should be introduced. However, 2004 comparatives will be required in IAS format for the 2005 accounts. This, in turn, means that in order to produce the 2004 numbers in IAS format, the balance sheet, as at 31 December 2003, needs to be compiled in IAS format. To wait until 2005 and then go back and restate 2004 would be a huge task and allows no time to address problems, not to mention that all hedging activity is unlikely to meet the formal documentation requirements of IAS 39 and therefore hedge accounting will not be permitted. Instead, start planning now and run parallel IAS accounting systems throughout 2003, as the changes from UK GAAP to IAS are considerable. This will allow time to train staff and address issues in advance of IAS reported results. *Figure 1* highlights why firms planning for a 2005 implementation of IAS need to begin now.

FIGURE 1
COUNTDOWN TO IAS 39 IMPLEMENTATION.



The importance of adopting a realistic timeframe for the implementation of IAS 39 has been underlined by numerous inefficient attempts to implement FAS 133. A dedicated multi-disciplinary team is paramount, with appropriate support at the board level. The treasury function will have a key role.

RECOGNITION OF ALL FINANCIAL ASSETS AND LIABILITIES. IAS 39 has significant business implications. All financial assets and liabilities will be recognised on the balance sheet and certain instruments, including derivatives, will have to be recorded at fair value. Where an asset or liability is recorded at fair value, changes in fair value from one period to the next will either be recorded in profit or loss, or equity, depending on the nature of the financial asset or liability. In addition, embedded derivatives will potentially have to be split out from the host contract (depending on certain conditions) and recorded and measured separately. This will impact not only financial assets and liabilities that usually come within the scope of the treasury function, but all embedded derivatives in any form of contract that the company is a party to.

IAS 39 defines four categories of financial asset. These are summarised in *Table 1* below along with the usual accounting treatment.

TABLE 1
FINANCIAL ASSET CATEGORIES

FINANCIAL ASSET	ACCOUNTING
Financial asset (or liability) held for trading	Fair value
Held to maturity investments	Amortised cost
Loans and receivables originated by the company and not held for trading	Amortised cost
Available for sale financial assets	Fair value

Derivative financial assets and liabilities are always assumed to be held for trading, unless specifically designated as effective hedges. All other financial liabilities should be measured at amortised cost, except liabilities held for trading (fair value). Those companies which have adopted IAS 39 have found the identification of embedded derivatives to be particularly challenging. Those firms that have adopted a co-ordinated effort in their search for embedded derivatives in all group companies, with adequately trained staff, have struggled the least with this complex issue.

A further practical issue has been the consideration of whether financial assets will qualify for the held-to-maturity category. Given the prescriptive nature of the definition and the restrictions surrounding any sales from that category, those companies attempting this classification will struggle for all but a minority of assets. Failure to apply the held to maturity assertion consistently could result in the inability to use the category for a two-year period – food for thought.

One further observation is that those assets that are held to maturity cannot be hedged (for accounting purposes) for interest rate risk.

HEDGING. Paragraphs 121 to 165 of IAS 39 fully define the hedging rules, but the following summarises some of the key points. Hedge accounting is permitted under IAS 39 in certain circumstances, provided the hedging relationship is:

- clearly defined and documented: what risk is being hedged, and what is the expected relationship between that risk and the hedging instrument? The documentation of the hedge relationship should also include the firm's risk management objective and strategy for undertaking the hedge;
- measurable: the company must define the technique to be used to assess hedge effectiveness; and
- actually effective: if, despite strategies and expectations, the hedge was not effective, or was only partially effective, the ineffective portion is not eligible for hedge accounting.

The company must designate a specific hedging instrument as a hedge of a change in value or change in cashflows of a specific hedged item – rather than as a hedge of an overall net position. It still may be possible to achieve the same effect as net hedging by linking the hedge to an individual exposure or portion thereof. Hedges of similar aggregated assets or liabilities are possible as long as certain criteria are met, specifically with respect to the individual items sharing the same risk exposure to the risk that is being hedged.

Given the burdensome requirements around documentation at the inception of the hedge relationship, it is worthwhile spending time developing this documentation early on. Failure to incorporate all aspects of the hedge relationship could result in the company not qualifying for hedge accounting. In the US, one early filer in accordance with FAS 133 failed to specify the method that would be used to assess the effectiveness of the hedge and as a result was forced to restate its financial information.

It is also worth noting that the International Accounting Standards Board (IASB) has not permitted the use of the short-cut method available under FAS 133, which allowed the assumption, for interest rate hedges, that there would be no ineffectiveness.

MORE EARNINGS VOLATILITY. Unfortunately, IAS 39 increases the potential for existing financial risk management strategies to increase earnings volatility. To follow are three examples of potential increases in volatility due to different hedge treatment, compared with current practice:

- any element of the hedge that is ineffective must be immediately recorded in earnings;
- where, for example, a company has in the past achieved hedge accounting by hedging its debt interest rate risk on the overall net position, this will no longer be possible. Hedges must be linked directly to underlying specific assets or liabilities, although aggregation of exposures is possible under certain conditions; and
- by splitting out the time and intrinsic value in purchased options a higher level of hedge effectiveness can be achieved. The advantage is that this may make the difference as to whether the hedge relationship qualifies for hedge accounting. The disadvantage is that the time element is recognised immediately in earnings.

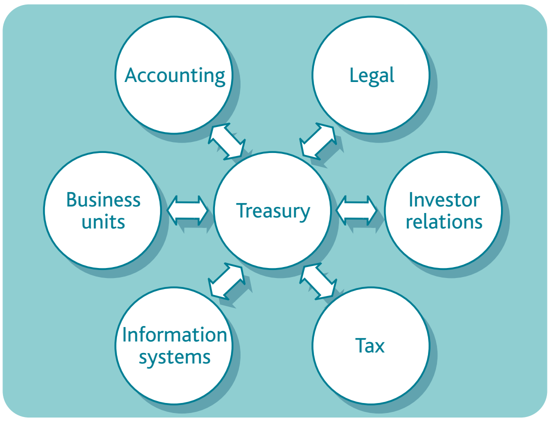
To ensure effective hedging, a thorough review of existing hedge policies will be required. Although hedge strategies that make good economic sense should not be ignored, the impact of these strategies on the reported results should be reviewed. Management needs to appreciate that market risks will be more visible and potentially cause more volatility to the financial statements.

☐ CORPORATE TREASURERS' ACTION LIST

PLANNING. IAS 39 is significantly different from current UK GAAP. To manage the implementation successfully, an IAS 39 project team should be appointed, encompassing the following areas:

- **Information systems.** IAS 39 is calculation intensive. Measuring fair value, segregating value changes into risk components (for example, interest rate versus credit risk components in a fair value

FIGURE 2
GETTING INVOLVED AT EVERY LEVEL



hedge), assessing hedge effectiveness, will require considerable skills and complex systems. Most companies will want to automate some or all of the process. An interface with the underlying books and records of the company will also be required.

Now is the time to begin the process of developing a system and infrastructure to maintain appropriate records. Treasurers will need to review existing treasury management system capabilities and assess whether an upgrade or even a new system is required.

- **Accounting and legal.** The treasurer must liaise with accounting to plan a co-ordinated approach to assessing the impact of existing treasury policies. In addition, business unit trading contracts may need to be reviewed to assess whether they are affected by IAS 39. Therefore, the legal department will play an important role in the planning and implementation process.
- **Tax.** The change in accounting may impact the tax treatment of hedging and other treasury risk management policies. Therefore, tax needs to be involved in the review to ensure there are no adverse tax consequences, either as a direct result of the implementation of IAS 39 or due to any resultant changes in hedging policies.
- **Business units.** Treasury will have to liaise with business units in order to assess the impact of IAS 39 on their activities and especially with respect to forming an inventory of all derivatives, including embedded derivatives.
- **Investor relations.** Although accounting should not drive risk management and hedging policies, it does undoubtedly impact the final reported outcome of such activity, and so the potential impact under IAS 39 of risk management policies must be discussed and agreed with senior management in order that there are no earnings surprises. This, of course, should be co-ordinated with investor relations to ensure that policies are properly explained to the investor community.

REVIEW CURRENT RISK MANAGEMENT STRATEGIES. Earnings surprises may be minimised by reviewing hedge and financing strategies. Suggestions include:

- **Carefully craft the terms of the derivative.** The more closely the cashflows of a derivative mirror the cashflows of the hedged item (timing and amount), the more effective the derivative will be. Mismatching the index in the derivative and the hedged item should be avoided where possible (for example, a Libor swap hedging a Euribor loan, or a three-month Libor swap hedging a one-month Libor-based loan).
- **Match the derivative's index.** An aluminium manufacturer, for example, may want to re-negotiate its supply contracts in order to match the pricing in the contract to the pricing of the available derivatives it plans to use for hedging. As a result, the derivatives used to hedge the price risk will be more effective.
- **Use cheaper options.** A more out-of-the-money option provides less protection. But it is cheaper and potentially less volatile. There are a number of strategies that can be devised to reduce the cost and the volatility associated with options.
- **Maximise opportunities for natural hedges.** There may be unexplored opportunities for netting natural exposures.
- **Strategically review overall exposures.** The business may be more or less sensitive to market risks compared with conditions when present hedge strategies were put in place. Hedge strategies sometimes become institutionalised – they stay in place even though no one can remember why they mattered in the first place.
- **Consider shorter hedge periods.** There is a trade-off between shorter hedge horizons (such as of forecasted foreign currency denominated sales), in this case, between less protection and lower volatility.
- **Review existing financing arrangements.** It may be wise to attempt to re-negotiate existing debt covenants so that they can withstand earnings volatility.

THERE'S TIME TO GET YOUR HOUSE IN ORDER. Compliance with IAS 39 may seem like a long way off, but firms need to start planning now in order to comply and to ensure there are no earnings surprises or adverse tax affects. This means appointing a multi-disciplinary IAS 39 project team. Achieving hedge accounting will be more difficult and involve extra work to prove hedge effectiveness.

The increased disclosure requirements will place more scrutiny on the activities of the treasury function. It does, however, also give the treasury department the opportunity to reassess risk management policies and to work closely with business units in understanding group wide risk.

Nathan Reeve and Peter Russell are Senior Managers at Deloitte & Touche, Peter in Corporate Treasury Consulting and Nathan in Assurance and Advisory.
nareeve@deloitte.co.uk
prussell@deloitte.co.uk

Further information can be obtained from Deloitte & Touche's publications 'International Accounting Standards: A practical guide to preparing accounts', 'Financial Instruments, Applying IAS 32 and IAS 39', *at www.iasplus.com or directly from Peter Russell and Nathan Reeve.*

ACT ACTIVITY

The ACT's IAS 39 Technical Working Group has submitted detailed comments to the ASB for inclusion in representations to the IASB on proposed changes to IAS 39. Please refer to the January and February 2002 Hotline features in *The Treasurer*.

The full text of the ACT's comments can also be viewed on the Association's website at **www.treasurers.org/treasury_resources/technical-papers.cfm**.

The ACT IAS 39 Technical Working Group will also be participating in the formal consultation process following the anticipated issue in April 2002 of an IASB exposure draft on the amended IAS 39 standard. Any member or non-member who is interested in joining the Working Group or contributing to the consultation on an informal basis should contact **technical@treasurers.co.uk**.