THE SECOND WAVE

WHILE THERE ARE NO CLEAR STANDARDS FOR MEASURING DERIVATIVES IN THE UK AS YET, THERE ARE SPECIFIC GUIDELINES TREASURERS CAN FOLLOW, AS **MICHAEL COX** AND **ROGER MURAY** OF ERNST & YOUNG EXPLAIN.

Internationally, accounting standard setters have approached the measurement and presentation requirements for financial instruments, including credit derivatives (CDs), in two waves. The first wave of standards, for example, FRS 13, IAS 32 and FAS 107 within UK, International and US GAAP respectively, concerned classification, presentation and disclosure issues. But here we will concentrate on the second wave, concerning the measurement of financial instruments. Key standards and their impact on the accounting for CD we will discuss are IAS 39 and FAS 133. However, there are as yet no specific standards on the measurement of derivative instruments within the UK. Nonetheless, there are certain guidelines available, which we will look at first.

CREDIT DERIVATIVES UNDER UK GAAP. The British Bankers Association (BBA) publishes statements of recommended practice (SORPs). While not mandatory for non-banks, the SORPs are a view of best practice within the market place and therefore provide useful guidance. In 1997, the BBA issued a SORP on derivatives. While this statement pre-dated the full development of the CD market, a revised version was issued in 2001 (which became effective in December 2001) that explicitly includes CDs.

The key driver of the accounting treatment under the SORP is whether the derivative transaction has been entered into for trading or hedging purposes. The nature of hedging transactions is explicitly defined within the SORP as "transactions entered into with the purpose of matching or eliminating the risk of loss or reduction in profit as a result of movements in interest rates, exchange rates, equity prices or commodity prices."

For our purposes, this definition can be extended to include changes in risk or profit resulting from movements in an underlying credit standing. The SORP goes on to say that hedging transactions "should be clearly identified and their purpose properly documented at the outset and a continuing assessment should be undertaken to confirm that such transactions do in fact manage risk to the degree sought". Factors that need to be assessed in determining the effectiveness of a CD are basis risk – that is risk arising from incongruence in the legal or economic terms as contained in the hedge documentation and the underlying, and any mismatches in the maturity of the underlying and the CD.

CDs held for trading purposes should be recorded on balance sheet at their fair market value, with changes in value subsequently posted to the profit and loss account. Where a derivative is considered to be an effective hedge, the profit and loss treatment of the derivative should mirror that of the underlying. Accordingly, if the CD has been bought to provide credit protection on a loan that is carried at cost, the CD will be off-balance sheet, at least initially, with the cost of protection bought recognised as an expense in the profit and loss account over the term the protection is in force.

If it is concluded that the CD does not represent an effective hedge, the CD should be carried on-balance sheet at fair market value, regardless of the accounting treatment of the underlying.

THE LOWDOWN ON IAS 39 AND FAS 133. The origins of IAS 39 can be found in US GAAP and at a high level there are only minor differences between IAS 39 and FAS 133. These standards call for the majority of financial assets to be recorded on-balance sheet at fair value. Under the standards, derivatives are always deemed as instruments held for trading purposes, and therefore are recorded at their fair value. The standards also seek to apply more stringent limitations on the application of hedge accounting. If the specified conditions, discussed in more detail below, are met, hedge accounting is applied by:

- recording through profit and loss the mark-to-market on the hedging instrument; and
- by simultaneously adjusting the carrying value of the underlying through profit and loss with respect to changes in market value relating to the risk being hedged.

The net effect is a flat profit and loss account, although this is achieved in a different way than discussed under current UK practice above and also results in hedging derivatives being recorded on-balance sheet at fair value, rather than off-balance sheet.

ARE ANY CREDIT DERIVATIVES NOT COVERED BY THESE STANDARDS? Both IAS 39 and FAS 133 contain definitions of what constitutes a derivative financial instrument. One key issue for our purposes is to consider whether a CD that is in essence a financial

guarantee contract is within the scope of the above standards. Taking IAS 39 first, paragraph 1(f) of the standard tells us that CDs are within the scope of the standard if they provide for payments to be made in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar underlying. Accordingly, CDS that provide for payments to be made solely if a debtor fails to make scheduled repayments are generally outside of the scope of IAS 39.

An example of this would be a purchased credit default swap that pays out only based upon the failure of a debtor to meet interest or principal repayments. Here, IAS provides little guidance on the accounting treatment in the records of the protection purchaser, but a logical move would be to follow the UK approach. Similar provisions are contained in FAS 133. Where a payment only occurs to the purchaser of the protection as a result of an underlying payment default, the instrument is treated as an insurance contract under US GAAP and should be accounted for accordingly.

REQUIREMENTS FOR HEDGE ACCOUNTING. Paragraph 142 of IAS 39 details the criteria that must be met to use hedge accounting. Applied to CDs, these can be summarised as follows:

- at the inception of the hedge there must be a formal documentation of both the hedging relationship and the risk management objective and the strategy for undertaking the hedge;
- the hedge must be expected to be highly effective in achieving off-setting changes in fair value attributable to the hedged risk;
- the effectiveness of the hedge can be reliably measured – that is, the fair value of both the hedge item and the hedging instrument can be reliably measured; and
- the hedge must be assessed on a continuous basis and determined actually to have been highly effective throughout the financial reporting period.

With respect to measuring hedge effectiveness, the IAS 39 states that a hedge is usually regarded as effective if at inception, and throughout its life, it is expected that changes in the fair value of the hedged item to be almost fully offset by changes in the fair value of the hedging instrument, and that actual results are within the range of 80% to 125%. FAS 133 contains similar criteria for applying hedge accounting, and also requires that a company defines how it will measure the effectiveness of a hedge at both the inception of the hedge and over the life of the hedge relationship.

TAKE NOTE. A credit-linked note represents a conventional corporate note with an embedded CD. IAS 39 contains guidance as to when embedded derivatives should be separately accounted for from the host. If, and only if, all of the following criteria are met, should the derivative be accounted for separately:

- the economic characteristics and risks and risks of the embedded derivative are not closely related to those of the host contract;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid (combined) instrument is not measured at fair value with changes in fair value reported in income.

Credit-linked notes meet the first two elements of the above definition. Whether the third element is met depends on how the hybrid instrument is classified and therefore accounted for under IAS 39. While this is beyond the scope of this article, essentially if the credit-linked note is being marketed to market through profit and loss, there will be no need to strip out and fair value the embedded CD.

COMING ON IN LEAPS AND BOUNDS. The European Parliament recently accepted the European Commission's proposal for listed EU companies to compile their consolidated financial statements under International Accounting Standards, from 2005. Given the need for comparatives, companies will be required to be IAS-compliant by the beginning of 2004. This clearly has implications for UK companies.

IAS 39 was developed as an interim standard and has still to be finalised. An exposure draft of a revised IAS 39 was expected in the first quarter of 2002. In the longer term, the UK Accounting Standards Board and the IAS Committee have participated in a joint working group of standard setters to develop an integrated and harmonised standard on financial instruments. In December 2000, a draft standard was issued by the group, which continues the drive towards fair value accounting. However, ultimate adoption of any revised standard published by the joint working group is at least five years away.

UK TAX ISSUES. Currently, there are no specific UK taxation provisions relating to CDs. Where used by a financial trader, their tax treatment will follow the accounts, contributing to the trading profits or losses of the company. The tax treatment for non-traders is unclear and could easily give rise to non-deductible losses, but capital gains on losses. This lack of clarity has been one of the driving factors behind proposals to extend and modify the existing rules for Financial Instruments in Finance Act 1994. Few CDs would fall within the scope of these rules. The new provisions, dealing with a wider range of 'derivative contracts' are to be included in Finance Act 2002 and should come into play on or after 1 October 2002. These rules have been subject to consultation with taxpayer representatives and the Inland Revenue approach has been outstandingly constructive.

According to the latest draft of the proposed legislation, a contract for differences whose underlying subject matter is credit risk should fall within these rules where it is treated, for accounting purposes, under FRS 13 or successor provisions, as a derivative financial instrument. Then profits or losses will be recognised on an accruals or mark-to-market basis, according to which is the appropriate accounting treatment. This should be the case even where the company concerned is not a financial trader and all gains and losses will be treated as income items. The over-mechanistic and prescriptive operative rules in existing Finance Act 1994 Financial Instruments provisions will be swept away in favour of following the accounts, so long as they conform to GAAP. This is real progress and may widen the range of companies able to use the markets.

One thing that is not proposed under the rules is bifurcation of complex instruments into simpler components. So a bond with an embedded credit derivative will be treated for tax purposes as debt, under the Finance Act 1996 Loan Relationships provisions. These rules are also reasonably closely linked to accounts, although there may still be some quirky effects in related party situations.

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