Common dilemma

Executive summary

- Two years after international financial reporting standards were introduced, shareholders are still unsure of their value.
- Two contrasting approaches are being adopted: a conservative approach that focuses on IFRS-friendly products, or an approach that views shareholder value as paramount and accepts unavoidable income statement volatility as and when it occurs.
- For the treasurer the dilemma is whether accounting or economics-based decisions should be pre-eminent.
- However, some companies have demonstrated that income statement volatility from financial instruments accounting can be explained successfully.

We all know that international financial reporting standards (IFRS) is a shareholder-focused initiative. Why then, two years since the introduction of IFRS, are we still trying to justify its value to shareholders? Many debates over the different directives and standards have raged over this time – particularly in relation to IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, the pre-eminence of either accounting or economics-based decisions has emerged as the treasurers' common dilemma.

In this sense, I have been witnessing two contrasting attitudes to IFRS in companies. Some take a conservative approach that focuses squarely on products which are very IFRS-friendly; others favour an approach that views shareholder value as paramount and accepts unavoidable income statement volatility as and when it occurs.

For instance, with IAS 39, the reality of creating a commercially effective hedge is often too far detached from the accounting testing required to allow the hedge to qualify for hedge accounting. Fair value gains/losses from a hedging instrument which complies with IAS 39 requirements for hedge accounting are either deferred in reserves, or offset in the income statement by equivalent adjustments to the underlying hedged item. Not achieving hedge accounting means fair-value volatility remains in the income statement – usually in finance income or expense.

Many treasurers are put off by this prospect and have changed their hedging strategy to avoid the accounting burden. However, in the wider context of shareholder value, not achieving hedge accounting is a secondary issue when compared to the overall financial performance of the company.

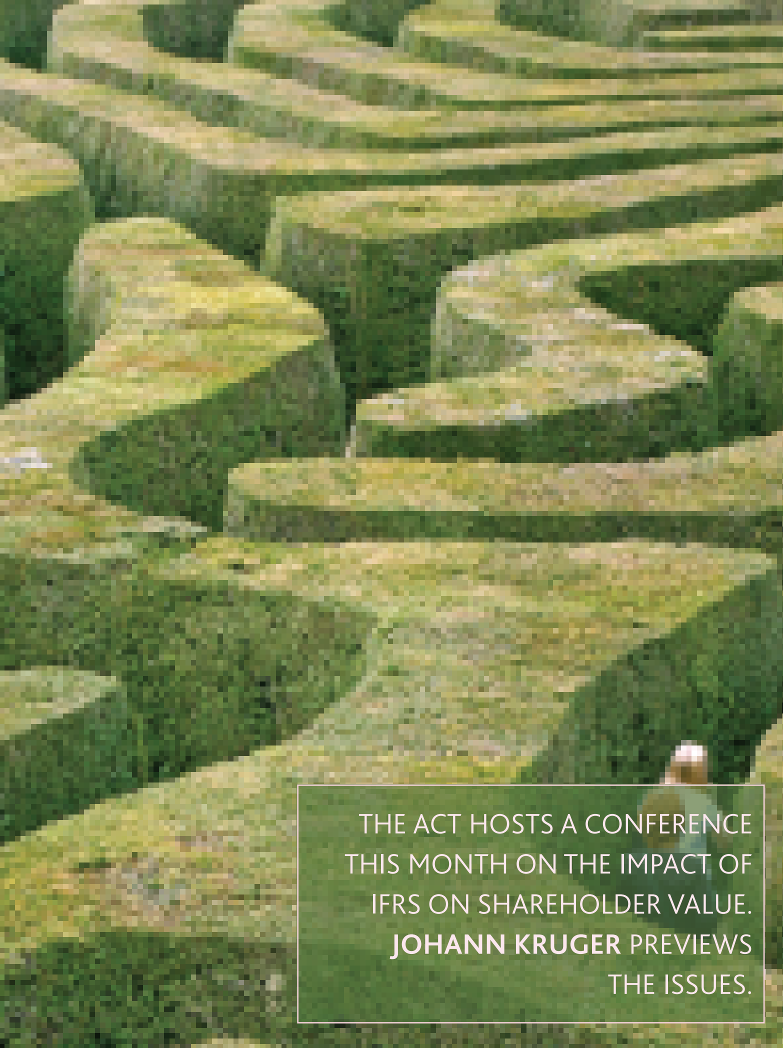
SOUND STRUCTURING Consider, for example, option-based instruments that often fail hedge-accounting criteria or pass the effectiveness test for IAS 39 (for example, a vanilla option) but have some residual time value volatility. This may put off many treasurers using these types of structures even though they might create greater hedging efficiency for the corporate. There are two approaches which may help reduce this volatility, making this product more hedge accounting-friendly.

The first is to attempt to get hedge accounting for the entire transaction using regression analysis, which can be laborious unless you have a service provider willing to do this for you.

The second is to structure a synthetic transaction that maintains the corporate's economic position but also allows it to achieve hedge accounting. This significantly reduces volatility without the need for regression tests. Correct structuring can therefore eliminate unwelcome volatility.

ACCOUNTING FOR OPTIMAL CAPITAL STRUCTURES Correct structuring is also beneficial in the wider context of liability management. By taking a step back and assessing a company's liability profile, a treasurer will be able to see how liabilities should be structured and managed to optimise the interest cost against volatility levels of its funding. It is therefore imperative that individual treasurers and their bankers establish the extent of their exposure to interest rates and inflation and understand how to minimise the cost and volatility impact of that exposure. However, achieving IFRS-friendly accounting is not straightforward and requires careful forethought and planning.

A CASE IN POINT By being so focused on IFRS compliance we are threatening the very value that IFRS was attempting ultimately to enhance. Indeed, there was a great deal of debate prior to the introduction of IFRS about the effect that it would have on transparency in reporting and the need for companies to provide



more information than the minimum required by the standards.

One company that has significantly enhanced transparency in its accounts through the use of IFRS is Rolls-Royce. It showed:

- a fully IFRS compliant set of accounts; and
- information that clearly illustrates the company's view of its underlying financial performance, including a reconciliation of the adjustments from the IFRS profit figure to explain IFRS's impact on underlying profit/earnings per share.

Rolls-Royce is one of the FTSE100 companies with the biggest portfolio of foreign exchange (FX) hedging derivatives with potentially the most significant ramifications in case of large exchange rate swings.

It disclosed an 'underlying profit before taxation' figure, a non-IFRS number with which the Rolls-Royce auditors must have been comfortable. This number is presented on the same page as its consolidated income statement. Comments in the Operating and Financial Review refer to this number as reflective of the group's performance. The financial statements indicate how the figure was calculated and the focus of the management commentary is to "avoid the distortions caused primarily by the treatment of derivative foreign exchange and commodity contracts under IAS 39".

The amount is different to IFRS profit before tax by around 49% (in 2006 it was 22%). In fact, IFRS profit changed from £477m in 2006 to £1,391m in 2007, but underlying profit changed only from £584m to £705m. Rolls-Royce went one step further in its 2006 accounts by also showing separately what it views as its underlying finance cost.

Hedge accounting in respect of foreign exchange risk management Rolls-Royce does not apply hedge accounting in respect of hedges of future foreign currency receipts/payments to be included in revenue or expenses. The impact in 2006 was an increase in profit of £696m. The net impact in 2005 was only £49m, but in a stable-state IFRS world (that is, without the impact of the transition hedging reserve) it would have reduced the company's profits by £399m, or 84%.

Share price movements subsequent to results announcement The Rolls-Royce share price largely tracked the FTSE100 index directionally during the periods January to the end of May 2006 and 2007 (see *Figures 1* and *2*). Price movements around the announcement of results and the publication of the annual report do not indicate any significant movements as a result of a negative impact of income statement volatility caused by IFRS. Analyst reports did not contain adverse comments on income statement volatility arising from IAS 39.

PAST THE ACCOUNTING NOISE Rolls-Royce appears to have successfully demonstrated that income statement volatility from financial instruments accounting can be explained successfully when communicating its results to the City, and analysts/investors are capable of looking past the 'accounting noise' from not applying hedge accounting to derivative hedging programmes.

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The ACT holds its 'IFRS and Shareholder Value: An Unlikely Marriage' half-day conference, sponsored by Lloyds TSB Corporate Markets, on Wednesday 31 October. For more, see www.treasurers.org/events

Figure 1: Rolls-Royce share price early 2006

Figure 2: Rolls-Royce share price early 2007