# IAS 39: THE PRESSURE BUILDS

HOW PREPARED ARE FIRMS IN EUROPE FOR IAS 39 AND FAS 133? **FRANÇOIS MASQUELIER** OF RTL AND **SEBASTIAN DI PAOLA** OF PWC REVEAL ALL.

The Euro Association of Corporate Treasurers (EACT) was formed in May 2002 to represent the interests of its member treasury associations from across the eurozone and, through those associations, the interests of companies operating treasury activities in Europe. The EACT works closely with other treasury associations, including ourselves and the International Group of Treasury Associations (IGTA). With the implementation deadline of International Accounting Standards (IAS) now looming for companies across Europe, the EACT, with the help of PricewaterhouseCoopers (PwC), surveyed companies across Europe to find out how prepared they are for IAS 39 and FAS 133 conversion. This article provides an overview of those findings, along with commentary on possible lessons for UK companies.

**REMINDERS ON THE BACKGROUND.** As we all know, accounting for derivatives and hedging activities has become a hot topic in the treasury world. The US's Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have released similar standards (FAS 133 and IAS 39) covering this complex area of accounting and focusing on extending the use of fair values for all derivatives.

Both standards are now in effect for businesses already reporting under IAS and US GAAP, and many companies have been struggling with the resulting implementation challenges, most notably in the areas of risk management and hedging. In some cases, the standards seem to have had a profound effect on hedging policies and on treasury processes.

For those companies which do not need to comply with US GAAP or IAS at the present time, the new rules are now critical, given the European Union's decision to adopt IAS for the consolidated accounts of quoted companies by 2005. This will imply an enormous change for European-quoted companies, and IAS 39 is set to be one of the main challenges in the conversion process.

What is clear at this stage is that treasury professionals need to develop a solid understanding of these new regulations and of how they affect their company's reported results. Doing so early will save a lot of headaches later on and significant value can be gained from the experiences of the first round of implementers.

**SURVEY OBJECTIVES AND COVERAGE.** The key objectives of the survey which the EACT has undertaken were to:

- assess the perceived impact of the new rules on companies in the eurozone, particularly on hedging policies, processes and strategies;
- identify the extent of preparation for FAS 133 and IAS 39 among corporates in the region; and
- identify any lessons which can be learned from those companies which have been or are in the process of implementing the new rules.

The survey questionnaire was deliberately brief, focusing on just 14 key questions, but the output is revealing in many respects, notably in highlighting the extent of divergence in views and expectations as to practical implications for hedging practices. Responses to the survey were received from 127 leading non-financial corporates in seven European countries (Luxembourg, Belgium, the Netherlands, Germany, Ireland, France and Spain), giving broad geographical coverage. The survey results suggest that national or cultural differences do play a part in the perceived impact of the new accounting rules on treasury practices. The survey results give an analysis of:

- FAS 133 & IAS 39 implementations in the eurozone;
- accounting methods used before conversion to FAS 133/IAS 39;
- the impact of FAS 133/IAS 39 on treasury policies;
- the implementation of hedge accounting rules; and
- the practical implications for treasury.

## RESULTS OF THE SURVEY

**FAS 133 & IAS 39 IMPLEMENTATIONS IN THE EUROZONE.** Unsurprisingly, the survey showed that local accounting standards continue to be predominant in Europe, compared with US GAAP and IAS. The number of companies which still need to convert to IAS by 2005 is extremely high. However, comparing this with another survey on IAS adoption in Europe (*International Accounting*

*Standards: 2005 or Now*, commissioned by PwC in 2000), reveals that the percentage of companies reporting either under US GAAP or IAS has increased noticeably (see *Figure 1*). The EACT survey showed that roughly 50% of the companies surveyed already comply with either FAS 133 or IAS 39.

It is fair to assume that, in the UK, the proportion of companies already applying either to IAS 39 or FAS 133 is probably lower than in the rest of Europe, owing to the strength of the local stock market and to the widespread acceptance of UK GAAP. This may mean a lower level of awareness of the issue among treasurers in the UK, and also implies a pressing need for companies to begin assessing IAS 39's potential impact on treasury policies and procedures.

Although UK GAAP may be more closely aligned with IAS than most local European accounting frameworks, this does not extend to IAS 39. In response to this, the UK's ASB has issued FRED 23 which, once finalised, is likely to move UK hedge accounting rules much closer to IAS. Treasurers in the UK should familiarise themselves with these rules and watch developments closely. The adoption of FRED 23 into UK GAAP would theoretically extend the application of the principles of IAS 39 beyond the quoted companies covered in the EU directive.

While IAS will apply for periods commencing on or after 1 January 2005, the requirement to provide comparatives implies a need for implementations to be completed earlier than 2005. Euronext, for example, has confirmed that it will require companies included in the NextEconomy and NextPrime segments to comply in full with IAS or provide a reconciliation to IAS for interim and annual financial information from 1 January 2004.

Other exchanges may follow suit nearer the time. Practically, this implies that companies must not delay any longer before launching their implementation projects. Experience from the first round of implementers shows that the project to implement FAS 133 or IAS 39 hedge accounting requires at least one year to complete, and may take longer in the case of complex users of derivatives. Following initial implementation, the process of fine-tuning processes and systems is a continuing one, with most of the companies which went live on 1 January 2001 still working to improve the efficiency of their processes and to implement more automated solutions. The message is clear: start now or risk facing unpleasant surprises as 2004 nears.

**LIFE BEFORE CONVERSION TO FAS 133/IAS 39.** About one-third of the survey respondents already apply mark-to-market (fair value) accounting for transactions in financial derivatives, and conversion to IAS 39/FAS 133 may be smoother for those companies. Nonetheless, synthetic and accrual accounting are popular methods for recording hedging derivatives under local GAAP in Europe and this is also true for many in the UK, meaning significant changes are needed to move to fair value accounting.

**THE IMPACT OF FAS 133/IAS 39 ON TREASURY POLICIES.** Unsurprisingly, the majority of companies in the survey hedge balance sheet foreign currency exposures. It is more interesting to note that many companies (71% of those surveyed) also hedge forecasted foreign currency exposures. Under IAS 39/FAS 133, companies can apply cashflow hedge accounting to hedges of forecasted transactions, which is often forbidden under local GAAP and was also usually not possible under US GAAP before FAS 133. Hedging forecasted exposures is particularly popular among Belgian, German and Spanish respondents, while Dutch, Irish and French companies appear to be more reluctant to extend the hedging horizon beyond balance sheet and firm committed exposures.

Hedging of forecasts has been one of the most complex areas for the early implementers of IAS 39 and FAS 133. Indeed, most companies have concluded that these types of hedges require hedge accounting, since the earnings volatility from a pure mark-to-market approach (with unrealised gains and losses flowing through P&L) was deemed unacceptable. The challenge of gathering exposure data from affiliates at a sufficient level of detail to allow for documentation, continuing monitoring and accounting for these hedges has put pressure on processes and systems (both treasury and accounting) at treasury centre and affiliate levels, since the

**FIGURE 1**
ACCOUNTING POLICIES USED: EVOLUTION 2000-2002.

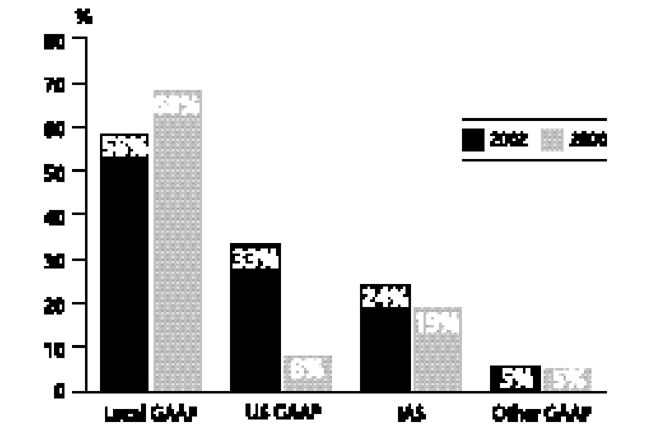
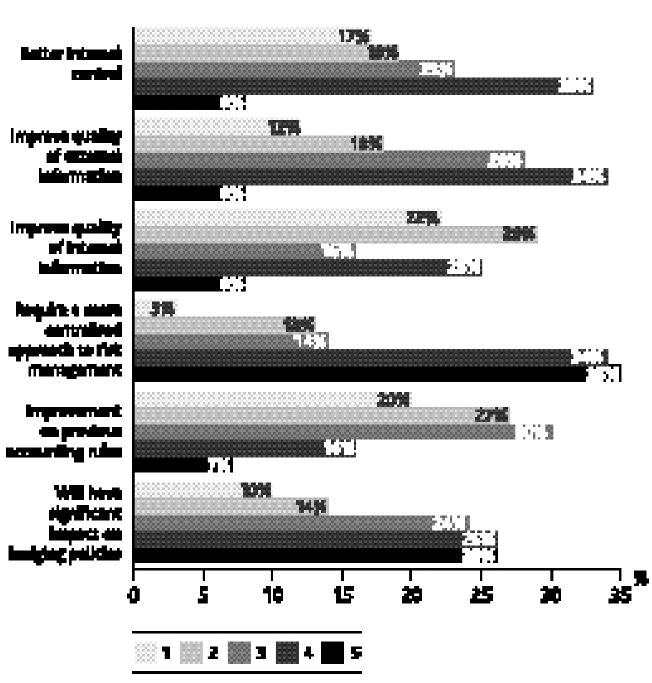



**FIGURE 2**
HOW NEW ACCOUNTING RULES AFFECT THE CORPORATE – FROM LOW (1) TO HIGH (5).



information requirements are significantly different from what was required or allowed before IAS 39 and FAS 133.

In addition, the need for a detailed linkage and clear documentation of the manner in which exposures are laid-off externally, along with the complex new rules surrounding treasury centre netting, have driven significant changes to central treasury processes and policies. The hedging of forecasted FX exposures through a treasury centre is one of the key areas for attention in any IAS 39 or FAS 133 implementation, and one which will drive major process change for many. Integrated systems, perhaps with an interface through the corporate intranet, are often part of the solution.

On a more general level, participating companies are still uncertain about the impact of the new accounting rules on their treasury policies. This is reflected in the survey results, where responses are almost equally divided between those who believe the standards do have an impact treasury policies (52%) and those who do not (48%). Again, this finding highlights the need for early assessment of the impact of the new rules. Companies which believe there is unlikely to be an impact on treasury and financial risk management policies, but which have not undertaken a detailed analysis of their particular circumstances to support this view, should be wondering whether there is something others know which they don't.

'TREASURERS LOOKING TO IMPLEMENT IAS 39 OR FAS 133 WOULD BE WELL ADVISED TO SPEAK TO THEIR EXISTING PROVIDERS AND UNDERSTAND WHAT FUNCTIONALITY IS ALREADY ON OFFER'

**IMPLEMENTATION OF HEDGE ACCOUNTING.** About 50% of the companies surveyed have already implemented or plan to implement the new hedge accounting rules for all their hedging strategies. The remainder of respondents are more inclined to apply a selective approach (for example, hedge accounting on most income statement-sensitive strategies). Only a few (9% for interest rate risk management and 7% for currency risk management) plan to use no hedge accounting at all and will therefore accept potential income statement volatility from not designating derivatives as hedges for accounting purposes.

A selective approach is often adopted by the more sophisticated implementers, who have a wider range of hedging strategies and need to assess carefully the cost of implementing hedge accounting (policy, process and system change) versus the benefit in terms of reduced earnings volatility. This analysis should be undertaken per type of strategy and hedging instrument to determine precisely where hedge accounting is possible and where it is needed.

The survey also reveals that FAS 133/IAS 39 is recognised as a company-wide issue, affecting not only the accounting and treasury departments, but other areas too, including tax, legal, IT, controlling and consolidation). Overall responsibility for managing the conversion to FAS 133/IAS 39 is allocated either to treasury (45%) or accounting (55%). With the conversion to IAS for 2005, the IAS 39 implementation will form part of a broader IAS project, probably driven by the accounting department under the sponsorship of the CFO. IAS 39 conversion will be one of the main components of the project and treasury would do well to ensure it is properly positioned as part of the project team, if possible as the lead on the IAS 39 component. In this way, treasury can ensure that its requirements are being properly taken into account and that the final solution is effective from a business perspective, rather than just for accounting purposes.

## PRACTICAL IMPLICATIONS FOR TREASURY

**THE IMPACT ON PROCESSES AND SYSTEMS.** Some 78% of respondents expect a moderate to high impact on treasury-related processes, reflecting recognition of the fundamental changes that are needed to the way in which hedging transactions are documented, recorded, tracked and accounted for. However, it is fair to say that, initially, much of the process change will be manual or spreadsheet-based, implying increased operational risk for many firms. Indeed, about 75% of respondents confirmed that they expect to rely on spreadsheets or manual workarounds to handle the burden of FAS 133/IAS 39. This is borne out by the experience of many of those who have already implemented, although among these companies, most are now looking for ways to further automate the hedge accounting process as a second phase to their implementations.

Ultimately, although most implementers have recognised that there are benefits to be gained from implementing the new accounting rules (notably in respect of internal control, integration with the underlying business and the opportunity to review and enhance hedging policies and strategies), the issue remains one of compliance. In practice, few companies are prepared to invest heavily in compliance processes, since they are not perceived as part of the core business, meaning that the key initial objective for implementers is quite simply to comply.

Less emphasis is generally placed on how efficient the compliance process is in its initial form. Thereafter, once treasury has learned to live with the new rules, there is naturally increasing focus on enhancing effectiveness and efficiency. These reasons, combined with the increasing availability of largely off-the-shelf system solutions, both from the larger treasury management system (TMS) suppliers and from internet-based providers, are driving the second wave of existing FAS 133 and IAS 39 implementations.

These implementers will continue to be the pioneers to which those companies adopting IAS for the first time will look for guidance, not just on the subject of compliance, but also increasingly regarding automation. However, manual or spreadsheet solutions will probably remain the most appropriate solution for those firms using only very low volumes of simple derivative instruments.

As regards the impact on existing TMS solutions, opinion is again mixed as to whether there is a need to upgrade or replace systems. Although 61% of respondents felt that no change would be needed, the remaining 49% believed that existing systems would require modification or replacement in response to IAS 39 or FAS 133. Belgian, German and Dutch companies, in particular, expect to amend or replace their treasury supporting systems to comply with the new rules, perhaps reflecting the high level of awareness in those countries of IAS and US GAAP issues. Irish respondents, however, did not expect any impact on systems, perhaps because of the large proportion of companies already reporting under US GAAP. French companies, though they perceived that there will be a relatively significant impact on hedging policies compared with other countries, are less prepared to dedicate resources to amend or replace systems merely for the sake of compliance.

As supplier solutions evolve beyond basic compliance to more advanced functionality, it is likely that greater adoption will follow. Treasurers looking to implement IAS 39 or FAS 133 would be well advised to speak to their existing providers and understand what functionality is already on offer so as to assess its benefits as part of their initial impact analysis.

**IMPACT ON TYPE OF DERIVATIVES USED.** The three most popular derivative instruments used by respondents are foreign currency forward contracts, foreign currency options, interest rate (and cross currency) swaps. Only 24% of companies in the survey use other types of derivatives. Responses were divided on the implications of the new rules on types of hedging instruments used. Again, the experience from existing European and US implementers is useful here. While IAS 39 and FAS 133 were initially perceived to have an anti-option bias (due mainly to the treatment of time value), this has changed as the rules have evolved and been better understood by treasurers and bankers. To simplify the implementation process, however, most companies have chosen to avoid complex or exotic products at first. Subsequent to this, and with the increasing understanding of how more complex structures can qualify for hedge accounting, many are now revisiting the possibility of using more advanced derivatives, including so-called 'exotic' options as an overlay to their core hedging programmes.

**DON'T DELAY.** Most of the respondents to the survey consider that the new rules will have a significant impact on hedging policies, will improve internal control, will enhance the quality of external information and will increase the drive for centralisation of risk management processes. However, many companies remain sceptical as to whether FAS 133/IAS 39 represent an improvement on previous accounting rules. That part of the debate will rage on, but the best advice for treasurers across Europe, including the UK, whose companies have not already implemented IAS, is to recognise that these rules are not going to go away before 2005, and to get on with the process of understanding and implementing the necessary changes. The time to start this process is most definitely now.

We would like to this opportunity to thank once again the treasury associations which have supported the survey, and in particular the treasurers and CFOs who took the time to complete the questionnaire. We wish them every success with their continuing implementation efforts.

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François Masquelier is Group Treasurer of RTL Group in Luxembourg, President of the Luxembourg Association of Corporate Treasurers (ATEL) and member of the Board of the EACT.
**Francois.Masquelier@rtlgroup.com**
www.rtlgroup.com

Sebastian di Paola is a Partner in the Corporate Treasury Solutions Group at PricewaterhouseCoopers and leads the firm's treasury advisory team in Belgium.
**Sebastian.di.Paola@pwc.be.**
www.pwcglobal.com/be