The Association of Corporate Treasurers

Comments in response to
Discussion Paper on "Reducing Complexity in reporting financial instruments"
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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer magazine*, our website, topic-specific working groups and our Policy and Technical Committee.

General

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The ACT welcomes the fact that the IASB has published a discussion paper reviewing some of the elements of accounting for financial instruments and hedging in particular. Almost since its inception preparers and users of accounts, and the IASB itself, have acknowledged that IAS 39 is one of the most complex accounting standards and one that has generated much concern over the detail and the outcomes it produces.

The ACT has in the past taken issue with the IASB over certain elements of the standard, but has accepted that the concept of marking to market the value of derivatives and other off balance sheet items is the right one, but that improvements are still required so that the accounts give a realistic picture of a company's activity and performance.

We accept that the current situation has a muddled mixture of measurement methods for different instruments and for different circumstances and that in an ideal world a more consistent and uniform approach would be far less complex. Reducing complexity is a laudable objective but ultimately the purpose of the accounts is to provide information on the financial performance and position of an entity that is useful to a range of users of the accounts. Sometimes the preparation of meaningful accounts will be complex.

The public debate over the characteristics of financial statements as defined in the IASB framework continues, but the concepts of understandability, relevance and faithful representation (by whatever names), must surely be core elements. Taking fair values of all financial instruments where there is no intention to trade them nor even any realistic possibility to do so adds complexity without furthering the aims of the framework. We therefore take issue with your premise that the long term solution is to measure all financial instruments in the same way, namely fair value.

The simple example here is where a company has issued fixed rate debt repayable in 10 years. Normally there would be no point in revaluing such debt which is intended to remain on the balance sheet and be repaid at par; indeed to do so would introduce a meaningless volatility in the net worth of that company. It is worth noting that the credit rating agency Standard and Poor's published an explanation of its methodology for adjusting debt in June 2008[1]. In essence where debt has been fair valued because of the fair value option or fair value hedging they adjust back to amortised cost. If professional analysts find that they have to adjust from the international standards in order to obtain useful numbers it would seem to imply that the fair valuing own debt is not the way forward. An alternative to satisfy those who consider it relevant would be to include fair values in the Notes to the accounts.

We are pleased to note that the IASB is conscious that fair value for everything immediately may not be feasible and that meanwhile some interim improvements are being proposed. But if it is inappropriate to go to full fair value accounting now we question what makes it a desirable objective long term?

Responses to specific proposals

Intermediate approaches to measurement

Interim solutions. Approach 1: Amend the existing measurement requirements

Currently IAS 39 includes four measurement categories for financial instruments namely - financial instruments at fair value through profit or loss, held-to-maturity (HTM) (held at amortised cost), available for-sale (AFS) financial assets (gains and losses go to equity until realised), and loans and receivables (amortised cost).

[1] Criteria | Corporates | General: Criteria Methodology: Calculating Adjusted Debt And Interest For Corporate Issuers http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,1,4,1204836643788.html
2 June 2008

The proposal being made here is to eliminate the HTM and AFS categories. An alternative idea given in the paper is that instruments traded in an active market are measured at fair value along with all derivatives.

From the ACT perspective management intentions are very relevant so that a HTM intention should quite fairly mean that the instrument is not revalued period by period. The IASB expresses discomfort with accounting treatment being different depending on management intentions, but if that reflects the real expectations for the use of that asset then surely that is what the accounts should be showing. We point out here the anomaly that the IASB is concerned that the same instrument should always have the same treatment whereas under IAS 39 it has not been concerned that two treasury transactions with the same economic effect can have different accounting depending on whether derivatives are used or not. (For example borrowings via an RPI linked bond as compared to a fixed rate bond plus swap into RPI linked.)

Currently there is a problem that if an HTM asset is in fact disposed of early it taints the whole of that basket of similar items so that they cannot get the HTM treatment. A minor simplification to remove the 'tainting' rules would be welcome. Another way of achieving this would be to eliminate HTM as suggested but allow instrument by instrument inclusion in the loans and receivable category where there are no tainting rules,

We do not believe it to be right to remove the AFS category either. It is essential, say, for minority stakes in other companies held for strategic and long term reasons. Market values can be difficult to obtain and can be extremely volatile and is it relevant to be recording these variations in P&L where the holding is for the long term and essential to the on-going business? Accounts are a report to shareholders, not for providing information for a potential break-up bid.

Approach 2: Replace the existing measurement requirements with a fair value measurement principle with some optional exceptions

The paper proposes a general fair value measurement with some exceptions that could be measured using a cost based method if the cash flows were unlikely to be particularly variable (eg fixed rate interest instruments), whereas those with highly variable cash flows (eg equity instruments or derivatives) would remain at fair value.

This approach is not fully defined but seems to have some merit even if it introduces its own complexity as to which treatment applies to which instrument. It would become more acceptable if in defining the lack of variability in cash flows it could be by reference to the principal amount paid, and taken over time. Thus for an equity investment held long term the variable dividend flows would rarely be significantly variable as compared to the invested principal. For a trading investment where a gain or loss on the principal is likely to be realised as a cash flow, the cash flows are likely to be sufficiently variable to require a fair value accounting treatment.

Simplifications to hedge accounting

We note the discussion of possible variations to hedge accounting in your paper and, to the extent that this implies that you recognise the importance of hedge accounting, we welcome it. However were this to be a holding measure prior to moving to eliminate hedge accounting in the hope that with more and more items fair valued there would be more natural offsets, we would be very disappointed.

Hedge accounting is essential if artificial volatility in the income statement and in the balance sheet are to be avoided where a genuine economic hedge exists.

Much of treasury management is related to risk management and to arranging a company's affairs or entering into special transactions in order to mitigate or eliminate some genuine economic exposure to risk and volatility. Taking this as the guiding principle if an economic risk to P&L or to balance sheet has been hedged away, then the accounts should follow suit or be, at best, misleading. . If in economic terms the effect of the hedging is such that volatility in the hedged asset (or liability) is eliminated then the value of the hedged asset (or liability) should remain unchanged.

Sometimes treasury management is concerned with changing a risk rather than eliminating a risk. This category of transaction should also be eligible for treatment as a hedge, where there exists an underlying hedged item unless the net economic position falls into an unacceptable category (e.g. equity linked return).

We would propose that rules over what risks can be treated as hedged in hedge accounting (IAS39.80Y) be eliminated and instead the test is that the hedge is determined by management to be an economic hedge (i.e. management or mitigation or elimination of risk). Thus a borrowing in the form of a fixed rate bond can be hedged into an RPI linked borrowing with an RPI swap since the combination achieves the economic purpose of creating an RPI linked borrowing. The borrowing remains at amortised cost, the gains and losses on the swap are held via reserves and the periodic charge to income statement is the combination of the fixed coupon and the swap accruals (receive fixed, pay RPI real coupon, accrete principal on RPI leg by inflation)..

The ACT appreciates that moving to a cash flow hedging type of hedge accounting and auditor discretion would be a significant change. However, it has the merit of reflecting what is actually going on both economically and managerially.

Although not ideal, the possibilities you include in sections 2.49 -2.54, would provide an additional flexibility as compared to the current standard and would be welcome as an intermediate step and not an ultimate position.

In section 2.49 you include the possibility of permitting "recognition outside earnings of gains and losses on hedged items."

This suggestion has the following features:

i. All (or at least many) financial instruments would be measured at fair value.

ii. Gains and losses on derivatives, instruments held for trading and instruments designated in their entirety at initial recognition to be measured at fair value are recognised in earnings.

iii. For financial instruments other than those described in (ii), entities would be *permitted* to recognise all unrealised gains and losses or unrealised gains and losses attributable to specified risks in either earnings or other comprehensive income, subject to one exception. The exception is that unrealised gains and losses on interest bearing financial liabilities attributable to changes in the entity's own credit risk must be recognised in other comprehensive income. An entity could also choose to report a specified percentage of the gains or losses on these financial instruments in earnings and the remainder in other comprehensive income.

For items in this category the choice would be made at inception but would be revocable and on changing designation the amounts so far taken to reserves would be reclassified to earnings in some systematic way over the remaining life of the instrument.

This proposal is similar to that made by the corporate members of the IASB financial instruments working group.

The proposal removes the need for any effectiveness testing and allows the entity to take both the gains and losses on a hedge and a hedged item through income statement, ensuring that any artificial volatility in earnings is removed. This discretion for the preparer is attractive. However since all financial instruments are measured at fair value the volatility in the balance sheet remains, which is not in accord with our objective

2 Maintain and simplify existing hedge accounting requirements

Experience since the inception of IAS 39 has shown that the rules for accounting for financial instruments are fraught with complications. A major re-think is due, but it is inevitable that any major changes would themselves be contentious and would probably re-create a different set of complications. If agreement on changes cannot be reached your alternative approach to maintain and simplify the existing hedge accounting requirements would allow some modest improvements.

In reviewing the ideas you put forward it does seem that many of those below that we find unacceptable have been designed to remove some of the existing features or exceptions without regard for the consequences. The rules are made less complex but that is not an end in itself, but rather the object should be to create meaningful and useful accounts.

Suggestion	**Implication**
Designation of hedge accounting is irrevocable.	This reduction in management flexibility is totally unacceptable. Hedging in the real world is a dynamic process and must adjust as the underlying business changes and develops. It is essential that the hedge accounting treatment be revocable to cope with changes to the hedged item or to the hedging requirements. For example - a fixed rate bond is issued and swapped into floating rates to provide a company with funding at a time when fixed rates are not competitive. It elects for fair value hedging. Some time later the company decides that fixed rates in the market are attractive and it reverses out of the swap at a profit. It will no longer make sense to be fair valuing its own liability and will need to terminate the hedging treatment.

Hedge accounting for partial hedges is prohibited.	This too in unacceptable. It appears to be an arbitrary change to reduce complexity with no regard to the effects on preparers. In order to meet the current hedge effectiveness criteria it is often essential to designate partial hedges. Indeed a large proportion of hedges are probably treated as partial hedges so that a rule change here would disallow many true economic hedges.
Eliminating the quantitative retrospective effectiveness test but requiring a prospective qualitative test.	We welcome this idea. It would increase the number of hedging relationships, provide greater flexibility and probably help many bona fide hedges to qualify where currently they fail.
'Similar items' test for portfolio hedge accounting is relaxed or removed.	This would reflect the way that entities manage economic risk on a portfolio basis and so increase the number of hedging relationships that qualify as hedge accounting. We welcome this idea.
The timing of reclassification of gains and losses to profit or loss for cash flow hedges is stated at inception of the hedge and will be recognised in profit or loss regardless of whether the forecast transaction occurs as planned.	This removes the need to demonstrate at the outset that the cash flows are highly probable. It would be less complex and reduces the need to track individual transactions. The need for stringent effectiveness testing would be less. However, mistakes in forecasting would cause volatility in profit or loss. This would be a risk for some preparers but for many who are hedging very distant flows or those where demonstrating high probabilities is difficult the benefits would be significant. Where the highly probable event is delayed it would be preferable if the recognition of the hedge could also be delayed, otherwise two periods of volatility would occur – one when the hedge goes through P&L and one where the delayed event goes through P&L. At the risk of increasing complexity in preparation (but simplifying the task of understanding for users) perhaps this proposal could be introduced as an option for preparers.

In addition to the ideas that you have put forward we would propose to you some further changes which are both simplifications and moves to a more rational set of rules. In common with treasurers across Europe and as mentioned in the response to you from the European Associations of Corporate Treasurers we would recommend a reconsideration and removal of the following:

- The rule about FX embedded derivatives where the accounting treatment applied by company A is affected by the functional currency of a third party with whom it contracts. In many cases A will not even know that functional currency, or even whether it changes at a later date. The currency of denomination should not per se create an embedded derivative.

- The arbitrary requirement of a 80-125% threshold for effectiveness testing.
- The prohibition on hedge accounting when hedging on a net basis through a treasury centre.
- The inability to hedge portions of non-financial (commodity) exposures.

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The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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