TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

# The Association of Corporate Treasurers

## Comments in response to
## *Exposure draft – Amendments to IAS 39 Financial Instruments: Recognition and measurement*
## *Exposures qualifying for hedge accounting*
## Issued by the ISAB, September 2007

January 2008

## 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*, topic-specific working groups and our Policy and Technical Committee.

## General

The ACT welcomes the opportunity to comment on this matter.

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## Response to specific questions

***Question 1 – Specifying the qualifying risks***
*The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.*
*Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?*

In the existing standard Para 81 states "If the hedged item is a financial asset or liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value … provided that the effectiveness can be measured." This was a principle, but has been replaced by a list of specific risks which is in essence a rule. The Board has acknowledged that this change is a move away from a principles basis, which many users, including our members, find to be a superior basis. A principles based standard does allow an element of flexibility and discretion, subject to audit agreement. It allows the standard to continue to be applied even if the instruments and hedging techniques in the markets evolve in some new direction. The list of specific risks that may be designated as hedged risks is helpful but only if included as examples in the application guidance rather than set in stone in the main standard.

A risk which is commonly hedged is inflation risk which is not specified in the list of risks nor very often can it be treated as a hedged item under the heading of a risk "associated with the contractually specified cash flows of a recognised financial instrument". A fixed rate bond, for instance may be issued by a company and turned into the equivalent of an RPI linked liability by entering into an RPI interest rate swap. To ensure the true commercial reality appears in the accounts the company will want to designate the RPI swap as a hedge of the RPI component of the fixed rate debt since any fixed rate is effectively made up of an RPI indexed component plus a real rate of interest. (See also next answer.)

***Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item***

*The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item.*

*Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why? Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?*

Applying the proposed amendment to IAS 39 to the previous example we would find that since the RPI cash flow is not contractually specified in the hedged item then it could not be separated out and hedged. This means that you will not be able to designate the effects of inflation on the value of fixed rate assets or liabilities as the hedged risk. Companies may validly seek to argue that para 80Y(a) stating that hedging FV fluctuations due to changes in market interest rates is permissible should allow this sort of hedge since the inflation rates curve can be viewed as 'market interest rates', indeed inflation rates over different periods are quoted and traded in the financial markets.

Surely the principles based test as to what portions may be treated as hedged items should be that the portion is capable of being identified, isolated and measured as to fair value?

***Question 3 – Effect of the proposed amendments on existing practice***

*The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising.*

*Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?*

Under the current standard it is possible to hedge the downside risk in forecasted foreign currency sales, floating rate debt, energy purchases etc using vanilla bought options, and to get cash flow or fair value hedge accounting to defer all P&L volatility from them until the underlying hedged transaction occurs, which is consistent with the fundamental objective of hedge accounting in IAS 39. At present the entire changes in value of a purchased option, including time value, can be designated as a hedging instrument and any ineffectiveness is eliminated by designating as the hedged item a hypothetical option being the change in value of a one sided risk, including an imputed time value.

Following the proposed amendment to IAS 39 (paragraph AG99E), most traditional option hedging strategies will have less favourable accounting outcomes. Changes in option time value could no longer be deferred in reserves because of the proposed new limitations to the prescribed effectiveness assessments under IAS 39 and will result in more P&L volatility.

Options are very often a highly suitable instrument for a company to use to hedge a downside risk while holding open the possibility of benefiting from favourable market movements that, if fully hedged, would have put the company at a competitive disadvantage. The new proposed accounting treatment introduces arbitrary volatility which may even put a company off using the optimal hedging strategy.

Your proposals are a change in practice and for users of options would be most unwelcome.

***Question 4 – Transition***

*The proposed changes would be required to be applied retrospectively.*
*Is the requirement to apply the proposed changes retrospectively appropriate?*
*If not, what do you propose and why?*

The proposals are to be applied retrospectively with restatement of the opening balance of shareholders' equity for the earliest period represented. The Board states that as all the hedges should be documented, the information required to make any restatement is readily available. In fact, despite having everything documented, it might not be an easy task to re-perform calculations required in order to come up with restated numbers. Either way, as a point of principle, we believe that changes should not be required to be implemented retrospectively, although voluntary early adoption should be permitted.

**Further comment**

There is also no attempt to extend to non financial instruments (such as hedges of forecast purchases or sales) the concept of taking only a portion of the cash flows as the item being hedged. IAS 39.82 indicates that the only risk that can be "carved out" of a non-financial hedged item is foreign currency risk. This is causing issues for some industries and is still not changing. So, for example, hedging the RPI element of price inflation of your forecast raw materials would not be eligible. As drafted the

ability just to look at portions applies only to financial instruments. This is consistent with the current standard but while reviewing this area we would have thought it was sensible to consider whether for the sake of consistency the principles behind the treatment of portions of financial instruments should be applied also to non financial instruments.

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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 .


| Contacts:<br>John Grout, Policy and Technical Director<br>(020 7847 2575; jgrout@treasurers.org )<br>Martin O'Donovan, Assistant Director, Policy and Technical<br>(020 7847 2577; modonovan@treasurers.org)<br>Peter Matza, Policy and Technical Officer<br>(020 7847 2576; pmatza@treasurers.org) | The Association of Corporate Treasurers<br>51 Moorgate<br>London EC2R 6BH, UK<br><br>Telephone: 020 7847 2540<br>Fax: 020 7374 8744<br>Website: http://www.treasurers.org |
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*The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address*