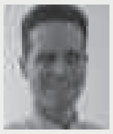
Ask the experts:

Do equity analysts care about IAS 39?

What IAS 39 *Financial Instruments: Recognition and Measurement* will mean in practice for treasurers, analysts and bankers.



Peter Russell, Deputy Treasurer, Alliance UniChem plc

It's 2005 and the dust has supposedly settled on implementing IAS 39. If only that were true! We have emerged from a difficult past year sorting out the practical implications of complying with IAS 39 but are left with the feeling that there are many unanswered questions resulting from anomalies in the standard. Although we as an organisation recognise the need for greater transparency, IAS 39 would seem to have created accounting problems that it may never have intended to.

With what we now know of IAS 39, a key question we asked ourselves was would our approach to financial risk management now be different? We concluded that economically our approach should not change, but it has become clear that the administrative burden to achieve hedge accounting is huge and some of the accounting results may not fairly reflect our approach, or indeed the approach of most corporate treasurers to hedging.

To illustrate this, Alliance UniChem has issued fixed rate long-term US private placement debt which we viewed as a liquidity source and not a hedge. Accordingly, we swapped the proceeds into floating rate euros, the currency in which the majority of our assets are based. The floating rate exposure is then hedged up to three years forward with interest rate swaps. Two issues arise. The first being the fact that although we have hedged all the USD risk from a cashflow perspective, IAS 39 forces us to prove and measure effectiveness in a manner that leaves us with an accounting exposure arising from the swap of the USD credit spread into EUR. Secondly, cashflow hedge accounting is not possible for the interest rate risk arising on the floating EUR leg. Although we have been able to allocate our swaps to other floating rate debt, this issue gives a theoretical cap on cashflow hedge accounting.

We recognise that there may be unwelcome P&L volatility if we do not comply with the hedge accounting criteria and so we will adhere to IAS 39 wherever possible, but we will not allow this to limit the amount of hedging we do. Our shareholders expect us to manage economic or cashflow exposures, not pure accounting exposures. A by-product of this is that our performance measurement will carve out any effects of IAS 39 that may arise, just as we currently carve out exceptional items and amortisation of intangible assets. That said, communication with equity investors and our lenders will be important in order to explain that P&L volatility may actually represent certainty of cashflows.

Peter Elwin, Head of Accounting and Valuation research, Cazenove

Do equity analysts care about IAS 39 and the way that it will impact company balance sheets and results? Yes. Will they change their earnings or cashflow forecasts, or views on company values as a result? Probably not.

Analysts use financial statements to help them to develop a view on the future financial performance of a company. Their views on the company's value will be based on this.

For most businesses, the balance sheet is a poor indication of future value generation, which is why analysts concentrate on cashflows and earnings.

Changes in fair values of assets or liabilities such as those arising from IAS 39 cannot be forecast, and have no direct bearing on the underlying performance of the business. For this reason, analysts ignore them when analysing historic earnings, and exclude them from their forecasts.

But that does not mean that the figures are irrelevant. The impact of IAS 39 on earnings and net assets will focus attention on the use of derivatives by companies in a way which has not happened before.

IAS 39 is complex and the financial accounting outputs are difficult to understand. Analysts will not find the earnings or net asset volatility helpful, but provided companies explain the figures they will look through the accounting to the underlying economics. However, companies that cannot explain the figures and their hedging policies are unlikely to be given the benefit of the doubt.

Sue Harding, Chief European Accountant, Standard & Poor's Ratings Services

We are paying close attention to the transition to IFRS, including IAS 39. We spent much of last year speaking to bond issuers about their transition and disclosure plans. More detailed evidence of corporate preparedness – as well as investor understanding of the changes to reporting – should appear as companies publish restatements of 2004 accounts within the next few months.

But we expect the actual impact on credit ratings to be minimal. While many of the accounting changes relate to financial obligations that will affect the balance sheet position and have some impact on profitability, many of these obligations are anticipated by S&P's adjustments to reported information. With respect to derivatives and hedging, we will continue to emphasise underlying risk and economic hedging policy in our analysis. Given that most of our corporate credit analysis revolves around cashflow to support debt service, this means few of our key measures will change meaningfully. Yet if future reporting under IFRS reveals new information regarding an issuer's ability to generate cashflows or its financial obligations – or consequences of IFRS influence actual changes in future cashflows, for example stemming from a change in economic hedging policy – ratings action could not be ruled out.