Mending the GAAP

THE PRINCIPLE OF PRESENTING RELEVANT AND DECISION-USEFUL INFORMATION IN THE REPLACEMENT IAS 39 STANDARD IS ESSENTIAL IF FINANCIAL REPORTING IS TO BE ALIGNED WITH SOUND CORPORATE RISK MANAGEMENT. **JOHANN KRUGER** EXPLAINS.

The International Accounting Standards Board (IASB) has come in for heavy criticism over the best part of the last decade. Yet it is on the progressive side of future developments in financial reporting. The fact that many companies have to provide "underlying profit" figures alongside their International Financial Reporting Standards (IFRS) figures is evidence that reforms are needed. In addition, the volatility of asset prices such as exchange rates or commodities that accompanied the financial crisis brought into focus the inadequacies of many companies' hedging strategies.

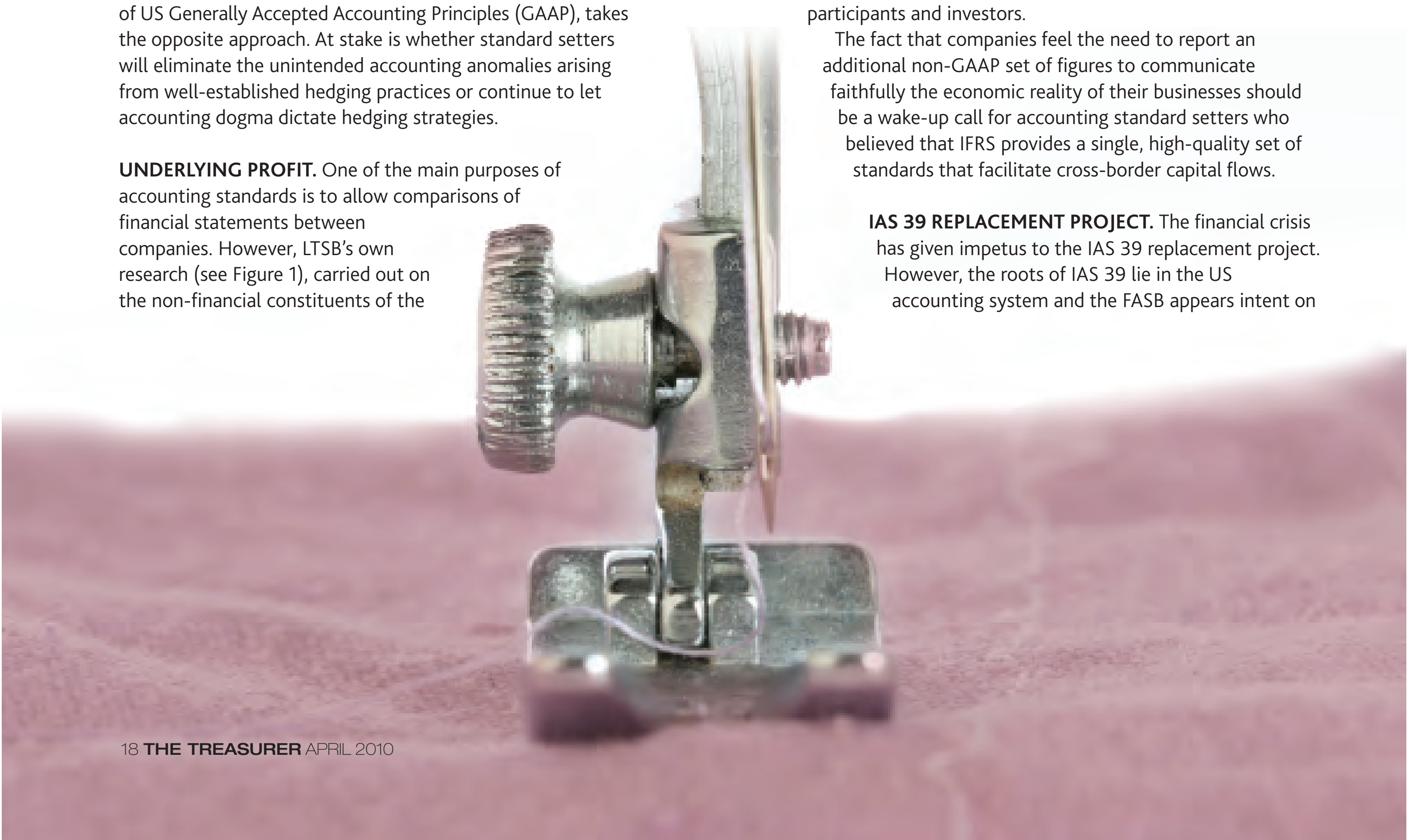
The IASB is actively trying to address the issues with its IAS 39 standard for recognising and measuring financial assets and liabilities, and is consulting market users and preparers. It is leaning towards a principles-based approach to hedge accounting, with gains and losses from hedging activities recognised at the same time as gains and losses from underlying hedged items. However, the Financial Accounting Standards Board (FASB), the US standard setter in charge of US Generally Accepted Accounting Principles (GAAP), takes the opposite approach. At stake is whether standard setters will eliminate the unintended accounting anomalies arising from well-established hedging practices or continue to let accounting dogma dictate hedging strategies.

UNDERLYING PROFIT. One of the main purposes of accounting standards is to allow comparisons of financial statements between companies. However, LTSB's own research (see Figure 1), carried out on the non-financial constituents of the FTSE 100, shows that almost 80% resort to non-GAAP profit measures, such as "underlying profit" or "adjusted profit" in their operating and financial review (OFR), and almost 60% present this information on the same page as the main income statement. The most common adjustments relate to exceptional items (such as disposals of subsidiaries and restructuring costs), goodwill impairment, intangible asset amortisation and non-cash IAS 39-related items. In fact, out of the companies that report non-GAAP profit measures, 60% adjust for so-called "IAS 39 noise".

For example, Rolls-Royce has grown its underlying profit steadily since 2005 while its IFRS figures has swung wildly, including a large loss in 2008 (see Figure 2). Yet the company is committed to generating shareholder value and believes in applying sensible hedging practices throughout the business cycle regardless of the accounting effect. The company's notes to its accounts detail its hedging practices and reinforce its credibility with market participants and investors.

The fact that companies feel the need to report an additional non-GAAP set of figures to communicate faithfully the economic reality of their businesses should be a wake-up call for accounting standard setters who believed that IFRS provides a single, high-quality set of standards that facilitate cross-border capital flows.

IAS 39 REPLACEMENT PROJECT. The financial crisis has given impetus to the IAS 39 replacement project. However, the roots of IAS 39 lie in the US accounting system and the FASB appears intent on



enforcing fair value accounting and limiting the availability of hedge accounting even more than under existing rules.

Early feedback from the IASB's consultation indicates it favours a more pragmatic approach to hedge accounting. Such an approach would strive to remove the current arbitrary elements of the rules and align reporting of hedging activities with their purpose and economic reality. With the IASB and the FASB seemingly on a collision course, companies and account users will need to make their views heard so that the new standard takes their needs into account.

OPTIONS. The constraints of IAS 39 hedge accounting have a material influence on corporate hedging behaviour. Some, such as improved governance, are positive. Some are counterproductive; in particular, corporates seeking to reduce earnings volatility have been coerced into using very inflexible hedging instruments as they cause fewer accounting issues. For example, for a vanilla option that is hedging the downside risk of an underlying cashflow (in other words, providing a worst case rate and with no leverage implications), deferring full fair value of the option in equity for hedge accounting purposes and releasing it to the income statement when the cashflow occurs would be consistent with the objective of IFRS financial statements of providing useful information[1].

Reporting all the volatility from movements in option time value in the income statement, as is currently required, communicates one of two realities to the reader:

- the option hedge is partially ineffective, when in reality it is fully effective; or
- the entity/group is trading in options, which would be incorrect if they were properly executed and designated hedges, and in conflict with statements in the OFR that the entity does not use derivatives for speculative purposes.

Such confusion about the purpose for which derivatives are used is not limited to options, and the resulting systematic overstatement of ineffectiveness is clearly not a faithful representation of the underlying economic events.

Since 2005 entities have made much less use of plain vanilla options. This trend has been observed during consultations with the Lloyds Banking Group client base, which covers most FTSE 350 companies. Clients recognised the value of these options in setting balanced risk management profiles, but fear of the unknown accounting volatility from option time value has deterred many. Market volatility since 2008 has caught many companies off-guard and exposed the weakness of their hedging practices across all risk classes, including foreign exchange, interest rates and commodity price risk, with some far too influenced by accounting consequences.

RISK COMPONENTS. Hedging components of risk (as opposed to hedging all risks for an item) reflects a practical approach. For example, a corporate that seeks to increase its floating rate debt after issuing fixed rate debt would hedge the fair value risk of its fixed rate liability, but not the credit risk inherent in the liability.

Current rules allow risk component hedge accounting for financial items but not non-financial items. IASB staff recommend the new standard contains the possibility both for financial and non-financial items to designate risk components of an item as a hedged item provided they are both separately identifiable and measurable in determining hedge ineffectiveness. These restrictions have proved workable for financial items and there is no reason why they should not be extended to non-financial items. Yet the FASB, in keeping with its move towards a full fair value model with little scope for hedge accounting, is not in favour. Convergence between IFRS and US GAAP has been on the agenda for years, but it is hard to see how convergence will be achieved with such divergent approaches (principles versus rules).

Figure 1: FTSE 100 financial reporting policies

% that use non-IFRS profit measures to communicate performance to shareholders	78%
% that adjust for non-cash volatility from IAS 39	48%
% that present the information on the face of the income statement	45%

Source: LTSB, based on non-financial FTSE 100 companies, September 2009

Figure 2: Best-in-class example: Rolls-Royce

Income statement impact	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
IFRS profit before tax	2,957	-1,892	733	1,391	477	364
Change	256%	-358%	-47%	191%	31%	–
Underlying profit before tax	915	880	800	705	593	364
Change	4%	10%	13%	19%	63%	–

Source: Rolls-Royce annual reports

A GOLDEN OPPORTUNITY. IFRS is fast becoming the local GAAP of choice. In the UK unlisted entities can expect to have to apply some form of IFRS from 2012 or 2013. This will have a material effect on reporting for covenant compliance and determination of distributable reserves. In a world where financial reporting is not aligned with sound corporate risk management, the risk of sub-optimal hedging practices, or worse, no hedging at all, is exacerbated.

The IASB has a golden opportunity to remove a serious impediment to unbiased financial risk management. If it follows the principle of presenting relevant and decision-useful information, everybody will be a winner. Preparers and users of accounts should actively take part in the IASB's initiative to reach out to interested parties by commenting on the exposure draft on hedge accounting when it is released.

Footnote

1 While US GAAP currently allows option time value to be deferred, proposed revisions could see this privilege removed.

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