A changed world

AN ACT CONFERENCE ON FINANCIAL REPORTING EXAMINED THE MAJOR TRENDS AND PROBLEMS IN ACCOUNTING IMPACTING THE ROLE OF THE TREASURER. **PETER WILLIAMS** REPORTS.

Accounting for financial instruments has dominated the accounting standard-setting scene for financial instruments. The standard setters' search for a solution has been made even more intense following the financial crisis and pressure by the leaders of the G20 for making mending broken accounting standards a must-do measure. But as Kush Patel, a senior manager at Deloitte, explains, replacing the IAS 39 standard has not been an easy task. Politics are proving a toxic mix with standard setting, and the story seems to change on a daily basis.

According to Patel, IAS 39 Financial Instruments: Recognition and Measurement is seen as difficult to understand, apply and interpret. It is also rules-based while the International Accounting Standards Board (IASB) wants principles-based standards. It was part of the deal with the US standard setter the Financial Accounting Standards Board (FASB) that IAS 39 would go, and it was seen as way past its sell-by date even before the financial crisis highlighted its weaknesses.

The first part of the IASB plan to replace IAS 39 happened in November 2009 with the release of IFRS 9 Financial Instruments. The IFRS 9 standard introduces new rules for classification and measurement of financial assets. Key changes include removing the available-for-sale and held-to-maturity classification, ending the concept of embedded derivatives in financial instrument and no longer allowing unquoted equity investments to be held at cost. The standard introduces a new classification for equities – fair value through other comprehensive income. The standard is due to become effective on 1 January 2013 but early adoption is permitted. However, the European Commission has to endorse IFRS 9 before European listed companies can use the standard and the timings on that adoption process were unclear.

THE TIMINGS EXPLAINED Patel explained the timetable for the whole IAS 39 replacement programme. While IFRS 9 deals with the classification and measurement of financial assets, final standards on impairment, hedge accounting and derecognition are all expected to be published in the second half of 2010 and become mandatory to use in 2013. But the conference heard there were still unanswered questions in the revised approach to accounting for financial instruments. One of the most difficult issues remains hedge accounting: the choice is to eliminate hedge accounting altogether, simplify existing rules or adopt a principles-based approach. The conference heard that the IASB tentative decision is to replace the mechanics of fair value hedge accounting with the mechanics of cashflow hedge accounting (this would mean there would be no basis adjustments for both financial and non-financial hedged items) and in turn simplify hedge accounting. The IASB had identified a raft of areas that could be simplified and the 100 Group of Finance

Directors had also put forward seven recommendations in this area including adopting a principles-based approach and reducing the burden of testing.

While many areas of accounting for financial instruments are still up for grabs, and decisions are awaited by standard setters, treasurers and their colleagues continue to work within the existing regime of accounting for various aspects of financial instrument. The conference heard from Lesley Flowerdew, tax and treasury director of Atkins, how her company had implemented IFRS 7 Financial Instruments: Disclosures. The accounting standard first became effective on 1 January 2007 but two years later a series of amendments were introduced in an effort to enhance fair value disclosures and extending the scope for puttable instruments classified as equity.

THE BOARDS DISAGREE ON VARIOUS ISSUES, INCLUDING LIABILITIES MEASUREMENT, SEPARATE DISCLOSURE OF LEASE LIABILITIES ON THE BALANCE SHEET, AND A REASSESSMENT OF THE INCREMENTAL RATE.

ENTERING THE VORTEX Flowerdew told the conference that the first thought was that wrestling with the standard was like entering a vortex. The standard was seen as complex, partly because of its interaction with other accounting standards. And when Atkins' financial team investigated the standard in depth, they were surprised as to what appears to be the wide definitions of financial assets and liabilities.

The project was jointly owned by the treasury and the accounting teams within Atkins. The team had to source the detailed information required by the standard and assess how it might apply in Atkins' particular circumstance. Flowerdew noted that they viewed the overriding objective of the standard as enhancing the disclosure of financial risk within the report and accounts to enable the reader to see this risk "through the eyes of the management".

In many ways Flowerdew welcomed the standard because it provided the company with a number of interesting challenges and discussions. Furthermore it raised the question of who "owned" the data which was required to be disseminated in order to comply with the standard.

As a large engineering consultancy Atkins is involved in major construction projects where it is standard practice to issue performance guarantees. A question arose as to whether there were disclosures as balance sheet liabilities (previously not) under IFRS 7 or whether they were more akin to insurance contracts as defined by IFRS 4. Atkins determined that the nature of these instruments was such that IFRS 4 was ultimately the applicable standard.

IFRS 7 created its own further work in terms of sensitivity analysis and stress-testing of the market, financial risks and other types of risk which the company knew it faced.

For Atkins the end result of implementing IFRS 7 was an expanded treasury policies and objectives note in the operating and financial review as well as more detailed notes to the report and accounts. For example, the risk management note provided enhanced narrative on market risks – foreign exchange, interest rate, price, credit and liquidity. This included a sensitivity analysis in connection with FX and interest rate risk, enhanced disclosure of trade debtor ageing, and an analysis of the debtor provision. The note on net finance income was also enlarged. And what, asked Flowerdew, was the benefit for the reader of the accounts for all that work and for those changes to the reports? The answer, she suggested, is that it provides shareholders with reassurance that Atkins understands the environment in which it operates and that it can manage its financial exposures appropriately.

RULES FOR LEASES If IFRS7 still seems rather exotic, then for any accountant with a long memory the desire to alter the accounting rules for leases has a familiar ring to it. Andrew Tempest, the financial reporting manager for easyJet, gave an update on lease accounting from the lessee's perspective. The proposal from the IASB is to abolish the existing distinction between operating and finance leases and place all leases on the balance sheet. An analysis of the 300 comment letters received by the IASB on its discussion paper suggest that opinion is split, varying from broadly supportive to implacably opposed. The IASB is working with the FASB on the issue and in March 2009 launched a public consultation in the form of a discussion paper. However, the discussion paper did not cover all the important issues and there still appears to be differences in approach between the two boards.

Tempest said that if a standard was introduced based on the discussion paper the implications for easyJet would be significant, altering the income statement, balance sheet and cashflow statement. As at the end of September, the company had a fleet of 181 aircraft; 68 were held under operating leases, six under finance leases and 107 were owned (25 of which were unencumbered). The company had a gearing of 38% after notional adjustment for operating leases, calculated at seven times the operating lease payments.

Under the current accounting standard only the assets and liabilities arising from finance leases are recognised in the statement of financial position. For an operating lease, the lessee simply recognises the payments as an expense over the lease term. In the discussion paper the IASB and the FASB floated the idea that lease accounting should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position. This approach is aimed at ensuring that leases are accounted for consistently across sectors and industries.

So that the project can be moved along, no consideration has so far been given to a whole host of issues, including lessor or sale and lease accounting. And the boards disagree on various issues, including liabilities measurement, separate disclosure of lease liabilities on the balance sheet, and a reassessment of the incremental rate. The issue of leases will rise on the treasurer's agenda this year as an exposure draft is planned for the second quarter of the year, a final standard planned for the first half of 2011 with companies using the standard for December 2012 year-ends. By then the IASB should have realised its aim of all leases being on the balance sheet.

Peter Williams is editor of The Treasurer
editor@treasurers.org