Meet the skeletons in the IFRS closet

IAS 39 IS ONLY ONE OF A HOST OF TRANSFORMATIONAL CHANGES DEMANDED BY THE DEVELOPMENT OF A SINGLE GLOBAL ACCOUNTING LANGUAGE. **STEPHANIE BRUCE** AND **YANN UMBRICHT** REPORT.

The move to International Financial Reporting Standards (IFRS) in the European Union is part of a project to develop one global accounting language. There are many advantages to such a move: it will improve the comparability of company performance, and companies will no longer have to report under different Generally Accepted Accounting Principles (GAAPs) if they are raising finance in different markets, particularly in the US.

As part of this project the International Accounting Standards Board (IASB) is currently working with the US standard setters on a project to converge IFRS and US GAAP. For treasurers, this is great news. It should become easier to evaluate financial performance when looking at acquisition targets, and the alignment of the reporting requirements of different markets should increase the availability of financing sources. But global convergence is a long-term goal, and the promised benefits are unlikely to emerge for some years. In the meantime, those companies that have made the move to IFRS have recognised that the transition also brings short-term pain and frustration. For treasurers, the focus has been on IAS 39 – one of the most controversial and complex accounting standards ever written. The standard is transforming treasury processes and accounting, and for companies there is ongoing investment in hedging strategies, processes and systems.

With all this complexity, it would be easy for treasurers to lose sight of the numerous other GAAP differences that also have an impact on external reporting of performance. Change to reported profits or net worth can affect financial covenants, credit rating and other key treasury metrics. Reported performance is likely to be more volatile with many new non-cash items. There will be much work to do in educating stakeholders such as credit rating agencies, lenders and trustees so that they understand performance trends.

New accounting principles on, for example, leasing, business combination, share option schemes and financial statements presentation, along with the interaction between IFRS and tax, might also significantly affect reported numbers and treasury operations. So what are the current IFRS treasury hot topics?

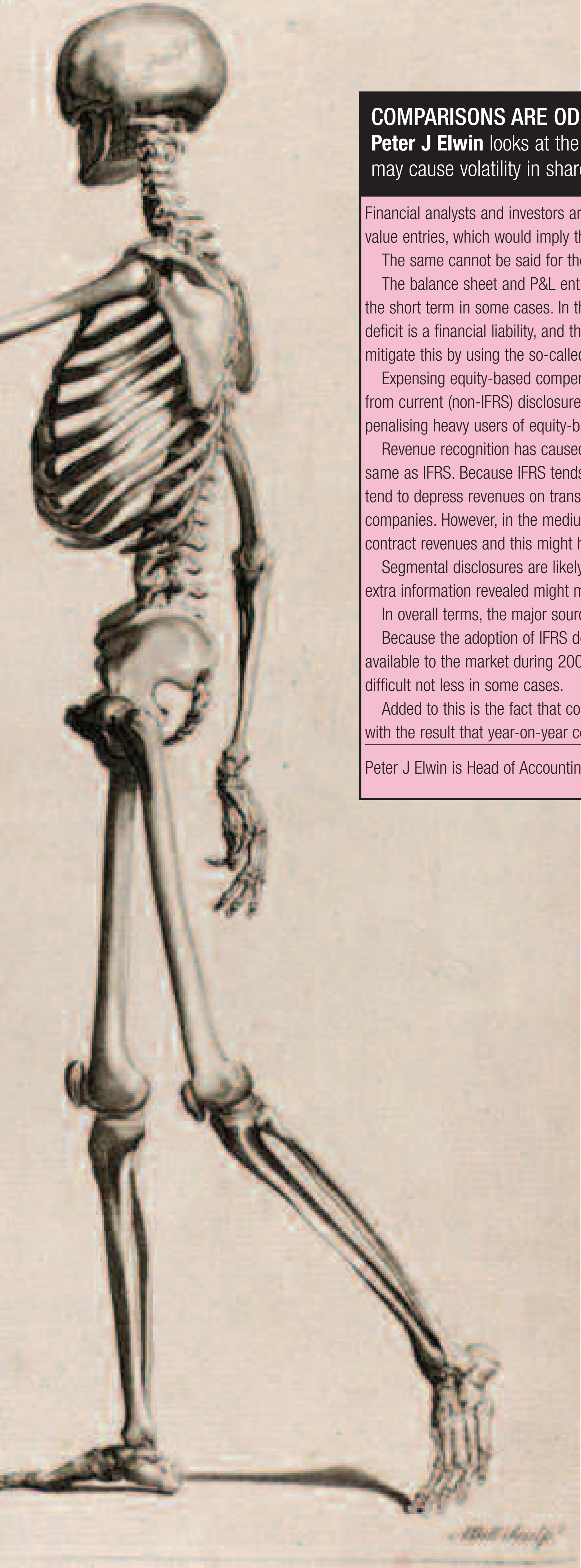
FUNCTIONAL CURRENCY There are a number of important differences between the international accounting standard on foreign currency (IAS 21) and the UK equivalent (SSAP 20). In particular, correctly determining the appropriate functional currency is critical for treasurers as it will determine the extent of transactional and translational exposures across the group. IAS 21 provides guidance in the form of primary and secondary indicators of functional currency, which require careful analysis of the business environment and operations of each entity. Only in limited circumstances can management judgement be applied to determine the appropriate functional currency. However, there is also a significant requirement: if a foreign operation is integral to the reporting entity (the parent) and carries on business only as an extension of the parent, then its functional currency must be the same as the parent.

Application of these indicators would normally be straightforward. But the analysis becomes complex for groups of companies with offshore finance and treasury vehicles, and for those with tax-driven subgroups. These intermediate holding or treasury companies generally do not have traditional sales. They are often, for example, a conduit for intra-group loans, or a holding company with the occasional dividend passing through but not much else. For these entities, management will need to consider the extent to which the entity operates as an extension of the reporting entity (parent) and its degree of autonomy from the parent.

For instance, consider a UK group with sterling functional currency

Executive Summary

- New accounting principles on areas such as currency, leasing, business combination, share options and presentation will significantly affect reported numbers.
- Numerous other IFRS transition changes can also greatly affect treasury operations and reporting.
- Applying the new rules is complex and can result in big changes.
- Treasurers will need to spend more time in understanding the new rules and their implications and in educating stakeholders.



COMPARISONS ARE ODIOUS.

Peter J Elwin looks at the IFRS standards (except IAS 39) which are causing concern and may cause volatility in share price from the financial/capital markets perspective.

Financial analysts and investors are expected to ignore the earnings volatility caused by the (non-cash) IAS 39 fair value entries, which would imply that shares will not become more volatile as a result of adopting this standard.

The same cannot be said for the impact of other International Financial Reporting Standards (IFRS).

The balance sheet and P&L entries required by the pensions standard (IAS 19) are likely to change perceptions in the short term in some cases. In the medium term, it will remove any doubts in investors' minds that a pension deficit is a financial liability, and the balance sheet volatility is likely to influence the share price. Any attempts to mitigate this by using the so-called 'corridor' approach will be treated with scepticism by investors.

Expensing equity-based compensation (including options) is new and it is hard to estimate the potential impact from current (non-IFRS) disclosures. Investors will look at earnings and similar measures on a 'post-options' basis, penalising heavy users of equity-based compensation.

Revenue recognition has caused a few surprises, since many people had assumed that the UK rules were the same as IFRS. Because IFRS tends to require revenues to be spread across the term of any related contract, it will tend to depress revenues on transition for some businesses, and this has caused problems for one or two companies. However, in the medium term, the 'smoothing' approach required by IFRS might reduce the volatility of contract revenues and this might have a similar share price impact.

Segmental disclosures are likely to be more detailed under IFRS, which will be welcomed by investors, but the extra information revealed might move share prices.

In overall terms, the major source of volatility during the transition to IFRS is likely to be lack of comparability.

Because the adoption of IFRS depends upon the company's accounting period, the accounting information available to the market during 2005 will be an unpleasant mix of 'local GAAP' and IFRS, making comparisons more difficult not less in some cases.

Added to this is the fact that companies are only required to restate one year of comparatives to an IFRS basis, with the result that year-on-year comparisons and longer-term trend analysis will be very difficult.

Peter J Elwin is Head of Accounting and Valuation research at Cazenove Equities. peter.elwin@cazenove.com

and an intermediate holding company based in the Netherlands. The holding company has no sales or operations of its own, and acts only as an intra-group funding vehicle. IAS 21 says that the activities of such an entity could be regarded as an extension of the parent, so the Dutch holding company should have a sterling functional currency. That means that non-sterling denominated loans into or out of the Dutch holding company would give rise to exchange gains or losses in the consolidated P&L – a potentially significant exposure.

QUASI-EQUITY LOANS Once the functional currency has been determined for all group entities, internal financing structures need to be examined. Complications arise where quasi-equity loans are made between group companies. IAS 21 specifies that a long-term monetary item denominated in foreign currency, receivable from or payable to a foreign operation, may be regarded as an extension of, or reduction in, the reporting entity's net investment in that foreign operation. This means that in the consolidated financial statements that include the foreign operation and the reporting entity, the exchange differences on retranslation of this monetary item should be recognised initially within a separate component of equity rather than in the income statement (the accounting treatment for a quasi-equity loan). Only on disposal of the net investment are these exchange differences recognised within the income statement as part of the profit or loss on disposal.

IAS 21 restricts the use of this method to specific intra-group transactions and structures (see the criteria in *Table 1*). In particular, there must be an investor/investee equity relationship, direct or

Table 1. Requirements for quasi-equity accounting treatment for intra-group monetary items

1 No intention or likelihood of settlement in the foreseeable future
2 The intra-group monetary item must:
- not be a trade receivable or payable
- be denominated in the same currency as the functional currency of either the reporting entity or the foreign operation
- be directly between the foreign operation and the reporting entity
- be designated as being part of the net investment

indirect, between the lending entity and the borrowing entities. This means that a loan between sister companies will not qualify for this quasi-equity loan treatment. *Figure 2* illustrates this situation:

- B makes a US dollar loan to C. IAS 21's guidance is that since B does not have a net investment in C, the exchange differences on its loan to C should not be taken to equity in A's consolidated financial statements. In substance, this situation is no different to B lending to A in US dollars and then A lending to C in US dollars. However, the detailed wording in IAS 21 makes it clear that there can be no substance override in this situation; and
- If B makes a euro loan to D, the situation is easier. B has a net investment in D and the exchange differences reported in B's income statement can be dealt with in equity, provided that the other IAS 21 criteria are met (see *Table 1*).

CASH POOLING Another 'group' issue concerns the treatment of cash-pooling structures. The conditions in IAS 32 allowing the offset of financial assets and financial liabilities, with the presentation of a net amount on the consolidated balance sheet, are considerably stricter than those in FRS 5. If the new conditions are not satisfied, groups can face the prospect of a significant "gross up" on the balance sheet of surpluses and deficits. By introducing stricter rules, IAS 32 has considerably reduced the ability of groups (and individual companies reporting under IFRS in 2005) to show their overdraft and cash balances which form part of a notional cash-pooling arrangement, net on the face of the balance sheet. IAS 32 requires that an entity must:

- Currently have a legally enforceable right to set off the recognised amounts at any time (not just in stipulated circumstances such as an event of default, or bankruptcy); and
- Intend either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Where there is both the right and the intention to settle net, then the standard allows a presentation that more appropriately reflects the amounts and timing of expected future cashflows, as well as the risks to which those cashflows are exposed. There are particular difficulties with notional pooling arrangements. This cash management technique allows groups to eliminate the need to physically move cash between accounts as the bank notionally aggregates participating account balances so it can calculate and enhance interest returns. But the fact that there are no physical cashflows that net settle cash and overdraft balances in notional pooling arrangements makes it difficult to satisfy the second criterion. Some companies are adopting strategies that will physically move cash balances and net settle at reporting dates in order to achieve net presentation.Each group will need to review in detail its specific cash-pooling arrangements and practices to determine whether they comply with the new requirements. Each group will probably have different structures, legal documentation and net settlement practices that may need changing to avoid a significant balance sheet gross up.

CONVERTIBLE DEBT DENOMINATED IN FOREIGN CURRENCY
Followers of the International Financial Reporting Interpretations Committee (IFRIC) know there has been debate over the accounting treatment of convertible debt denominated in foreign currency. The critical area is whether the convertible debt has a component that has to be accounted for in equity rather than within debt. The current IFRIC view is that a contract to be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as liability.

"Although this matter is not directly addressed in IAS 32," noted IFRIC, "it is clear that when the question is considered in conjunction with guidance in other Standards, particularly IAS 39 *Financial Instruments: Recognition and Measurement*, any obligation denominated in a foreign currency represents a variable amount of cash. This is evidenced by the fact that IAS 39 allows cashflow hedge accounting for transactions denominated in a foreign currency because such transactions expose the entity to variability in cash flows." However, IFRIC members have concerns about this outcome and are now exploring possible amendments to IAS 32 to recommend to the IASB. In the meantime, the whole instrument will be classified as a financial liability, with IAS 39 then applied to identify embedded derivatives requiring separate valuation and accounting.

SIGNIFICANT IMPACT The introduction of IAS 39 has had a significant impact on treasury processes. However, there are numerous other GAAP differences that IFRS has introduced in 2005 that may affect reported results and trigger performance ratio changes. These changes could cause companies to breach, refinance or renegotiate loan covenants, requiring treasurers to have a good understanding of the impact of IFRS on reported results and ratios. Some application of these standards in specific situations may appear counter-intuitive and result in more focus on cashflow reporting. After all, cash is cash.

Stephanie Bruce is Partner and Yann Umbricht Director with the Treasury Solutions Group at PricewaterhouseCoopers.
stephanie.bruce@uk.pwc.com
yann.umbricht@uk.pwc.com
www.ifrs.co.uk

Figure 2. Intra-group loan illustration