

WILL YOUR SYSTEM COPE WITH IAS 39?



WITH IAS 39 COMPLIANCE LOOMING, **PETER BARNES** AND **SUZANNE REYNOLDS** OF KPMG LLP OFFER ADVICE ON UPGRADING YOUR SYSTEM.

The introduction of the International Accounting Standard 39 (IAS 39) *Financial Instruments: Recognition and Measurement* has been long-awaited by companies throughout Europe. Although the standard must be applied by all EU-listed companies to their consolidated financial statements for accounting periods starting on or after 1 January 2005, there is a proposed requirement for comparative figures for at least 2004 (under UK GAAP reporting), and in some cases 2003 (under US GAAP reporting). This has led to many companies addressing the implications of IAS 39 now. For those that decide to seek hedge accounting treatment a critical question is 'how will we record, monitor and report upon the hedge relationships?' In most cases, the company will have a treasury management system (TMS) and view this as the natural tool to assist in complying with the standard. This article looks at the questions treasurers need to ask their system suppliers when evaluating their IAS 39 credentials.

THE SUPPLIER'S POSITION. Suppliers have a business need to develop IAS 39 functionality to support their existing and

prospective clients. However, any new functionality requires a considerable lead-time to specify, develop and test, and there is a cost associated with the development process. As a result, suppliers are keen to understand their clients' requirements, often before the clients have fully assessed these requirements themselves, in order to be able to deliver the necessary functionality on time.

The IAS 39 functionality currently available has been based largely on the suppliers' interpretation of companies' requirements. There is likely to be further development required to meet the practical needs of their clients. In many cases, suppliers do not have dedicated in-house accounting expertise to advise on the impact of IAS 39 and are reliant on input from their clients or from external advisers.

THE TREASURER'S POSITION. Treasurers, on the other hand, are keen to find out what capability their treasury system has to support compliance with IAS 39. In some instances, this can occur before the treasurer has fully assessed the impact of the standard

Questions to ask your TMS supplier

Most treasury systems appear to have the capability to designate hedge relationships, meet documentation requirements, record expected future cashflows (to enable foreign exchange cashflow hedging) and use at least one method of assessing the effectiveness of the hedge. However, there are differences in functionality between the major treasury systems and most suppliers are continuing to develop their IAS 39 solutions with further releases planned for later this year.

When considering the IAS 39 capability of your system or when evaluating the treasury systems in the market, we suggest the following eight questions are included in the assessment.

1. How has the IAS 39 functionality been developed within the system?

Has the system supplier worked closely with IAS 39 experts and other corporate clients, and do those clients have similar requirements to your company? A solution developed for one client will not suit all, especially if that client has a relatively simple treasury function or does not use a wide range of financial instruments. Development work that does not involve clients can lead to solutions which appear to address the requirements of the standard but that do not fully meet clients' practical requirements. Similarly, development work which does not involve IAS 39 experts may lead to solutions that are not acceptable to your auditors.

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< 2. How many clients are using the system to meet their IAS 39 requirements and to what extent are they using the functionality?

Many companies in the UK are just beginning to consider the implications of IAS 39 on their financial accounts and hedging strategies, while only a few have fully implemented the standard. When reviewing systems' IAS 39 functionality treasurers must be wary of long lists of existing IAS 39 users. They should ask suppliers to provide reference sites of companies which have a similar portfolio of derivative and debt instruments. Treasurers should also establish whether those companies are using any system 'workarounds' to enable their company to comply with IAS 39 requirements.

3. Do I need to upgrade to obtain the IAS 39 functionality?

IAS 39 functionality is likely to be available in the latest release of a system with future enhancements due later this year. This will mean that, in order to implement the IAS 39 functionality, the treasurer may have to upgrade to the latest version of the system, which could result in a significant project, depending on the version currently installed. The upgrade process should not be underestimated and should be included when assessing the systems impact of IAS 39. Alternatively, the treasurer may decide not to use the treasury system and to develop a spreadsheet-based solution.

4. Can the system produce all the necessary accounting entries?

The requirements for handling the accounting entries resulting from IAS 39 can be complex. For example, systems should be able to post the different accounting entries that may be required, depending upon the categorisation of the financial instrument, whether a derivative or financial instrument is designated as part of a hedge relationship and whether or not that hedge relationship has any ineffectiveness or fails the effectiveness test. The system should also have the ability to change the required accounting entries if hedge relationships are 'de-designated' before the financial instruments mature or are designated any time after the financial instruments have been entered into.

5. How flexible is the effectiveness testing solution?

IAS 39 does not prescribe a single method for assessing hedge effectiveness and therefore companies can design their own effectiveness tests, within the parameters set out in the standard. Most treasury systems allow the user to exclude the time value of a derivative from the hedge relationship and use a calculation similar to the FAS 133 dollar-offset method to assess effectiveness. However, at present, systems only allow the user to make limited choices when setting up effectiveness tests for hedge relationships. This may not be suitable for all hedge relationships, particularly as not all systems support the use of regression analysis, nor allow a derivative to be split into its

'THE UPGRADE PROCESS SHOULD NOT BE UNDERESTIMATED AND SHOULD BE INCLUDED WHEN ASSESSING THE SYSTEMS IMPACT OF IAS 39. ALTERNATIVELY, YOU MAY DECIDE TO DEVELOP A SPREADSHEET-BASED SOLUTION'

component risks (as a derivative may be used to hedge different underlying items), nor give the user the option to use the clean or dirty price of a bond.

Given the limitations of current solutions the treasury system should allow the user to manually input either the mark-to-market valuation of the financial instrument or the result of the effectiveness test, as the inability to do so may result in relationships being labelled as ineffective by the system and hedge accounting treatment unable to be applied.

6. Can the system support all hedge relationship models?

IAS 39 specifies three hedge accounting models: the fair value and cashflow hedge accounting models, and the hedge of a net investment in a foreign entity. Most systems allow the user to designate cashflow or fair value hedge relationships but not all systems currently have the functionality to designate a hedge of a net investment in a foreign entity. This could result in a manual workaround if the company uses its foreign currency debt portfolio to hedge its net investments.

7. Does the system allow you to input planned financial instruments?

Most treasury systems allow the user to input forecast cashflows to enable cashflow hedges to be recorded but not all allow the user to assign planned financial instruments, in particular debt issues where companies may wish to hedge the interest rate exposure in advance.

8. Can the system produce the accounting entries for a particular hedge relationship to meet both the requirements of FAS 133 and IAS 39?

Companies which have a listing in both the EU and the US will be required to produce financial statements under both international accounting standards (IAS 39) and US GAAP (FAS 133). Whereas most of the requirements to achieve hedge accounting are the same under FAS 133 and IAS 39, there are some differences that could result in different accounting treatments being applied. Not all treasury systems have the ability to produce separate accounting ledgers or trial balances for FAS 133 and IAS 39, which may result in manual accounting entries for US GAAP purposes.

and the treasurer may even be looking to the supplier to find out what their requirements are under IAS 39 and what the suppliers' other clients are doing.

It should go without saying that to rely on a system supplier for guidance on the best way to interpret such a complex accounting standard is not good practice. It is essential treasurers have a clear understanding of IAS 39 and assess their own company's requirements, especially around hedge accounting documentation and effectiveness testing, before evaluating treasury systems. Once the treasurer has understood the standard, there will be many detailed questions which need to be asked of the current TMS supplier (see p19 and 20).

SYSTEM EVALUATION. It is not enough just to obtain verbal answers to these complex questions. As with any systems evaluation exercise the best way to assess the functionality of a system is to use test data. The treasurer should produce a number of hedge relationships using real examples and document the requirements and expected outputs. They should then hold a workshop with the supplier to run through the test data to see how the system manages the hedge relationships and to verify the accounting entries that are generated. At the end of the workshop, it should be clear how well a system can meet treasury's IAS 39 requirements and what are the gaps, if any, in functionality.

In the short term, the treasurer may be able to live with a spreadsheet workaround and to work with a supplier to develop the missing functionality in a system. Suppliers have an ongoing development process in place and many have IAS 39 featuring in the next release of the system. There is a clear advantage to the treasurer to work with the supplier as soon as possible to ensure that the treasurer's own specific requirements are reflected in the development process and that the functionality will be included in the next release of the system.

If the treasurer is not satisfied with the supplier's approach or commitment to meeting IAS 39 requirements then there may be a need to look at another solution, such as using a third party add-on or even replacing the treasury system altogether.

WHAT SHOULD THE TREASURER DO NOW? In this brief article we have tried to feed back to treasurers some of the important lessons coming out of the early implementations of IAS 39. Four key messages are:

1. IAS 39 implementations can be complex, so it is important to understand your own detailed system requirements.
2. Don't assume that your treasury system supplier will have developed all the necessary functionality – ask the right questions.
3. Move now to ensure that your needs will be reflected in your supplier's future developments or to begin the process of seeking an alternative solution.
4. Ensure that the supplier is committed to continuous development of IAS 39 functionality as the standard has yet to be finalised.

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