TREASURERS FROM VARIOUS BUSINESS BACKGROUNDS JOINED IN ON OUR ROUNDTABLE DISCUSSION ON INTERNATIONAL ACCOUNTING STANDARD, IAS 39. WHILE ALL PARTICIPANTS ARE BROADLY SUPPORTIVE OF THE STANDARD, MOST OF THEM HAVE SERIOUS ISSUES WITH THE IT. HERE IS WHAT THEY HAD TO SAY.

GETTING TO GRIPS

Around the table

Chairman: **MARTIN O'DONOVAN**, Technical Officer, The Association of Corporate Treasurers.

ANTONIA BUTLER, Regional Treasurer, RWE Thames Water, part of the German multi-utility group RWE. The company has been reporting under IAS since 2001. It does not use a large variety of derivatives, but is currently discussing how to approach retail price index (RPI) hedging.

JOHN GROUT, Technical Director, The Association of Corporate Treasurers.

JONATHAN LOGAN, Assistant Treasurer (Europe), GlaxoSmithKline. GSK is a global business with a centralised treasury approach. The group does not engage in a large volume of hedging.

MARK MORRIS, Group Treasurer, Rolls-Royce plc. The group, as one of the UK's main exporters, operates predominantly in US dollar-denominated markets, hedging its trading flows as far forward as 10 years. IAS 39 has significant implications for the group, based on the level and duration of its hedging activity.

FRANCOIS PRINSLOO, Senior Manager, Corporate Treasury Solutions Group, PricewaterhouseCoopers.

IAN WELDON, Director of Treasury and Tax at FirstGroup, a leading ground passenger transportation group with significant operations in the UK and the US. It has interest rate risks in sterling and the US dollar, dollar translation and transactional risks, commodity risks, and significant bond and leasing commitments.

S WITH IAS 39

The International Accounting Standards Board (IASB) published a revised version of two of its standards dealing with financial instruments in December 2003. IAS 32 focuses on the disclosure of financial instruments. The more controversial standard, IAS 39, deals with recognition and measurement of financial instruments and requires derivatives to be reported at fair value, rather than cost. As a result of comments received on the proposals, the IASB decided to issue a further exposure draft on the subject of macro hedging, which was published in August 2003. Some amendments to IAS 39 may result from the proposals on macro hedging, which will be announced later this year. Listed European companies will be expected to apply international standards from 2005.

The proposals contained in IAS 39 have prompted a strong reaction, particularly from banks and other financial institutions. It was the sustained pressure from banking groups that persuaded the IASB to release separate proposals on macro hedging. The effect of the standard on companies, though, is less clear. The Association of Corporate Treasurers (ACT) and *The Treasurer* organised this roundtable discussion in order to gain an understanding of the opinion of leading companies of the standard, and of their preparations for implementation.

BROAD SUPPORT

All the participants were broadly supportive of the IASB and its ultimate aim in producing IAS 39, of improving the transparency of accounts of companies that hold derivatives. Even so, all had specific problems with the standard, particularly with how it would be applied in practice and the practical implications for companies.

LOGAN GSK started to look at IAS 39 in October 2002, on the grounds that we were concerned about the requirement for two-year comparatives and so we put something in place for 1 January 2003, which we are still refining. We are at a point where we have hedge documentation in place for everything we do and we are testing effectiveness testing, but that is an area we are still working on because there have been some unexpected results.

BUTLER We have been compliant with IAS for our consolidated accounts since 2001. With no time for a planned implementation, it has been a learning process for everyone, including our auditors. At times, it has been a little frustrating. We are still reporting in the UK under UK GAAP and it will be interesting when those accounts switch over.

MORRIS We are one of those companies that will be disproportionately exposed because of the nature of our business. We have transactional, economic and translational exposure. We use a number of foreign exchange (FX), interest rate and commodity derivatives to mitigate economic risks over time periods that can extend up to 10 years. We already show our derivatives marked to market in the notes to our accounts under FRS 13. That number can show some significant movements from one balance sheet reporting date to the next.

WELDON I am very strongly supportive of more transparency in the reporting of derivatives, but I am concerned about the impact of certain aspects of the standard, for instance, the proposals that do not allow you to hedge a derivative.

O'DONOVAN Do you all have the necessary systems in place for implementation?

WELDON We have a number of people working full-time on implementation.

MORRIS We have two people working full-time.

LOGAN The implementation is often frustrating. On one occasion, we spent several months waiting for clarification on the accounting treatment of a fixed-to-fixed cross-currency swap. The problem is that everyone still seems to be working on the interpretation of the standards, when it comes down to detailed implementation.

PRINSLOO Some companies have already decided, based on a cost/benefit analysis, that adopting hedge accounting is simply not worth it for certain categories or types of financial instruments, particularly those which will have an insignificant impact.

SPECIFIC PROBLEMS

It was clear from the discussion that companies are going to be affected by IAS 39 in different ways, depending on the nature of their business, their sector and their exposure, in terms of financial instruments. The different companies represented around the table all had slightly different complaints about the standard, depending on their business. This, in itself, explains why companies have not formed a strong unified opinion against the standard that has been clearly communicated during the consultation process. Banks and other financial institutions have collected together to lobby strongly against the proposal. There has been no similar outcry coming from the companies themselves, although the ACT has been speaking out on some of the key problems that are considered to be more universal (see Richard Raeburn, page 62 and Hotline, page 16.)

volatility from IAS 39 should not cause any problems. However, what is not certain is how users of the current UK GAAP accounts such as Ofwat or the banks will react.

WELDON I am curious about the prohibition on hedging a derivative. Many companies raise funding in a currency different to the currency of debt that is being refinanced or investment that is being acquired, and use swaps to convert. Whether the swaps are fixed-to-fixed or basis swaps will usually be determined by interest rate risk policy, which may use separate derivatives to achieve the required overall fixed floating balance over a timescale. This is a well-established hedging approach, but it may be undermined by IAS 39 because a hedge of a derivative is not a valid hedge. My particular issue with the IASB on this matter is that I do not know what its basic objection is to hedging a derivative in the context of economic hedging to manage volatility. I have yet to see its rationale.


JONATHAN LOGAN


IAN WELDON

LOGAN GSK has a centralised treasury approach. All operating units lend or deposit to a central finance company and significant external funding and investments are dealt with centrally. We operate a monthly inter-company netting process dealing with a large volume of FX. Our problem comes when we want to net a fair value hedge of the FX risk arising on our inter-company deposits with a net investment hedge on our foreign currency net assets. We can have a couple of billion euros each way that we net off. If the standard remains as it is, the question is whether we gross up the FX externally, which would likely break both parties' counterparty limits, or come up with another strategy.

BUTLER We have done a trawl through all of our agreements to check for any potential problems for covenant compliance. Potential

MORRIS Our policy is all about proportionate hedging. The objective is to dampen down inter-year exchange rate volatility and lock in rates that are attractive for the group. Within the policy, we operate within minimum and maximum cover band limits that are a function of total net dollar income, and the level of cover taken will depend on the attractiveness of the exchange rate. That in itself is a problem under IAS 39. We do not specifically link hedge contracts to an underlying commercial contract, but rather hedge the level of net dollar income in a given timeframe. We have been operating this rolling dynamic policy for over 15 years and it has proved very effective in providing achieved rate stability for the group.

BUSINESS DECISIONS

One of the key overriding concerns for many companies, and at least two of them around the discussion table, was that the IAS 39 proposals may force companies to rethink economic and funding decisions. Logically, it cannot make sense to abandon a prudent hedging policy just because the accounting outcome may display some short-term volatility. The fear was that outside pressures from covenant compliance or from shareholders, analysts and rating agencies might force a company to alter its treasury behaviour.

WELDON FRS 13 was a good standard and hugely helpful. It did not get the credit it deserved.

LOGAN The problem is that the proposals are not mirroring what is happening in practice in a sensible way, particularly when operating a central treasury function. We broadly support what the IASB is trying to do, but IAS 39 is causing us a headache. The principles are relatively clear, but implementation has not been straightforward. The key question for us in treasury is, should we let the accounting drive our business; in other words, will we have to change what we do because of a new accounting rule?

MARK HARRIS AND ANTONIA BUTLER

JOHN GROUT

Overall, there seem to be strong concerns that the standard does not reflect the way in which companies approach business and business decisions. In particular, Mark Morris pointed out that many companies, Rolls-Royce included, operate a central treasury operation and net their FX exposure, treating the balance as a general portfolio to be hedged. IAS 39 does not allow this treatment.

MORRIS It all boils down to the purists' view of life against business pragmatism. The strict hedging criteria that must be met basically requires a company to hedge an exact cashflow. The reality, of course, is that most treasuries and banks hedge on a portfolio basis for particular reasons: cost savings; processing efficiencies; and scale of economy. The standard will potentially penalise those that actively engage in the process of hedging in order to protect shareholders from risk against those that do not.

Marking-to-market is not new – it was introduced by FRS 13 – but putting it through earnings or reserves is an additional complication that is not necessary. It runs the risk of being misleading, in that the economic effect of hedging is a reduction in real risk, yet the income statement and balance sheet may indicate otherwise.

MORRIS Under FAS 133 in the US, there seems to be anecdotal evidence that US companies are changing their hedging policies in response to the accounting standard. I find that, personally, very worrying. We [at Rolls-Royce] strongly believe that the accounting tail should not wag the economic dog but, as with all these things, an important consideration will be where we sit with our view compared with the majority of other companies. Everyone prefers security in numbers, as the market will always perceive the exception with suspicion.

WELDON I would not wish to see an accounting standard affect our fundamental funding and interest rate decisions. That would be completely wrong. The presentation of the p&l will be key, and the extent to which investors and other users can discern volatility that is induced by IAS 39 from economic volatility as we know it. The standard could destabilise plain business practices to manage volatility.

COMMUNICATION

All the companies represented had significant concerns about how their IAS 39 accounts would be read by their shareholders, potential investors, analysts and credit ratings agencies. In particular, there was considerable concern that the accounts would be misread or misinterpreted by readers and users.

MORRIS Accounts are becoming more complicated, not less. While greater transparency is welcomed at one level, it should not result in increased confusion between what is accounting risk and real economic risk.

WELDON I am doubtful about how the analyst community is going to assimilate all of this, given the timescale. It is a huge challenge.
MORRIS Analysts choose what they want to hear, at the end of the day. We are already thinking about communication and educating brokers and equity analysts. The question is when to do something. There is a big challenge out there. The fact is there will be a transitional period for this standard and not a transitional date, because different companies have different year ends.

WELDON One concern is the credit ratings agencies. What view will they take of any company that chooses to move away from economic hedging? Those companies that are a notch away from a downgrade need to be careful about the impact on credit rating [from the volatility that could result from adoption of the standard].
O'DONOVAN Credit ratings agencies should understand what is going on.

MORRIS They said that about FRS 17. When the limelight hits and IAS 39 gets the sort of media publicity FRS 17 did, there is a real risk that IAS 39 may be interpreted differently, rightly or wrongly, by credit ratings agencies. And this is in an environment where you get far more split ratings than you did before.

WELDON I am convinced that the agencies will have difficulty with IAS 39.

PRINSLOO This is certainly not an easy standard to implement and difficult to interpret in some cases. Early communication will definitely be a good strategy to have. One of the benefits of implementing the standard however, is the increased focus required related to the accuracy of forecasted exposures, specifically future foreign currency exposures in the corporate treasury environment.

BUTLER It has forced us to be much more stringent in the information we are getting in.

WHERE NEXT?

IAS 39 has been published in its supposedly final form for all parts, save those covering hedging a portfolio of interest rate risk. Even so, the furore continues, with the French government in particular supporting continuing complaints by their banks. There is a widespread belief that the standard will need amending at some point, but we may have to wait some time for this to happen.

The IASB made it clear at the outset it was not intending to reconsider the fundamental approaches contained in IAS 32 and IAS 39 – standards that were originally issued in 1995 and 1999 respectively by its predecessor body, the International Accounting Standards Committee. To reconsider the fundamental arguments, said the IASB, "would have resulted in a delay of several years in the production of a new standard". The requirements of the standards, however, are close to the requirements of US standards and convergence is a key aim of the IASB.

MORRIS The basic supposition of the standard is you are guilty of speculating until you have proven that you have hedged. They want to drag the issue of derivatives out of the notes under FRS 13 and into the accounts. The argument is as follows: derivatives have value, otherwise companies would not enter into them, and that value should be reflected on the balance sheet. I can accept both those points. But [the IASB] has missed the third point, that companies undertake a hedge to protect another item, for example, a future cashflow that is not on the balance sheet.

GROUT It is clear that the impact of IAS 39 on a group is contingent on the group's business and industry. Even if 90% of companies in an industry are not affected by some of the proposals, the effect on one company could be vital.

MORRIS That is the problem with the one-size-fits-all approach when companies are not homogeneous. We have to live with the fallout from the IASB. The standard is administratively cumbersome, resource destructive and runs the risk of confusing, rather than enlightening shareholders and analysts. Much of the information required can already be found in the accounts; FRS 13 already tells them what we do.

GROUT I think the IASB's eyes are caught in the headlights of the financial services industry. The problem is that the impact on companies is contingent on the type of company they are and their circumstances. The impact of the standard on banks is extremely uniform. If every company was affected to the same extent, companies would have made as much noise about the proposals as banks have.

LEARNING TO LIVE WITH IAS 39

The roundtable discussion clearly illustrates that companies are already struggling with the standard. As Morris put it: "We try to take one step forward and get the technical people reading us the riot act. Everyone is trying to apply a technical theory to practical situations." Antonia Butler, who has already been through the process, describes it as "a pain". The fact is, though, that further key changes to the proposals at this stage are unlikely, and companies must learn to deal with the standard. Communication of the effect of IAS 39 on a company's reported income, and perhaps on reserves as well, will be a key element of its implementation strategy.