IAS 39: A MUCH EASIER PATH TO COMPLIANCE

FROM 1 JANUARY 2005 ALL LISTED FIRMS WITHIN THE EUROPEAN UNION WILL BE REQUIRED TO BE IAS 39-COMPLIANT. **CLIVE BAKER** AND **SYLVAIN TESSIER** OF SITA FOUND THEIR OWN WAY ROUND THE OBSTACLES.

SITA is a leading provider of global information and telecoms solutions to the air transport industry. With more than 50 years' experience, it provides a total service to some 740 air transport industry members and more than 1,800 customers, supporting them globally in more than 220 countries and territories.

With about 3,800 employees of more than 130 nationalities around the world, SITA provides access to local markets with specific industry knowledge. The group offers value-added solutions to the air transport industry that include: application services, meeting the requirements for airline, airport, aerospace, aircraft applications and systems; end-to-end desktop and infrastructure services; and network services focusing on systems integration, outsourcing and consulting, in support of complex solutions.

FOREIGN EXCHANGE FOCUS. As a global provider, Sita reports in dollars and transacts much of its business in the same currency, with most of its revenues (about $1.5bn of turnover) collected centrally. A large and growing part of the business is in long-term contracts for airport refurbishment and new airports all over the world, where the organisation delivers technology solutions that may include the entire technology infrastructure. However, many of the central and corporate functions are based in either eurozone countries, Switzerland or the UK.

All this adds up to some substantial currency mismatches and, while attempts have been made to maximise the level of 'natural hedges', SITA has had to be very active in managing the exposures that remain to protect its financial position, maintain contract profitability and deliver against business plans. While financial instruments are from time to time also used to cover other risks, the main concern for the company is with foreign exchange (FX) risk.

This is not unusual and is a situation that is faced by many companies. SITA had a Board-approved financial risk management policy in place, which prescribed what exposures would be hedged, and when, what instruments would be acceptable, and delegation and reporting requirements. It also made it clear that only well-identified cashflows should be hedged and that no hedging activity should increase the inherent risk beyond that of taking no action. It was decided to apply the approach of cashflow hedges for hedge accounting purposes and not fair value or equity hedges.

Therefore, there was reasonable confidence that SITA would already be compliant with any reasonable accounting standard that would primarily be aimed at the accounting requirements. That was the first, thankfully short-lived, error. Initial conversations with external auditors and with peers in other companies, followed by a careful comparison of its practices to *International Accounting Standard 39 Financial Instruments: Recognition and Measurement* (IAS 39), highlighted several important points.

CLIVE BAKER AND SYLVAIN TESSIER

First, that the standard is long and detailed, but still remains non-specific in many important areas. Second, that the matching principle, which accountants learn at an early stage, becomes a privilege to be proven, rather than an obligation for hedge accounting. Third, that despite the many guidance notes, accepted practice had not yet been uniformly defined across the accounting profession. Finally, it also highlighted that despite the use of absolutely standard risk management procedures, there was a risk that the financial reporting would not reflect properly the business practices, as intended with the associated impact on volatility of the profit and loss account (P&L), should hedge accounting principles not be applied.

STARTING FROM SCRATCH. The first step was to establish if the adoption of a fairly onerous set of new procedures was justified. This was important in order to avoid P&L volatility, since for hedging instruments that are assessed to be non-effective the fair value based on a period end, mark-to-market calculation must be posted directly into P&L. Effective hedges, and the effective portion of hedges are accounted for in the equity account as other comprehensive income and released into P&L at the moment the hedged cashflow occurs.

If certain contracts could not be accounted for under IAS 39 using hedge accounting, an inability to continue matching the exposure with the hedge effect would provide an unacceptable risk on those contracts, as the mark-to-market valuation of all hedging instruments at year end represented an amount close to 50% of the budgeted pre-tax profit of the company.

IAS 39 is compulsory as of 1 January 2005 for all listed companies within the European Union, which requires for the previous year to be in line and consistent. US Generally Accepted Accounting Principles (US GAAP) convergence with International Accounting Standards (IAS) may make it easier to comply with US GAAP Financial Accounting Standards 133 (FAS 133) once IAS 39 compliance is achieved – although compliance with one accounting code does not automatically imply compliance with the other. Nonetheless, companies with a US registration that produce accounts reconciled to US GAAP may decide to go a step further and comply with hedge accounting under FAS 133, on the basis that the majority of the additional workload is now required for IAS 39.

These are compelling arguments. Being a small treasury team and with limited in-house accounting expertise on IAS 39, there was a clear need to focus on the essential requirements and reach water-tight compliance in those areas. Having discussed the matter with our auditors, a number of requirements were identified. The treasury team took responsibility for implementing all procedures required for compliancy and one person was assigned to the job over six months.

THE NEED FOR A FINANCIAL RISK MANAGEMENT POLICY AND DOCUMENTED INTERNAL PROCEDURES. The financial risk management policy needed to be Board-approved and included: objectives of the FX risks management policy, definition of exposures (cashflows), horizon of the hedging policy (budget year, business plan); and instruments to be used as hedging instruments (forwards, swaps, collars, options). This was already in place for SITA. The internal procedures document on hedging management must address:

- The segregation of duties, authorisations, scope of approvals.
- The documentation needs and reporting contents – in particular effectiveness testing.
- The types of hedging instruments to be used in further detail than the risk management policy.
- Guidance on roll-overs and early closure of operations and how any roll-overs will lead to a similar or increased level of hedge effectiveness, and the time that may elapse after cancellation of the previous hedge before a replacement one is put in place.
- Agreeing these policy documents with the auditors, and demonstrating compliance with them, was an important step in clarifying the grey areas and inconsistencies within IAS 39 for SITA.

Having put in place these key documents, the following areas proved to be the most critical.

THE OBJECTIVE IS RISK REDUCTION, NOT SPECULATION. Many firms have a clear policy of only hedging identified exposures, but may state that they have a 'position' on a certain risk, such as dollar strength. This is an anathema to IAS 39, but for many companies that are managing a cost exposure with an eye to, for example, their competitors' cost base, some judgement may still be exercised through the decision not to hedge or to partially hedge a risk. Both decisions are acceptable while being in compliance with IAS 39.

IDENTIFICATION OF HEDGED ITEMS AND THE RELATIONSHIP WITH THE HEDGING INSTRUMENTS. SITA's target is to hedge future cashflows, as is the case in most companies. While cashflows must be identified on a gross basis without netting against opposite flows, it is, however, acceptable to hedge only a proportion of the gross exposure. Hedged cashflows, or hedged items, need to be identified in sufficient detail so it can be demonstrated that they have a high probability of occurring. Existing expenses already being incurred are useful, such as payroll costs by currency. Also important are long-term plan costs and budgeted expenses once the budget has been prepared. An analysis by business unit or cost centre and, importantly, by P&L line, is required. In many cases, hedging is put in place based on groups of cashflows with similar risks. The relation between hedging instruments and hedged items should be demonstrated at inception, and while the cashflow forecast can be refined after the initial hedging date, it is important that the high probability of the cashflow, at the hedging date, is not put in doubt. As it is difficult to anticipate the actual date when a hedged cashflow will occur, the SITA policy only requires this to be in the same quarter as the hedge maturity.

HEDGING EFFECTIVENESS AT INCEPTION. Documentation of hedge effectiveness at inception is another requirement. There is limited guidance in the standard, but it was relatively straightforward to implement a model to check the spread of the anticipated hedging results against the movement in the underlying exposure, which was expected to remain in the 80%-125% range. If the hedging instrument and the hedged exposure are not in the same currency, it is it also necessary to show a correlation that is within the range.

HEDGING EFFECTIVENESS TESTING BETWEEN INCEPTION AND MATURITY. Again, there is limited guidance provided in the standard. However, by re-performing the test at inception on a monthly basis, up until the realisation of the hedge, it was possible to maintain compliance. As an internal policy, it was decided that, as one hedge is rolled into another, relative to the same underlying exposure, only a more effective replacement hedge could be used. Documentation on this regular testing became part of the monthly treasury reporting.

OTHER REQUIRED DOCUMENTATION. At year-end, it is necessary to provide the supporting evidence in the form of bank statements and confirmations of all outstanding hedge operations. Most banks are already adopting the provision of mark-to-market calculations for their customers at the same time. Much of this was already a requirement for reporting, but now the fair value of the outstanding hedge instruments has to be recorded in the equity account as other comprehensive income. Many companies will need to carry out the same valuations at each quarter end.

CONCENTRATE ON THE KEY REQUIREMENTS. This standard is disappointing. It is administratively unnecessarily difficult to demonstrate compliance. It brings considerable risk that the users of accounts will be confused and that reported Income will be more volatile. Worst of all, some treasurers will lose the ability to make a key value contribution because of the cost and complexity of compliance. But compliance can be achieved, even in a smaller company. It does take a significant effort, but by establishing a set of straightforward internal procedures, in compliance, it is possible to focus on the key requirements and to avoid some of the more complex and inapplicable features of the standard.

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