The wrong notes

Despite consultations, the International Accounting Standards Board (IASB) has yet to address several common issues. As many corporate treasurers in the UK have found, there are many situations where there is a disconnect between what the accounts reflect under IAS 39 *Financial Instruments: Recognition and Measurement* and the true economic reality. In some instances this may even have the impact of hedging policies being changed to sub-optimal structures. Indeed, many products with a participation element may become ineffective under IAS 39, given that it is generally biased towards microhedging and hedge products with linear pay-offs compared to underlying items.

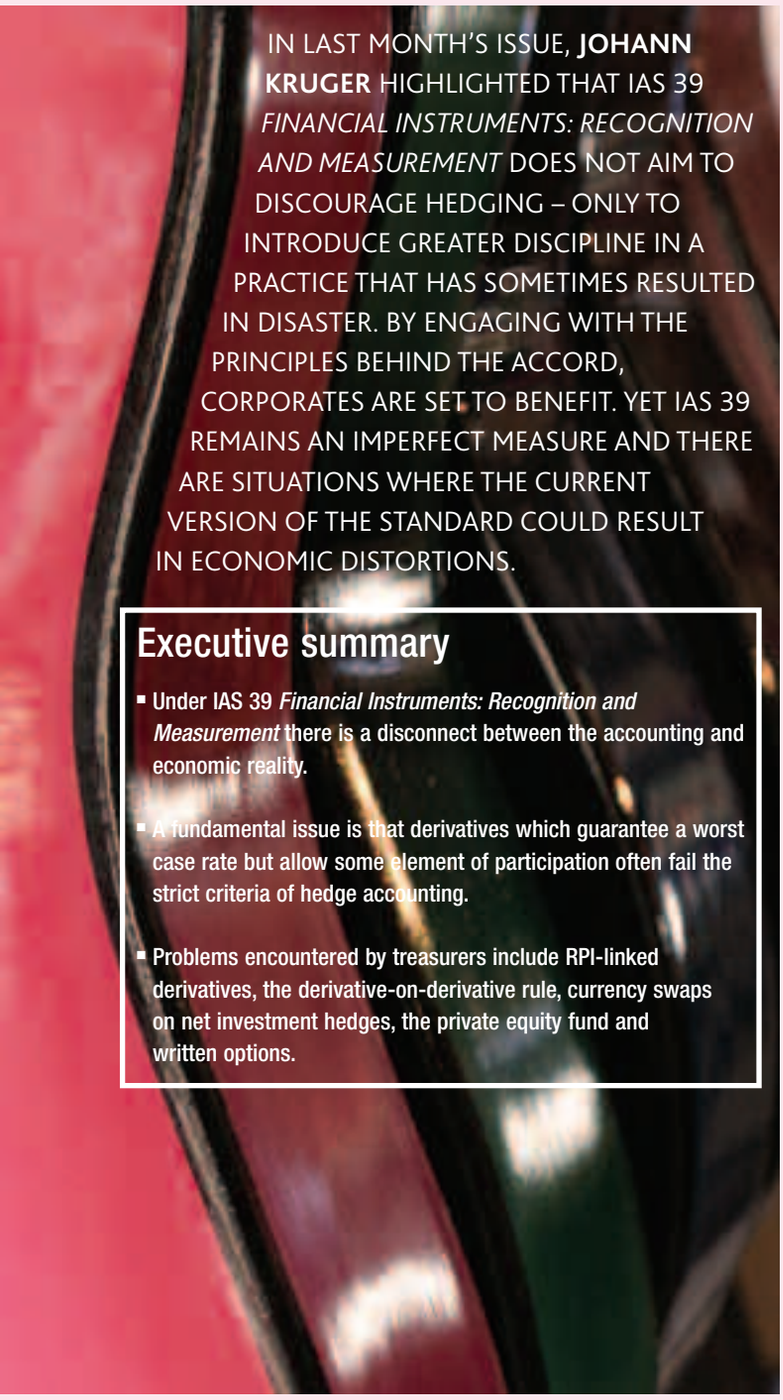
One of the fundamental issues is that derivatives which guarantee a worst case rate but allow some element of participation often fail the strict criteria of hedge accounting. This means corporates are not able to apply hedge accounting on those otherwise valid hedges where movements in the underlying exposure are not mirrored in fair value movements in the derivative (when market rates are better than the protected rate). This issue is causing many corporates to opt for vanilla forward-based instruments when participating structures may have offered better value.

Some specific examples where IAS 39 could benefit from improvement follow. The first three examples relate to hedge accounting, followed by two other common problems.

1. RPI-LINKED DERIVATIVES Many industries have exposure to retail prices – some implicitly, such as retail companies, others explicitly. The latter include water companies, whose income is set by the regulator according to a formula that includes the official Retail Price Index (RPI); property companies, who receive rent based on RPI indexation; and Private Finance Initiatives – long-term private/government partnerships contracts where income is RPI-indexed.

There are also commercial reasons for entering into an RPI swap rather than issuing index-linked debt and hoping the auditors do not insist upon separation of an embedded RPI derivative. Index-linked debt currently attracts a spread premium of 15–35 basis points over standalone corporate bonds. Issuing in the deeply liquid corporate bond market and swapping into RPI therefore present significant cost savings, yet the accounting poses a problem.

IAS 39 requires that an RPI swap, being a derivative, must be stated at fair value on an entity's balance sheet. Obtaining hedge accounting for standalone RPI swaps is extremely difficult. The reasons depend on the nature of the underlying item and are very technical. When a financial item, such as a bond or bank debt, is designated as the hedged item, the technical question is whether market interest rates can be broken down into smaller parts – of which inflation would be one – in order to achieve hedge accounting



IN LAST MONTH'S ISSUE, **JOHANN KRUGER** HIGHLIGHTED THAT IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT* DOES NOT AIM TO DISCOURAGE HEDGING – ONLY TO INTRODUCE GREATER DISCIPLINE IN A PRACTICE THAT HAS SOMETIMES RESULTED IN DISASTER. BY ENGAGING WITH THE PRINCIPLES BEHIND THE ACCORD, CORPORATES ARE SET TO BENEFIT. YET IAS 39 REMAINS AN IMPERFECT MEASURE AND THERE ARE SITUATIONS WHERE THE CURRENT VERSION OF THE STANDARD COULD RESULT IN ECONOMIC DISTORTIONS.

Executive summary

- Under IAS 39 *Financial Instruments: Recognition and Measurement* there is a disconnect between the accounting and economic reality.
- A fundamental issue is that derivatives which guarantee a worst case rate but allow some element of participation often fail the strict criteria of hedge accounting.
- Problems encountered by treasurers include RPI-linked derivatives, the derivative-on-derivative rule, currency swaps on net investment hedges, the private equity fund and written options.

under IAS 39. The position of some accounting firms has been to disallow hedge accounting in this case.

When a non-financial item, such as a stream of highly probable future revenue payments, is designated as the hedged item, IAS 39 indicates that the hedge relationship must be in respect of either foreign exchange (FX) risk (if it exists), or the entire risk associated with the underlying item. The future stream of cashflows can therefore not be broken down into other types of component parts – for example RPI and K in the case of water companies' pricing equation – in a hedge relationship. The pricing formula which UK water companies are obliged to use include a factor "RPI + K". Since K is reset every five years by the Office of Water Services (OFWAT), the water company regulator, and can vary significantly, the effectiveness of the hedge cannot be demonstrated.

IAS 39 could be improved to allow RPI as a component that can qualify for hedge accounting along with FX risk. It is commonly accepted in the financial markets that nominal interest rates consist of an element of inflation and an element of real interest. The RPI is a widely used indicator of the inflation element of nominal interest rates. IAS 39 would do well to accommodate this.

2. DERIVATIVE-ON-DERIVATIVE RULE This rule states that an exposure created by a derivative instrument cannot be the hedged item in an IAS 39 hedge relationship. This situation frequently occurs when corporates issue fixed-rate debt and immediately swap it to floating. They would then manage the interest rate exposure on, say, a two- to three-year time-horizon basis and take opportunities based on market levels. This strategy is very common among listed companies, being no different from cashflow hedges of (non-synthetic) floating rate debt and yet it is penalised by IAS 39.

Another common strategy is for a corporate to issue in the fixed-debt market, swapping back to floating, and have revolving bank debt.

Consider for example a revolver fluctuating between zero and £100m during a business season, and fixed debt of £100m with a 10-year maturity, all of which is swapped back to floating. If the corporate's hedging strategy is to maintain at least a 50% fixed profile going three years out, it could not designate the hedge against the revolver, as existence of interest flows on the revolver is not highly probable. Since it has no other floating-rate debt (other than the synthetic floating rate debt), it has to record the volatility of the interest rate swap to its profit and loss account.

Clearly a corporate should not be discouraged by accounting rules from borrowing at the most economical terms. IAS 39 could be improved by indicating that if a cashflow exposure in an underlying item exists because of a fair value hedge relationship, a derivative which manages that cashflow exposure can achieve hedge accounting subject to the usual requirements.

3. THE EFFECT OF CURRENCY SWAPS ON NET INVESTMENT HEDGES Floating-to-floating cross currency swaps provide the most effective net investment hedges, since the fair value of the currency swap is predominantly determined by exchange rates. Fixing the interest rates on either or both of the currency legs poses a Catch-22 situation.

If the currency swap is dealt with one or both legs fixed, ineffectiveness arises on the net investment hedge. And if a separate interest rate swap is dealt, it cannot achieve hedge accounting due to the derivative-on-derivative rule.

IAS 39 could be improved by allowing hedge accounting for a separately dealt interest rate swap in this situation as a specific exception to the derivative-on-derivative rule.

4. THE PRIVATE EQUITY FUND An inconsistency arises where a private equity fund holds both warrants and equity shares in a target company. These are subject to the same underlying risk – the performance of the company in question – and also become equally liquid when an entity is sold. This means that the two types of asset ought to be treated similarly in the accounts. But IAS 39 defines the warrant as a derivative and therefore insists that changes in its value must be recorded under profit and loss. However, changes in the fair value of the equity are reported under reserves, unless they are designated as held for trading – which is clearly not applicable to

Figure 1. Example of a $/£ restructure of a cylinder (an FX collar) for an importer

	Initial dealing rate	Restructured rate	Example cash generated/(cost)	Hedge accounting available post-restructure?
Option 1				
Protection Rate	1.90	1.90	100,000	No, as net premium generated. Advantage Rate
	1.97	1.93		
Option 2				
Protection Rate	1.80	1.84	(100,000)	Yes
Advantage Rate	1.85	1.85		

a private equity firm. This inconsistency could be addressed in one of the following two ways:

- Highlighting the fact and reconciling the numbers in the notes to the accounts, which enables investors to adjust their models as they see fit.

- Applying IAS 39: Appendix A, paragraph AG81, if the equity investment is very illiquid – i.e. the warrants may not be measured at fair value and should be stated at cost. Since IAS 39 indicates this situation is very rare, the approach may be hard to justify in practice.

IAS 39 could be improved by allowing an entity that owns both equity shares and warrants in a company to apply the same accounting treatment to the warrants as it applies to the shares – a choice it would have to make upon first acquiring the warrants, and which ceases upon disposal of the equity shares.

5. WRITTEN OPTIONS Covered sold (or written) options do not currently qualify for special hedge accounting under IAS 39 – despite being fully supported by an underlying asset or highly probable cashflow and not exposing the organisation to any additional risk. Corporates can generate shareholder value through giving up the opportunity to participate in favourable market movements, or achieve better hedged rates through 'geared' structures. Yet as a result of IAS 39, this alternative tends to be avoided.

Written options cause volatility to the profit and loss account when:

- future cash flows represent the underlying item; or
- the underlying item is an asset which is not accounted for at fair value through profit and loss.

In addition, when a corporate enters into a collar, hedge accounting is not allowed when the collar generates a premium, either in the form of a cash payment to the corporate, or in the form of better deal terms. This problem often appears when a corporate restructures two strips of collars at zero cost, where the participation window on one collar is narrowed while keeping the protection rate of that collar static, and improves the protection rate on the other collar (see *Figure 1*). In this case IAS 39 would disallow hedge accounting prospectively for the collar which generated a premium upon restructuring.

IAS 39 could be improved by allowing sold options to qualify for a type of 'offset' accounting under certain circumstances – in particular when an entity does not increase risk. To avoid abuse of such a rule in the case of future highly probable cashflows, a strict maturity limit of, for example, two years could be applied, along with specific 'tainting' rules where the future cashflows regularly do not materialise.

There are more examples of situations where accounting rules fail to communicate true economic reality. However, it is unrealistic to expect the IASB to incorporate every eventuality in the rules – it would become far too complex. The onus is on European Union-listed entities to identify common issues and to lobby the IASB for change, taking a lead from the lobbying in respect of the fair value option.

For uncommon issues and until the common issues are addressed, the routes of additional disclosure – coupled with full explanation, and in extremely rare circumstances, the true and fair override – will have to be followed. In the end it is a case of finding the best balance.

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