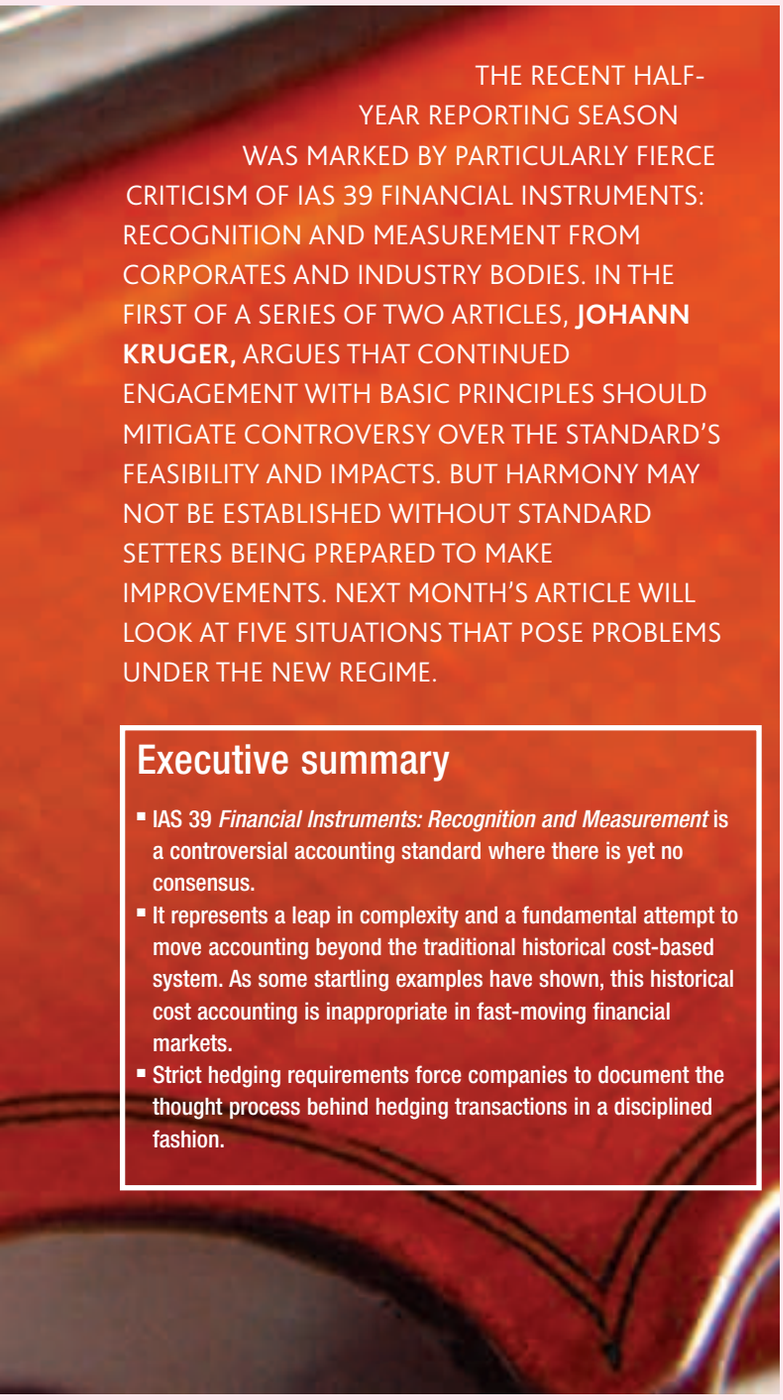
The perfect pitch

The intended benefits of IAS 39 *Financial Instruments: Recognition and Measurement* have often been concealed behind controversy over its feasibility and potential impact. During the half-year reporting season IFRS, and in particular IAS 39, attracted fierce criticism from corporates and industry bodies. Yet if UK corporates continue to engage with the basic principles behind the new standard and standard setters are prepared to make improvements where necessary, we may yet see harmony between the two parties.

When it comes to IAS 39, it seems the only consensus is that there isn't a consensus – yet. At one end of the spectrum is an insistence that accounting standards are superficial considerations when compared to the core business activities that are being reported. The presumption is that analysts and stakeholders can be trusted to see through accounting volatility – changing business practice to suit new accounting categories would therefore be a case of the tail wagging the dog. But implementation holds real fears for others. These companies regard resulting volatility in the profit and loss account as potentially so damaging that they will either minimise the use of 'IAS 39-unfriendly' instruments, or make them subject to lengthy approval procedures. So lengthy, in fact, that the window of opportunity presented by a certain instrument may have passed by the time approval is granted. And yet companies in this category tend to be the smaller listed companies with generally tighter profit margins and



THE RECENT HALF-YEAR REPORTING SEASON WAS MARKED BY PARTICULARLY FIERCE CRITICISM OF IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT FROM CORPORATES AND INDUSTRY BODIES. IN THE FIRST OF A SERIES OF TWO ARTICLES, **JOHANN KRUGER,** ARGUES THAT CONTINUED ENGAGEMENT WITH BASIC PRINCIPLES SHOULD MITIGATE CONTROVERSY OVER THE STANDARD'S FEASIBILITY AND IMPACTS. BUT HARMONY MAY NOT BE ESTABLISHED WITHOUT STANDARD SETTERS BEING PREPARED TO MAKE IMPROVEMENTS. NEXT MONTH'S ARTICLE WILL LOOK AT FIVE SITUATIONS THAT POSE PROBLEMS UNDER THE NEW REGIME.

Executive summary

- **IAS 39 *Financial Instruments: Recognition and Measurement* is a controversial accounting standard where there is yet no consensus.**
- **It represents a leap in complexity and a fundamental attempt to move accounting beyond the traditional historical cost-based system. As some startling examples have shown, this historical cost accounting is inappropriate in fast-moving financial markets.**
- **Strict hedging requirements force companies to document the thought process behind hedging transactions in a disciplined fashion.**

Box 1. Some hedging disasters

The dangers of inadequate financial reporting have been amply demonstrated by apparently sound entities being brought down by liabilities arising from the use of derivatives.

In 1994, Metallgesellschaft, which had hedged its forward exposures in the metals market using futures, failed when the regular margin payments required by the futures exchange became too great for the company's finances to bear.

In 1996, Sumitomo Corporation lost $2.6bn – roughly 10% of annual sales at the time – in its non-ferrous metals division stemming from unauthorized trades conducted by London-based trader Yasuo Hamanaka, who formerly headed copper trading at the Japanese conglomerate.

The most recent high-profile example is state-owned China Aviation Oil Corporation, which effectively bet against rising oil prices and, as a result of getting it wrong, had to seek protection from the courts. China Aviation Oil began trading options in the second half of 2003, and built up a naked short position of the equivalent of over 50 million barrels of jet fuel. It closed out those shorts at historical highs, racking up losses of more than $550m in the process. There are public allegations that officials at the parent company were aware of the losses and did not disclose them to investors when they sold a 15% stake in the subsidiary for over $100m, a month before the bankruptcy. An investment offer supported by up to date IFRS-compliant financial statements would have made this type of suppression of information impossible.

IAS 39 requires all hedge relationships to be documented at the outset – meaning at the point the hedge is put in place. Such documentation must address, amongst others, the following points:

- How the hedge forms part of the entity's overall risk-management policies;
- Detailed specification of the hedged item, hedging instrument and the specific risk being hedged; and
- How the effectiveness of the hedge will be demonstrated, both prospectively and retrospectively.

These requirements are consistent with tight corporate governance procedures and, if applied consistently, would significantly increase management's understanding and ability to actively monitor the use of derivative hedging instruments – and hopefully avoid or detect disaster before it happens.

cashflows, for which the employment of economically optimal hedging practices may be more business-critical than for their larger peers.

Only a reporting standard as complex as IAS 39 could elicit such a broad range of responses. IAS 39 does indeed represent a leap in complexity – or sophistication. The question some struggle to answer is: why take such a dramatic step? In the face of broad-ranging criticism over the standard's many different detailed rules – as well as its allegedly prescriptive nature and lack of adequate consultation – its rationale has too often been passed over. This has resulted in the polarised responses from UK corporates.

What does IAS 39 stand for then? It is first and foremost an attempt to move accounting beyond the traditional historical cost-based (or accruals) system. While this valuation approach makes sense for physical assets, it is obsolete for financial assets – the values of which are determined by increasingly complex and fast-moving markets. This is especially the case for derivatives, where the historical cost does not accurately reflect the full extent of economic risks (and rewards) inherent in the commitment. These economic risks escape from an accrual-based system. But the resulting liabilities can be huge. Indeed, scaremongering stories such as Metallgesellschaft (lost $1.5bn on oil futures), Proctor & Gamble (lost $102m on interest rate derivatives leverage), and Sumitomo Corporation (lost $2.6bn from copper derivatives) are real enough to have justified a review of derivatives accounting (see *Box 1*).

Secondly, its strict hedge accounting requirements force companies to document the thought process behind hedging transactions in a disciplined fashion. Investors clearly benefit from such discipline.

Derivatives are frequently used in hedging relationships, where changes in their value are mirrored in fluctuations of the underlying asset that they support. The standard acknowledges that these relationships are largely market risk-neutral by allowing hedge accounting to take place for them – meaning volatility in the value of the derivative is not recorded in the profit and loss account. As such, the standard fundamentally embraces the use of derivatives for hedging purposes – meaning cessation or reduction of hedging on account of IAS 39 is contrary to the aims of the standard.

ACHIEVING HEDGE ACCOUNTING But, and it's a big 'but', the International Accounting Standards Board (IASB) has gone to great – some would say excessive – lengths to ensure that hedge accounting alternatives are only available for true hedging relationships. As such, it seeks to prevent IAS 39 being applied where a clear correlation with the underlying exposure has not been demonstrated. Applying this distinction is the source of the standard's much-vaunted complexity and controversy.

IAS 39 starts from the premise that all derivatives must be stated on the balance sheet at their fair value and movements in this fair value must be stated in the profit and loss account. The standard does, however, introduce different accounting alternatives that allow the effects of this potential volatility to be removed if the derivative in question lies within a defined hedging relationship. But in order to ensure that these hedge accounting alternatives are not abused to gain maximum accounting benefit, all hedging strategies must be documented at the outset. Furthermore, strict rules similarly govern redesignation and termination of hedge relationships.

These options are:

The Fair Value Hedge: This enables a non-derivative financial instrument – such as a fixed rate borrowing – that is the underlying hedged item to be carried at fair value, with gains and losses recognised in profit and loss.

The Cashflow Hedge: This allows hedging of the risks attached to a forecast future cashflow with a derivative, and for changes in the value of that derivative to be removed from the profit and loss account until the underlying cashflows affect the accounts. This cashflow could either be the result of a 'highly-probable' future transaction, or of changes in the risk associated with a recognised asset or liability – such as changes in the servicing costs on floating rate debt.

The Net Investment Hedge: This option is used for hedging the currency translation risks associated with overseas investments and local currency borrowing.

Within these categories, corporates can therefore hedge their exposures without fluctuations in the value of the hedging instruments creating volatility in the profit and loss account – provided the relationships are fully documented from the outset. A further alternative to hedge accounting is the "fair value option" (see *Box 2*).

Yet the apparently complex routes to gaining approval for hedge accounting do in most cases themselves bring added accuracy and transparency to hedging. For instance, the standard demands that the validity of hedging relationships is verified on a regular basis. This was not previously formally required, but nonetheless brings 'imperfect hedges' out of the realm of subjective judgments – or received wisdom – and into a more robust and transparent framework. Oil-related exposures may, for instance, be hedged by oil derivatives – but the risk in question may not be 100% dependant on oil prices. The degree of interdependence in such relationships will, under IAS 39, be subject to more regular re-appraisal – with the attendant economic benefits for the company in question.

Box 2. The fair value option

IAS 39 provides an alternative to fair value hedge accounting known as the "fair value option". This allows any financial asset or liability to be stated at its fair value – to be designated upon the later of initial recognition or transition to IFRS – with changes in fair value booked to the income statement. This alternative has been controversial, but in summer 2005 the IASB revised IAS 39 to restrict its use to situations where it will result in more relevant information for the users of financial statements. In particular, where:

- it eliminates or significantly reduces a measurement or recognition inconsistency (an accounting mismatch); or
- a group of financial instruments is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management strategy and information about the group of financial instruments is provided internally on that basis to the entity's key management personnel; or
- where a financial instrument contains an embedded derivative requiring separation and fair value accounting under IAS 39.

Investments in equity instruments whose fair value cannot be reliably measured cannot be designated as at fair value through profit or loss.

The fair value option can only be applied to assets or liabilities in their entirety and must take account of full fair value. It could not, therefore, be applied to 50% of an issued bond or to only one type of risk associated with a particular asset or liability.

This ought to provide welcome relief for companies seeking to avoid the difficulties and ongoing administration associated with fair value hedge accounting. And for hedging instruments with the same critical terms, this method ought to offset fair value fluctuations in the derivative. However, if the derivative has a shorter maturity – or if it is terminated early – offset cannot be achieved. Moreover, the designation of the fair value option cannot be reversed during its life. And for some companies – for instance those with less stable credit ratings – volatility could still be significant under the fair value option.

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