1.3 IFRS AND THE TREASURER

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Summary: An introduction to the impact of International Financial Reporting Standards on the treasurer.

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1 Introduction

Accounting standards have been in use for many years to control the variety of accounting policies in use by companies and to increase comparability and transparency in accounts. International Financial Reporting Standards (IFRS) are becoming more widely used world wide. Treasurers need to be aware of some of the issues associated with these standards.

The term 'International Financial Reporting Standards' (IFRS) means:

- International Financial Reporting Standards issued by the International Accounting Standards Board (IASB);
- International Accounting Standards (IAS's), issued by the IASB's predecessor body, the International Accounting Standards Committee (IASC); these have subsequently been adopted by the IASB;
- SIC Interpretations issued by the Standing Interpretations Committee; and
- Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC).

Interpretations set out how the standards should be applied, and have equal standing with the standards.

While this subject is of more technical importance to accountants than treasurers, there is still substantial involvement with standards and the main areas are:

- Use of accounting definitions in loan agreements.
- Preparation of statutory accounts (mainly valuations).
- Derivatives and hedge accounting.

2 IASs, IFRSs and GAAP

Prior to IFRS, accounts were prepared under the Generally Accepted Accounting Principles (GAAP) of each local jurisdiction. In many jurisdictions local GAAP is still required for the publication of local statutory accounts and as the basis for tax calculations. Subsidiaries of large groups therefore commonly keep two sets of accounts. They keep local GAAP accounts for tax and local accounts filing purposes, and they keep accounts in the parent's GAAP for the consolidation

required by the parent company.

However, local GAAP evolves over time and in many jurisdictions the local GAAP is moving towards IFRS with the content of new standards, and amendments to existing ones, mirroring those of IFRS. This process is referred to as *convergence* and should lead to cost savings for multinational groups.

European Union (EU) law requires the consolidated accounts of all companies governed by the law of a member state with securities listed on a regulated exchange within a member state to be produced under IFRS. This has meant a time-consuming and complicated transition from previously applied local GAAP.

Note that IASs and IFRSs are effectively the same thing. IASs were established by the IASC, but when the IASC was replaced by the IASB, the latter changed the designation of the standards to IFRS and restarted the numbering.

The other major issuer of accounting standards is the Federal Accounting Standards Board (FASB) which controls US GAAP.

Due to the effect of convergence, in this reading we will discuss accounting issues in the context of IFRS, whilst acknowledging the continued existence of local GAAP.

3 Convergence of Other Jurisdictions with IFRS

In most jurisdictions, companies can report under IFRS or using their local GAAP. Individual countries (or the EU) may require certain companies to report under IFRS, and the remainder can use local GAAP or IFRS as they wish. Meanwhile, countries' local GAAP is generally being changed so that it is more closely aligned with IFRS – but commonly adapted for local concerns. The EU has adopted IFRS, and Swiss listed companies already make extensive use of IFRS. Australia, New Zealand and South Africa have adopted standards based on IFRS. Canada and Japan are also seeking to bring their national standards closer to IFRS.

In the United States, the FASB is cooperating with the IASB on a convergence program. The requirement to create US GAAP accounts to list securities (debt and equity) in the US has long been a huge hurdle for non US companies wishing to access the US market because it involves a time-consuming and costly process of

reconciliation. Convergence of IFRS and US GAAP would help all companies wishing to use the US markets. Such a convergence process is laid out in a memorandum of understanding signed in 2006 by the IASB and the FASB in the US.

Moves towards global convergence should bring significant benefits to companies, investors and other participants in world capital markets. This should enhance the efficiency of such markets by increasing the availability, consistency, transparency and comparability of financial information. In turn, this should lower the cost of capital for companies because improved information leads to lower risk and thus lower required returns. Greater international investment will be encouraged, thus driving down prices through competition.

4 Credit Issues

One area which has been heavily impacted by the adoption of IFRS is that of covenants within loan documents. Loan documents commonly include performance measures called 'financial covenants' among the undertakings made by the borrower. Covenants often refer to accounting measures such as 'cash flow', 'EBITDA', 'net debt' and 'the group'. These measures will always be made by reference to accounting standards and the issue is to understand the implications for those measures (and ratios) under revised standards. Usually the measures are subject to 'frozen GAAP' so that lenders are able to ensure consistency, but this can result in a need to maintain two sets of accounts, one under latest GAAP (or IFRS) and one under frozen GAAP. If the borrower maintains many loan agreements with lenders arranged over several years, then many sets of accounts might be required.

However if frozen GAAP is not used then care must be taken to ensure that any covenants which were reasonable under standards at signing would remain reasonable under any revised standards. Alternatively, the treasurer may have to formally renegotiate covenants.

Another credit issue with which treasurers need to be familiar is the view of financial statements prepared under IFRS taken by the credit rating agencies. The main issues often cited are the expected increase in earnings volatility caused by the need to fair value derivatives under IAS 39 (covered below) and the impact of bringing pension fund liabilities on-balance sheet (covered below). Generally, rating

agencies have stated that provided there has been no change in the underlying economic position then their credit view will not change but that it may do so in the event that the new accounting rules reveal information which the agencies had previously been unaware of.

5 Distributable Reserves

Treasurers must understand the factors which affect the company's ability to make distributions to its shareholders. One key factor is likely to be the level of *realised* (distributable) profits. A company may have substantial cash balances but, if it does not have sufficient distributable profits, its ability to pay dividends may be hampered. Convergence with and adoption of IFRS, and the potential for increased volatility in accounting profits, may affect the value of distributable reserves in companies. This in turn impacts their ability to legally pay dividends.

6 International Standards of Specific Relevance to Treasurers

This section looks at those IFRSs that treasurers are more likely to come across in their work. We will use IFRS terminology, and rather than refer to 'companies' we will use the IFRS terms 'reporting entity' or simply 'entity' when referring to a publisher of IFRS financial statements.

6.1 IFRS 7 Financial Instruments: Disclosures

IFRS 7 requires reporting entities to provide disclosure in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance, the nature of risks arising from financial instruments to which the entity is exposed, and how the entity manages those risks.

It should be noted that IFRS 7 is complex and given this complexity and the fact that much of the information used in providing the disclosures will come from treasury systems, treasurers are likely to be heavily involved in the efforts of companies to meet the requirements of this standard.

6.2 IAS 7 Cashflow Statements

IAS 7 sets out the requirements for cash flow statements. It requires the reporting of movements of cash and cash equivalents, classified as arising from three main activities – operating, investing and financing. The cash flow statement is one of the primary statements within the financial statements and, given that cash management is an integral part of the treasurer's role, it is one with which they need to be familiar. Whilst all three activity classifications are important, the treasurer is likely to be involved in the review, and perhaps even the preparation of the information relating to investing and financing.

6.3 IAS 17 Leases

Whether or not a lease is classified as a finance or operating lease is important since it determines the accounting treatment and whether or not the leased asset and associated borrowing liability are recorded on the balance sheet in accordance with IAS 17. A finance lease transfers to the lessee substantially all the risks and rewards of ownership and the accounting reflects the substance of this by requiring the leased asset, and associated liability, to be recorded on the balance sheet, with the liability often being considered by analysts as part of net debt.

All leases other than finance leases are operating leases for which the rental payments are expensed over the lease term. Despite the fact that operating leases are not recorded on the balance sheet, a company's total future commitment under operating lease agreements is required to be disclosed in the financial statements and may also be considered by analysts and credit rating agencies when assessing the company's debt (Credit rating agencies often reclassify assets under operating lease as fixed assets and treat the future rental obligations as debt). It is therefore necessary for a treasurer to understand the figures disclosed in respect of operating lease commitments.

6.4 IAS 19 Employee Benefits

Employee benefits are all forms of consideration paid for services of employees, and those of most relevance to treasurers are pensions. Two important types of pension are *Defined Contribution* and *Defined Benefit*.

Defined contribution plans are those where a savings 'pot' (in the name of the employee) is built up over an employee's working life, which is then used to buy a pension annuity on their retirement. Defined contribution plans are relatively straightforward to account for as the amounts of cash paid into the pot by the

employer are charged to the income statement as an expense, as they are paid.

Defined benefit plans are those where the employer commits to provide pensions at a future level, typically related to employees' earnings. The difficulty with this approach is that it is impossible to say with certainty what size of savings 'pot' (in the name of the employer) will be required to fund the future pension and fulfil the earlier promise. The accounting standards define the approach that must be used to value the savings 'pot' and (more importantly) to value the expected future pension liability which the pot has to fund. A reporting employer is required to put in their balance sheet an asset (or a liability if the result is negative) equal to the net of: the fair value of any plan assets, less the present value of future amounts expected to be payable under the pension plan.

6.5 IAS 21 The Effects of Changes in Foreign Exchange Rates

This standard is relevant for any entity or group of entities which enter into transactions in foreign currencies or have foreign operations. It prescribes how to include these in the financial statements of an entity and how to translate them into a presentation currency (the currency in which a company *presents* its financial statements).

IAS 21 requires an entity to determine its *functional currency*, defined as the 'currency of the primary economic environment in which the entity operates' and in which it will account.

An entity may *present* its financial statements in any currency (the presentational currency), so the presentational currency need not be the same as the functional currency. For a group containing entities with different functional currencies, the results and financial position of each are expressed in the group's presentation currency in order for consolidated financial statements to be prepared. Assets and liabilities are translated at the closing rate and amounts in the income statement are translated at rates applicable on the dates of the transactions (in practice, an average rate for the period is often used). A treasurer considering the management of translation risk (exposure to exchange rates on preparation of accounts) should understand IAS 21.

6.6 IAS 32 Financial Instruments: Presentation

This standard applies to the *presentation* of financial instruments. It establishes principles for presenting financial instruments, as financial assets, financial liabilities or equity, and for offsetting (ie netting) financial assets and financial liabilities on the

balance sheet. IAS 32 extends to interest, dividends, gains and losses relating to financial instruments. The definitions of a financial instrument, financial asset, financial liability and equity instrument are referred to in IAS 39.

Treasurers spend much of their careers transacting in financial instruments (such as raising debt, raising or redeeming share capital and transacting in the foreign exchange and derivatives markets) and it is essential that they are familiar with the principles of financial instruments' accounting.

IAS 32 limits an entity's ability to offset a financial asset and financial liability to circumstances where an entity has both:

- a currently enforceable *legal right* to set off the recognised amounts and
- *intends* either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

This may be important when both surplus and deficit bank account balances are held with the same bank and where companies usually prefer the amounts to be shown netted.

Example 1: Company Z

Company Z has two bank accounts at the same bank which are off set for interest calculation purposes. Account 1 has a balance of 100 surplus (credit) at the balance sheet date and Account 2 has a shortfall (debit) balance of -50. Company Z is legally and contractually owed 50 net by the bank.

Unless the Directors of Company Z can satisfy its auditors that it intends to settle the balances net, these balances will be accounted for as cash of 100 and short term borrowings of 50. In the absence of any other information, credit analysts may disregard the 100 cash in their evaluation, and analyse Company Z on the basis of the 50 borrowings.

7 IAS 39 Financial Instruments: Recognition and Measurement

IAS 39 is a particularly important standard for treasurers and so merits its own section.

IAS 39 establishes the principles for *recognising and measuring* financial assets and liabilities and also deals with requirements for hedge accounting.

The key requirement of IAS 39 is that financial transactions are *recognised* – ie accounted for, when they are entered into. Thus even if a transaction has no cash flows for some time, it has to be accounted for immediately.

On recognition, financial assets and liabilities are measured, either at fair value or at fair value less transaction costs, and placed into an asset or liability category:

On subsequent reporting dates, the value at which financial assets and liabilities are held in the balance sheet, and what happens to value changes (if any), depends on which category they are placed in on recognition:

- 'Financial asset or liability at fair value through profit or loss[1] (FVTPL)'
- 'Held to maturity investments (HTM)' and 'Loans and receivables (LR)'
- 'Available for sale financial assets (AFS)'
- Other financial liabilities

Examples of particular assets, and the treatment of each category above, are shown in the following table:

[1] The IAS 39 terminology refers to "Profit & Loss", although IAS1 refers to the "income statement".

Instrument	Likely Classification	Initial Valuation / Measurement	Subsequent Valuation Method	Value Fluctuations	Remarks
Bank / Deposit account	LR	Fair Value plus transaction costs	Amortised Cost	Income statement	Bank accounts are classified as "loans and receivables" even if they are deposit accounts.
Bank / money market deposit	HTM	Fair Value plus transaction costs	Amortised Cost	Income statement	Short term investments are "held to maturity" if : • They are not derivatives • They have fixed or determinable payments & maturity, & • There is a positive intention & ability to hold to maturity, & • They are not loans or receivables If the investor sells more than a negligible proportion of investments back to the market early (*tainting*), the entire class may be designated as AFS.
Investments in Commercial Paper and similar securities	HTM, maybe AFS	Fair Value plus transaction costs	Amortised Cost	Income statement	If short term investments in traded securities fail to satisfy the HTM criteria they are likely to be classified as AFS. Alternatively, they may be termed "held for trading" and classified as FVTPL.
Money Market Funds	AFS	Fair Value plus transaction costs	Fair Value	Equity until disposal, then accumulated change through P&L ("recycling")	Although the fund has the characteristics of a deposit account, the investor buys and sells shares in the fund, so money market funds are classified as AFS.
All types of borrowing	Other Liability	Fair Value plus transaction costs	Amortised Cost	Income statement (although value should remain constant in ordinary circumstances)	All corporate borrowings are classified as "Other liability" whether bank account loan or overdraft, term loan or revolving credit facility, or debt securities such as commercial paper or bonds.
Derivatives	FVTPL	Fair Value	Fair Value	Income statement unless designated as part of a 'hedging relationship'	All derivatives (eg forward foreign exchange deals, interest rate swaps, options) are classified as FVTPL unless designated as part of a 'hedging relationship'.

Valuation Methods:

- Fair value is intended to represent the open market value of an instrument; IAS 39 sets out methodologies for calculating fair value ('marking to market').
- Amortised cost uses time value of money techniques to amortise (allocate) the cost of the instrument at a constant rate of return over its life.

8 IAS 39 and Hedge Accounting

As can be seen from the table above, derivatives are accounted for on the balance sheet. They are marked to market at the period end, and the difference between the previous and current fair values is taken to income.

Derivatives are commonly used by companies to 'hedge' risks such as currency risk and interest rate risk that affect their activities. Hedging is the process of entering into an offsetting position (the hedging instrument) to neutralise the effect of possible changes in the future value of or cash flow associated with a position (the hedged item).

Example 2: November Group - Hedging

We work for the November Group whose functional currency is USD. We expect to receive EUR 5 million in 6 months time. To manage the risk that the EUR may be worth more or less than its USD value today, we could enter into a forward foreign exchange transaction and agree with a bank that we will sell the EUR for USD at a fixed rate in 6 months time.

Whatever happens to the EUR/USD exchange rate over the next 6 months, the company has fixed the rate at which it will sell EUR, and the fluctuation in value of the EUR receivable is exactly compensated for by the fluctuation in the value of the forward foreign exchange contract. The expected receipt is said to be *hedged*.

Quantified financial risks are referred to as 'exposures' or 'positions'. In the above example the company is hedging an exposure of EUR5 million. Once hedged, the accounting standards refer to hedged exposures as 'hedged items'.

A *hedged item* is normally a commercial transaction, such as a foreign currency sales receipt, the agreement to buy an item of machinery denominated in a foreign currency some time in the future or the issuance of a new debt instrument. In each case, in order to counteract the

risk due to fluctuations in a market rate, a company may put in place a *hedging instrument*. More specifically, a hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation.

A *hedging instrument* responds to changes in a market rate (for example, an interest rate or exchange rate) in the opposite way to the hedged item that it is hedging, thereby removing, or significantly reducing, the impact of the movement when both the hedging instrument and the hedged item are taken together. In the example above, the forward foreign exchange contract is the hedging instrument.

The problem for the company is that although the forward FX transaction is accounted for and revalued, the expected EUR receipts are not – they are in the future and as they are not contracted, they will not be accounted for. This introduces volatility into the company's current income statement, despite the economic effect of the hedge being to reduce volatility in the future.

So IAS39 includes a workaround in the form of 'hedge accounting'. Hedge accounting seeks to reflect the results of hedging activities, in particular hedging using derivatives, by reporting the income effects of the derivative and the risk being hedged in the same period.

Hedge accounting allows entities to override the normal FVTPL accounting treatment for derivatives or to adjust the carrying value of assets and liabilities. It is therefore a privilege, not a right, and has to be earned. Entities can only obtain the right to achieve hedge accounting if they meet the requirements set out in IAS 39. These requirements are numerous and complex and include concepts of designation and effectiveness (see below).

IFRS offers a hedge accounting treatment for three types of hedging transactions:

- cashflow hedges (hedges of future cash flow streams eg sales receipts or floating rate interest payments)
- fair value hedges (hedges of market values of financial instruments such as fixed rate bonds)
- net investment hedges (in consolidated accounts) (hedges of the value of subsidiaries or other investments denominated in foreign currency such as an overseas subsidiary)

Hedge accounting seeks to balance up the income statement, either by recognising corresponding movements in the hedged item, or by deferring movement on the hedging instrument in reserves.

8.1 Requirements to Achieve Hedge Accounting

IAS 39 permits *hedge accounting* provided certain conditions are met. These include the need to designate formally and document the hedge relationship (ie both the hedging instrument and the hedged item) and to demonstrate that the hedge is 'highly effective', from both a prospective (forward-looking) and retrospective (historic) perspective. A hedge is considered to be highly effective if its fluctuations in value compensate for fluctuations in the value of the exposure within a range of 80% to 125%. In order that the accounting treatment may reflect economic and commercial realities, hedge accounting allows the hedged item (and sometimes the hedging instrument or derivative) to be accounted for in a manner which differs from its normal treatment.