*Many companies have only weeks to ensure that they can start reporting under IFRS. But getting off the mark has not been made any easier by ongoing amendments to IAS 39 such as the EU's recent carve-out of the Fair Value Option. By **Simon Emery** and **Matt Read**.*

On your marks... for IAS 39

Executive summary

- UK-listed corporates will soon have to report under IFRS. Many are still making the necessary changes to their systems and financial reporting processes before the start date of 1 January 2005.
- The EU's recent decision to adopt a carved-out version of IAS 39 has made the transition to IFRS more difficult for many companies.
- It is also unclear whether the DTI will allow UK companies to use their own concept of a 'true and fair override' and apply full IAS 39 and the Fair Value Option.
- UK companies with listings in the US are also in the dark over how they will deal with dual reporting requirements.
- UK corporates adopting IAS 39 must impress on stakeholders that business risks and financial risks are managed appropriately.
- Traditional risk management strategies do not fit in with the hedge qualification criteria laid down in IAS 39. This could lead to greater balance sheet volatility than when accounts were prepared under UK GAAP.
- Companies need to adopt a strategic framework for managing risk and use the appropriate tools to aid their internal decision-making process.

WITH LESS THAN THREE WEEKS TO GO until UK-listed corporates have to report under the new International Financial Reporting Standards (IFRS), many are still effecting the required changes to their systems and financial reporting processes. While many difficulties were originally anticipated, these have been further exacerbated by the continuing discussions over EU adoption – specifically adoption of IAS 39 Financial Instruments: Recognition and Measurement.

There are still many questions as to how UK companies will be impacted by the EU's adoption of a carved-out version of IAS 39 (see News, page 6, The Treasurer, November). Will the Department of Trade and Industry (DTI) endorse the recently revised version of IAS 39? Or will UK corporates still be able to apply full IAS 39 and the Fair Value Option if they want to?

It is also still unclear whether the DTI will allow UK companies to establish an equivalent concept of a 'true and fair override' and apply full IAS 39 and the Fair Value Option. The latter would potentially allow UK companies to adopt fair value accounting for their own debt.

The impact that carving out macro hedging of core deposits will have on corporates is also still uncertain. And what are UK companies, with dual reporting requirements – for example, those reporting under US Generally Accepted Accounting Principles (US GAAP) – going to do in these amended circumstances?

> ‘The transition from UK GAAP to IFRS carries significant potential business risks and needs to be managed strategically.’

It may be that each EU member state will be able choose between adoption of the IASB version of IAS 39 and the amended EU version. Clearly, the former will be of greater benefit to companies required to file with the Securities & Exchange Commission (SEC).

STRATEGIC APPROACH TO RISK MANAGEMENT. The transition from UK GAAP to IFRS carries significant potential business risks and needs to be managed strategically. Therefore, UK corporates must impress on their stakeholders that the management control environment they work in is very effective, with both business and financial risks appropriately managed.

A key priority is to disseminate information to stakeholders on how adoption of the standards will impact the company and its financial statements both at transition and thereafter (see Is the UK ready for IFRS? page 30). While they have been provided with a lot of information through the UK GAAP reporting process, stakeholders will now need help to reconcile IFRS financial statements to prior UK GAAP accounts. They must also be given an appreciation of the inherent volatility in a typical IFRS balance sheet and income statement and, most importantly, the real economics behind the numbers.

A key impact of IFRS filing will be the fundamental change in the accounting treatment of derivatives used by the corporate as part of its traditional risk management. They will be carried at fair value on the balance sheet, with changes in fair value passing to the income statement unless a stringent hedge relationship threshold can be met. If the latter is met, then changes in fair value can be deferred on the balance sheet until the underlying hedge item passes to the income statement.

For the vast majority of companies, traditional risk management strategies will not fit neatly within the hedge qualification criteria laid down in IAS 39. Traditional risk management strategies will, therefore, lead to more volatile balance sheets and income statements than when accounts were prepared under UK GAAP. Corporates will be faced with a choice of continuing to hedge economically and accepting income statement volatility, or not hedging at all.

The ARC’s carve-out of IAS 39

On 1 October 2004, the Accounting Regulatory Committee (ARC) met to discuss the recommendations it would put to the EU Commission on IAS 39. The ARC agreed to recommend endorsement of IAS 39 with two major ‘carve-outs’ to the EU (see News, page 7, The Treasurer, October). These proposals have since been adopted by the EU (see News, page 6, The Treasurer, November).

The EU-adopted version of IAS 39 does not include:

The Fair Value Option – This was carved out following comments from the European Central Bank, among others, which expressed reservations over companies electing to fair value any financial instrument, particularly their own debt. However, the International Accounting Standards Board (IASB) believes this option provides greater transparency and the user can make his/her own decisions based on the information provided. The IASB is hopeful of issuing an amended version of the Fair Value Option by April 2005. Therefore the adoption of this carved-out version may represent a temporary delay in the full application of the standard.

Macro hedging of core deposits – The approval for endorsement by the ARC said that ‘Hedge Accounting for a Portfolio of Interest Rate Risk’ is neither complete nor ready for agreement, and it could not endorse the IASB’s proposals here. The key sticking point has always been whether or not companies should be able to designate demand deposits as hedged items in a portfolio hedge of interest rate risk. The IASB argues that a deposit that can be demanded today from a bank by a customer cannot be subject to fair value risk beyond that demand date. The ARC’s recommendations, however, allow entities to designate demand deposits as part of portfolio hedges of interest rate risk. The amendments also appear to allow greater flexibility in how entities conduct hedge effectiveness tests.

Both ‘carve-outs’ are complicated by questions as to whether the ARC has the power to alter accounting standards before granting a recommendation of approval to the EU. ARC was created to provide an independent approval process – not to draft or edit proposed standards from the IASB.

A top-down approach that concentrates on the economic risk, but is executed in the most 'accounting efficient manner', can be recommended here (see Figure 1). Although rational, this approach will lead to income statement volatility – something which stakeholders will rightly question. In order to respond effectively, the economic and accounting risks need to be quantified and articulated through both the financial reporting process and the investor relations process. The chairman's statement can be used to explain not only any changes in earnings volatility reported by a company, but also the sensitivities of those exposures to certain economic changes and the tools that have been employed to manage the exposures.

One approach companies should consider involves looking at the strategic framework for managing risk and using the appropriate tools to aid their internal decision-making process. The starting point for any corporate must be to review its derivatives portfolio and, where possible, look to obtain hedge qualification. Toolkits exist that can help corporates to navigate the complexities of hedge effectiveness testing and reduce the related administrative burden, whether a statistical (eg regression analysis, risk-reduction method) or non-statistical (eg ratio analysis) test is chosen. It is also worth having an audit-friendly mechanism for documenting and reporting these hedge assessments.

Meanwhile, Earnings-at-Risk (EaR) can be used as a metric to gain an understanding of the income statement volatility that may arise on the 'non-compliant' part of a derivatives portfolio (see Figure 2). EaR estimates the biggest loss for a given probability (confidence level) between one or several reporting dates in the future. It employs the Value-at Risk approach, calculating the impact to earnings having allowed for the accounting treatment of underlying assets, liabilities and designated hedges.

Applying this strategic overview can provide corporates with an element of foresight – a quantitative assessment of the relative benefits of economic versus accounting tools. It should also help stakeholders to feel comfortable that the corporate has a robust risk management framework in place.

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Figure 1. Corporate hedges

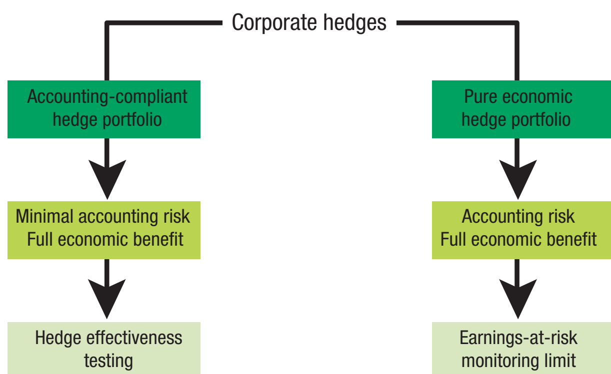

Figure 2. Earnings-at-Risk for a financial instrument