The Association of Corporate Treasurers (ACT)

IAS 39 implementation experiences reported by members

A background paper for IASB Financial Instruments Working Group

July 2005

In order to assist the IASB's Working Group in gaining a further understanding of the effects of IAS 39 in practice the ACT has asked its members to provide feedback on the precise circumstances where the implementation of IAS 39 has caused undue complications or accounting outcomes that seem illogical, confusing or even misleading to users of the accounts. This report explains the specifics reported to the ACT by individual companies. In essence it simply catalogues the issues that have arisen.

Certain companies preferred that we do not include their names but all the examples are from substantial companies. The companies are referred to by the letter from A to N in order to demonstrate that these are not hypothetical circumstances but are genuine experiences by real companies.

Information on The Association of Corporate Treasurers and contact details are given at the end of this paper.

Summary

The Association of Corporate Treasurers has in general been a supporter of the introduction of IAS 39 and the concept of fair value accounting for financial instruments. During its development we have submitted our views on certain elements and have been pleased that the IASB has been receptive to many of our comments eg the hedging of intra group forecast cash flows, the availability of the fair value option and very recently, in the related area of IAS 21, the treatment of foreign currency difference on quasi equity loans. On the other hand our previous comments on the use of treasury centres and the netting of foreign currency exposures remain an issue.

From our members' feedback we found that the main issue is where normal commercial treasury transactions and practices give rise to accounting results that do not seem to follow the true economics of what is being undertaken. The stringent rules on what constitutes a hedge in accounting terms, cause most of the anomalies in this respect. For example a transaction to create a fixed rate borrowing in a company's home currency will have a different accounting treatment if it is effected by a direct home currency fixed rate borrowing as compared to borrowing in a foreign currency and swapping the deal into the home currency with a subsequent swap into fixed rates. This is not a sensible outcome.

The hedge of a hedge problem

Cross currency funding

For efficient funding companies will want to borrow in the markets and in the currencies that provide the lowest cost of funds at the time the debt is raised. They will look for a spread of maturities, which sometimes will require a diversity of markets and currencies in which the original borrowings are undertaken.

Unless there is a specific need for foreign currency liabilities any foreign currency borrowings raised will need to be fully hedged back into the company's functional currency. This is done by using cross currency interest rate swaps (CCIRS).

Scottish & Newcastle wanted to create a Euro liability to hedge Euro denominated assets. A non Euro borrowing was raised and swapped using a cross currency swap into floating rate Euro. The decision as to rate fixing and period for this Euro liability was taken separately. Any overlay swaps from floating Euro into fixed rate Euro done to align with the company's fixed/floating policy fail to get hedge accounting and must be marked to market introducing spurious volatility.

An identical example to Scottish & Newcastle is Company D which has sterling as its functional currency. It has borrowed fixed rate $ which have been swapped into floating rate Euro in order to hedge its Euro assets. A synthetic Euro borrowing has been created using swaps which can be used to create a valid net investment hedge but it can not achieve cashflow hedge accounting should it decide to fix the rates on its synthetic Euro liability using swaps.

However, if it had issued floating rate debt directly in Euros and then fixed it with a swap, it could achieve both net investment hedging and cash flow hedging. This appears iniquitous. The accounting may therefore force corporates to issue debt in less liquid markets in order to get the accounting to work, at the expense of interest costs.

A further example comes from company A with an A$ functional currency. Typically, when company A raises debt in foreign currencies, whether this is done using fixed rate or floating rate instruments, it is swapped back to floating rate A$ and then, as a separate exercise, swapped from floating rate A$ to fixed rate A$.

This two step approach is partly caused by practical considerations and partly to ensure that the best pricing is obtained. The practical consideration arises because the CCIRS are entered into in the middle of the night Australian time when the US$/A$ CCIRS market is most active. This is a time when there are no quotes available in the domestic swaps markets to convert from floating A$ to fixed A$ and the company must therefore break the hedge into two steps.

The issue of best pricing arises because it is good practice to hedge the currency exposure as soon as it arises. It is appropriate to allow more leeway on hedging interest rate exposure since this is less volatile and it can be possible to add value by managing the timing of the interest rate hedging into fixed rates. However under IAS 39, the second leg could be regarded as a hedge of a hedge and consequently ineligible for hedge accounting. It is anomalous and certainly inconsistent with the real meaning of the words "true and fair" to record an exposure on the

floating to fixed swap when all aspects have been fully hedged, merely because the hedge has been engineered in two steps instead of one.

In this case the auditors of company A have been convinced of the logic of treating the two step approach as a single hedge but conditional on the interest rate hedge matching the whole of the borrowing and the CCIRS. However if they wanted to hedge only some of the interest rate exposure arising from the CCIRS, that partial hedge would be ineligible for hedge accounting treatment and the interest rate exposure would be accounted for as if is it was fully unhedged. Tactically the company may wish to average into its rate fixing by deliberately spreading the fixings over an extended period.

BP and Rexam who gave presentations at an ACT conference on IAS 39 in April 2005 have both encountered the same problem and are having to decide whether they should go for a sub-optimal funding directly in the target currency or fund in a more competitive market and live with the consequences of not achieving hedge accounting.

Splitting of a cross currency swap

As mentioned above Company D has borrowed fixed rate $ which have been swapped into floating rate Euro in order to hedge its Euro assets. In order to achieve Fair Value hedge accounting of the fixed rate $ debt and Net Investment hedge accounting of the groups Euro assets the company has been forced to split contractually the cross currency swap. It has had to split the cross currency swaps into:

- A receive fixed USD, pay floating GBP + fixed margin swap (Fair Value hedge of USD Debt for FX and interest rates)
- A receive floating GBP + fixed margin, pay floating EUR + fixed margin swap (Net Investment Hedge)

This was required by Company D's auditors but it is not clear whether all firms are applying the same rather stringent interpretation of the standard.

Net investment hedge plus subsequent interest rate management

Company B, with a sterling functional currency, decided to hedge its investment in the US by executing a cross currency swap (floating / floating) out of sterling and into US$ to create a $ liability. This swap gets hedge accounting as a net investment hedge. A subsequent decision to fix the rate on the synthetic $ liability using a $ floating to $ fixed swap does not get hedge accounting, although it would have done had the net investment hedge been created by entering into a $ borrowing.

Company E, with a sterling functional currency, has created a net investment hedge of its Euro based subsidiary using FX swaps rolled quarterly, effectively swapping sterling floating into Euro floating. It has entered into a Euro interest rate swap to swap floating (quarterly) Euro into fixed Euro but this fails to qualify for hedge accounting.

Straight forward interest rate management

Company C (sterling based) sought to fund itself long term at floating rates. Since investor demand for floating rate paper is limited it was more efficient to borrow at fixed rates in sterling and combine this with a swap to floating rates. Hedge accounting was allowed for this swap.

Later the underlying business flows evolved so that it was no longer appropriate to have a floating rate position and a second swap was executed to go from floating back into fixed rates. This second swap was ineligible for hedge accounting, which it would have been if the underlying borrowing had been raised directly in floating form.

Ineffectiveness

Company D mentioned earlier has borrowed fixed rate $ which have been swapped into floating rate Euro in order to hedge its Euro assets. The fact that it has swapped the full USD coupon on the USD debt into EUR means that it has ineffectiveness in the P&L due to the credit spread on the USD debt. Although the credit spread issue can be eliminated with interest rate swaps, it cannot be eliminated with cross currency interest rate swaps. This results in accounting ineffectiveness that is not reflected in the cash flows.

The deals have been broken down into:

- A receive fixed USD, pay floating GBP + fixed margin swap (Fair Value hedge of USD Debt for FX and interest rates)
- A receive floating GBP + fixed margin, pay floating EUR + fixed margin swap (Net Investment Hedge)

Even though IAS 39 allows an entity to ignore the credit margin in simple interest rate swaps, the fact that it has been swapped into another currency means that it cannot be ignored. This is because when looking at the fair value of the whole cross currency swap, the USD flows in the swap (full coupons and principal) are discounted using the swap curve, whilst the cash flows of the USD "hedged item" exclude the credit spread. Thus from day one the net present value of the USD leg of the currency swap ($104 for example) is different from the net present value of the debt ($100 if issued at par). This means that when the GBP/USD rate changes, the change in value of the debt (in GBP terms) will be different from the change in value of the currency swap. Ineffectiveness exists even where the company has hedged all the GBP/USD risk. The fixed GBP margin is also exposed to fair value changes due to changes in GBP interest rates, therefore introducing more volatility. Another way of looking at this is even though the embedded interest rate swap will be highly effective (ignoring credit spread in the debt), the embedded basis swap has a fixed USD margin and a fixed GBP margin that introduces ineffectiveness in terms of fair value hedging of FX risk.

The fixed margin on both legs of the Net Investment Hedge also introduces P&L volatility as the margins cannot be designated in an effective hedge relationship. If the "spot method" is used to measure effectiveness, then the change in mark-to-market of the margins will be shown as volatility in the P&L. If the forward method is sued the ineffectiveness will be recognised in reserves.

Interaction of IAS 21 and IAS 39

Internally generated FX balances

We are aware that the IASB at its June meeting agreed to amend IAS 21 in such a way as to address two elements of the problems in this area. However difficulties remain over whether some short tem balances should be treated as quasi equity loans.

Company F has encountered problems with the treatment of uneliminated FX on consolidation caused when there is a monetary payable or receivable between 2 group companies which have different functional currencies. As this is an internal balance (which eliminates in the Group balance sheet) it does not impact Group net assets (i.e. shareholder funds) however, unless there is a basis for taking the FX to group equity on consolidation, it is in the position in which one side of the FX is in Group P&L and the other (the consolidation adjustment) is in Group equity which is wholly illogical as well as misleading.

IAS 21 addresses this to a limited extent via paragraphs 15, 32 and 33 however this requires the intra-group monetary item to form part of the net investment in a foreign operation and it must also be long term. Where the monetary item can be treated as being part of the entity's net investment in a foreign operation and where the currency of the item is the functional currency of one of the parties then paragraph 33 allows the FX difference to be reclassified to equity so that there is no overall group P&L distortion.

However this does not provide a solution with respect to balances which cannot be termed long term (even if they are non-trading). Furthermore paragraph 33 contains the peculiar rule that if the inter-company item is in a currency other than the functional currency of either of the two parties involved the reclassification to equity is not allowed.

Having recognised that this issue over internal balances exists for long term funding loans it is unclear why IAS 21 treats intra-group trading balances in a different manner. Like the long term balances forming part of the net investment in a foreign operation, they are internal so do not impact the value of the Group, nor should they impact group P&L. Furthermore a group will often fund its foreign operations by allowing intra-group trading balances to remain outstanding and will arrange its external hedging on the basis that those trading balances form part of the net investments. Commercially they treat these balances as part of the net investment yet in accounting terms they are unable to do so.

Company F has also looked at paragraph 80 of IAS 39 with regard to designating an internal balance as a hedged item and applying net investment hedging under paragraph 102 of IAS 39. Here they have identified a conflict between the 2 standards which is difficult to reconcile. In addition to the specific point raised above there is a general point that there is some conflict between IAS 21 and IAS 39 which needs to be addressed. It would be good if the working group is looking at IAS 39 were to review how the 2 standards interact.

Companies I, J and L have also reported the anomaly of paragraph 33 of IAS 32 where the accounting depends on the currency of inter company funding of its net investment.

Application of net investment hedging

Unlike SSAP 20, IAS 39 does not apply to net investment hedging on a solus basis. Company F operates so that certain subsidiaries individually hedge their own net investments and they do this by borrowing in currency from the central treasury, but without hedge accounting in the solus accounts this will produce a large number of P&L differences in the Group P&L as described in the previous point. Company F has agreed an alternative approach with its auditors which involves the subsidiaries treating their hedges as fair value hedging rather than net investment hedges however it does seem that this was only necessary due to an oversight by the IASB which they were reluctant to rectify. If would be much more straightforward if IAS 39 recognised the economic reality and allowed net investment hedging on a solus basis in the same way as SSAP 20 does.

With respect to net investment hedging on consolidation (which is permitted in IAS 39), this would benefit from a thorough review in order to ensure that hedging arrangements at a Group level are recognised as such i.e. external debt that is hedging the **net** of all assets and liabilities in that currency. There would be a need to ensure there is no conflict with IAS 21.

Functional Currency of treasury funding companies

Many companies, and specifically Companies E, L, M and N have reported to the ACT that they are experiencing problems in getting their auditors to agree on a foreign functional currency for their treasury funding companies. Typically a sterling based parent will inject equity into a treasury company which then lends inter-company to fellow members of the group in, say US$. Given that its assets and income are all US$ based the treasury company will wish to take US dollars as its functional currency.

However a widespread interpretation of ISAS 21 is that the economic environment test can only be applied to a trading company rather than a treasury company, even though this is not specified in the standard. In a case like this the activities of the treasury company are usually deemed in essence to be an extension of the parent and therefore the functional currency must be the same as the parent. This appears to be another case where the IFRS accounting is unclear and the general interpretation does not follow the normal working practices of a corporate treasury department.

<u>Portfolio hedging</u>

Hedging short term intermittent borrowings

Company A has predictable cash in flows and outflows. It funds short-term negative cash balances through the issue of very short-dated commercial paper timed to coincide with expected cash flows. It hedges the interest rate exposure arising from future forays into the CP market with a pretty high degree of confidence around the amounts involved. However, it is unable to account for these hedges as hedges under IAS 39 as they are unable to match the hedges against specific borrowings.

As a consequence they have decided that they will not hedge these interest rate exposures

FX exposures

Company A makes many of our purchases from overseas which are small in value and the date of arrival (and thus the due date of payment) uncertain. This is dealt with by buying marketable parcels of the key foreign currencies and allocating the contracts to individual payments when money is paid to the supplier.

In order for these hedges to be accounted for as hedges, IAS 39 requires certain criteria to be met in terms of identifying the specific risk being hedged. The change in practice necessary to comply with IAS 39 would be likely to increase the cost of buying currencies and would impose a bureaucratic straightjacket that would provide no economic benefit. Once again the company has decided it is better to cease its hedging to avoid the complications rather than to hedge and suffer the volatility.

Miscellaneous topics

IAS 32 Offset of pooled bank accounts

An entity may operate many bank accounts around the world and have entered into a legally enforceable agreement with its bank that these may be pooled or offset against one another and that interest is only accrued on the net balance. In the past it would have been the net balance that is shown. However IAS 32.42 (b) requires that in order to be able to account on a net basis there has to be an intention to settle on a net basis or to realize the asset and liability simultaneously. The concept of settling net does not sit well with a bank pooling arrangement which is intended to operate continually with fluctuating balances continuing for the foreseeable future. Therefore normally an offset will not be allowed in the accounts even though on insolvency the offset may be legally enforceable. We question why an intention to settle net should be a requirement.

Index-linked swaps

Company B has issued long dated index-linked bonds. It also has borrowed using fixed rate bonds swapped to index-linked. These are both regarded internally as natural hedges of a large part of UK revenue that is by its nature very highly correlated to moves in the RPI. The RPI bonds do not have to be bifurcated since it can be demonstrated that the RPI is 'closely related' to interest rates and are not marked to market, however the RPI swaps are marked to market and do not get hedge accounting because the linkage of the underlying revenues cannot be demonstrated over a long period'. This is both inconsistent and nonsensical.

An identical situation faces Company K which is contemplating raising index linked debt. It can either borrow via an index linked bond of via a fixed rate bond plus index linked swap. Both give the same commercial effect although market conditions are such that the direct index linked bond is less competitively priced than the alternative route. However in accounting terms the fixed rate bond plus swap gets marked to market, whereas an issue of an index linked bond would not.

The Company is debating with its auditors whether, if the fixed bond plus swap route is used, the fixed rate on the fixed rate bond can be regarded as made up of a real rate of interest plus an indexation element, and hence whether the RPI swap can be designated as a fair value hedge of the indexation component of the bond.

Earnings Hedging

Although the rationale for hedging overseas earnings is not universally accepted there may in individual circumstances be a good justification to do so. One Company has successfully hedged earnings of US subsidiaries for several years under UK GAAP, thereby protecting earnings from the decline of the dollar. The latest position of the IASB effectively means that hedging overseas earnings will fail in accounting terms.

Short-cut method

The point has been made by some that the IASB should allow the use of the shortcut method for interest rate swaps, in the same way as permitted under U.S. accounting. As well as being a logical approach that removes the onerous requirement to prove hedge effectiveness in all cases (even when the hedge is clearly effective) it would also have the benefit of being consistent with the approach adopted by the FASB.

Tainting

Company G has found that the tainting provisions cause limitations around the held to maturity (HTM) category of financial assets. The stringent nature of the tainting provisions and the criteria for allowing a sale of a HTM asset mean that the whole category of assets could be penalised and marked to market even if there is a good commercial reason for the sale. The company has had to put a policy in place that no assets will be sold without the prior approval of group treasury.

Embedded foreign currency derivatives within supplier or sales contracts.

Company G has found issues surrounding embedded foreign currency derivatives for foreign currency stock purchases, namely purchasing in USD from the Far East. There is still uncertainty across the big accountancy firms as to which currencies represent "currencies commonly used" in a country. As a result this company could potentially have a different accounting treatment for goods purchased from China to those purchased from Hong Kong. Administratively this makes it impossible to establish a common process of accounting for stock purchases and hedges of stock purchases and represents a significant increase in the amount of manual accounting work required.

Company H has the identical issue in its sales contracts and is being required to treat the currency element of certain contracts as a mark to market amount via P&L. If the currency of the contract is that of either the Company or its customer then AG 33 (d) provides that the embedded

derivative does not need to be accounted for separately from the host contract, specifically if the currency is "the functional currency of any substantial party to the contract".

This raises some interesting effects. Company H has a sterling functional currency and may be selling in US $ to two Japanese companies one of which uses the Yen as its functional currency and one of which is an oil company using US $. It is difficult to see why H's shareholder` value should be recorded differently dependent on a third party's status. Company H is further discussing with its auditors a more extreme possible example of this peculiarity. If H is selling in US $ to a Japanese company that accounts in Yen, but whose parent has the $ as its functional currency should it look through to the ultimate parent's currency and therefore not separate the embedded derivative?

The Association of Corporate Treasurers

Established in the UK in 1979, The Association of Corporate Treasurers (ACT) is a centre of excellence for professionals in treasury, risk and corporate finance operating in the international marketplace. It has over 3,300 members from both the corporate and financial sectors, and its membership includes representatives from 95 of the FTSE 100 companies.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education.

The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

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