Comments on behalf of
The Association of Corporate Treasurers

International Accounting Standard 39: Financial Instruments, Recognition and Measurement: Exposure draft of Proposed Amendments

The ACT is concerned that proposed accounting rules for financial instruments threaten – unless amended by the IASB – to have major adverse impact on treasury best practice in non-financial sector companies.

Two key points are being urged by the ACT on the IASB:

- **Central netting should qualify for hedge treatment in consolidated (group) accounts**
- **Prospective hedge effectiveness should be tested against the same 80% to 125% band as is applied for the retrospective test**

The ACT commented last week to the IASB (International Accounting Standards Board) in response to the Exposure Draft from the IASB, "Exposure Draft of Proposed Amendments to IAS39 Financial Instruments: Recognition and Measurement: Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk".

The ACT welcomed the new flexibility included in the exposure draft but believes that before IAS 39 is finalised – and before it is adopted by the EU - certain outstanding points must be properly dealt with.

<u>What needs to change?</u>

The substantive points made by the ACT are:

Central netting should qualify for hedge treatment in consolidated accounts:
This impacts those groups of companies whose operating units have commercially offsetting currency exposures. Accepted best practice to minimise both the exposures and operating risk is to centralize the exposures into a central Treasury by means of internal inter-company deals and then the centre hedges externally based on the net position. While IAS 39 as currently worded achieves hedge accounting for these internal deals within the accounts of the subsidiary companies, hedge accounting is not allowed (except for the residual net amount) when accounts for the consolidated group are prepared. The ACT believes that companies should be allowed to preserve the entire hedge accounting treatment on consolidation where there is proper documentation and the net of the internal contracts is laid off externally by the treasury centre – no internal profits would arise from this.

Under the IASB's proposed rules such net positions and internal deals properly laid off by external contracts, are expressly (and, in the ACT's view, perversely) prohibited from counting as hedges.

US GAAP permits central netting as hedging in consolidated accounts.

Prospective hedge effectiveness should be tested against the same 80% to 125% band as is applied for the retrospective test
To qualify for hedge accounting it must be possible to demonstrate that the value of the hedge instrument and the underlying hedged item are closely linked when movements in the market occur. The IAS includes a retrospective test criterion of 80% to 125% correlation, but in addition imposes a prospective test that the relative movements must be "almost fully offset".

The ACT believes that *both* the prospective and retrospective tests should be set at 80% to 125%. In the commercial world this level of correlation is often the best that can realistically be achieved. Commodity hedging in particular creates the need for this flexibility – because it can be impossible in practice to achieve a closer match given the limited choice of commodity futures.

US GAAP sensibly applies the same 80% to 125% criteria to both prospective and retrospective testing. The IASB seemed to adopt this policy at its July meeting but reversed the decision in October without further exposure.

Short cut method for interest rate swaps should be allowed
No periodic effectiveness testing should be required where the hedge and the hedged item meet certain conditions designed to demonstrate that they are perfectly matched and that there is no chance of any real ineffectiveness. This is allowed under US GAAP. While clearly of less impact on companies than the first two points raised by the ACT, it would particularly help smaller companies and public sector bodies with few and simple transactions.

Why the concerns?

Treasurers' concerns arise from the objective that normal commercial hedging carried out as standard best practice in non-financial sector companies should not be caught out by the rules and fail to qualify as hedges.

The ACT's comments and recommendations to the IASB are based on principles that are important for the IASB, support the application of best practice in risk management and reduce the chances that IAS 39 will encourage work-around solutions such as the use of non-consolidated vehicles, or entering into pseudo fictitious deals with banks that net to nil. These principles are:

- Accounts should not give a misleading picture of routine treasury activity
- The accounting process should not introduce excessive administration/costs
- Accounting rules should not drive corporates to change soundly based hedging policies, to their commercial detriment, simply on account of the accounting presentation and
- Rules should not encourage companies to use "work-arounds", special purpose vehicles and so on to avoid the commercial impact of unsound accounting rules .
- Convergence of IAS with US GAAP should be a general objective of the IASB where this can be achieved without compromising the fundamentals behind IAS.

In each case the ACT's proposals, if adopted, would avoid IAS 39 breaching these principles.

Background

The ACT was an early advocate of the main principles behind IAS39

- that derivatives should be measured at fair value but
- subject to effectiveness testing and designation, hedge accounting may be applied with any ineffectiveness recognized in earnings

Treasury associations in Europe and other representatives of the non-financial corporate sector have clearly expressed these views since the early days of IAS39.

Note to editors on hedge accounting:

The general aim of IAS39 is to ensure that all derivative transactions should be measured at fair value. Subject to certain rules a derivative can be designated as matching an underlying commercial exposure of the business. Hedge accounting means that where a derivative is so designated, and if, say, the derivative is standing at a gain, then that gain is not recognised in the P&L until the corresponding loss that will exist on the underlying commercial item is recognised.

Hedge accounting is particularly crucial where the underlying commercial exposure being hedged is not normally recorded in the books. This could happen where a company is expecting to make sales next year that will be denominated in a foreign currency. It quite properly enters into the derivative hedge to cover its future risk. It would be misleading to show a gain on the hedge and ignore the unrecognised loss on the hedged item. Hedge accounting solves this.

International Accounting Standards are soon to be adopted for use within the European Union, replacing national generally accepted accounting principles.

Contacts:
John Grout, Technical Director
Martin O'Donovan, Technical Officer

The Association of Corporate Treasurers
Ocean House
10/12 Little Trinity Lane
London EC4V 2DJ

Telephone: 020 7213 0728
Fax: 020 7248 2591
Website: http://www.treasurers.org