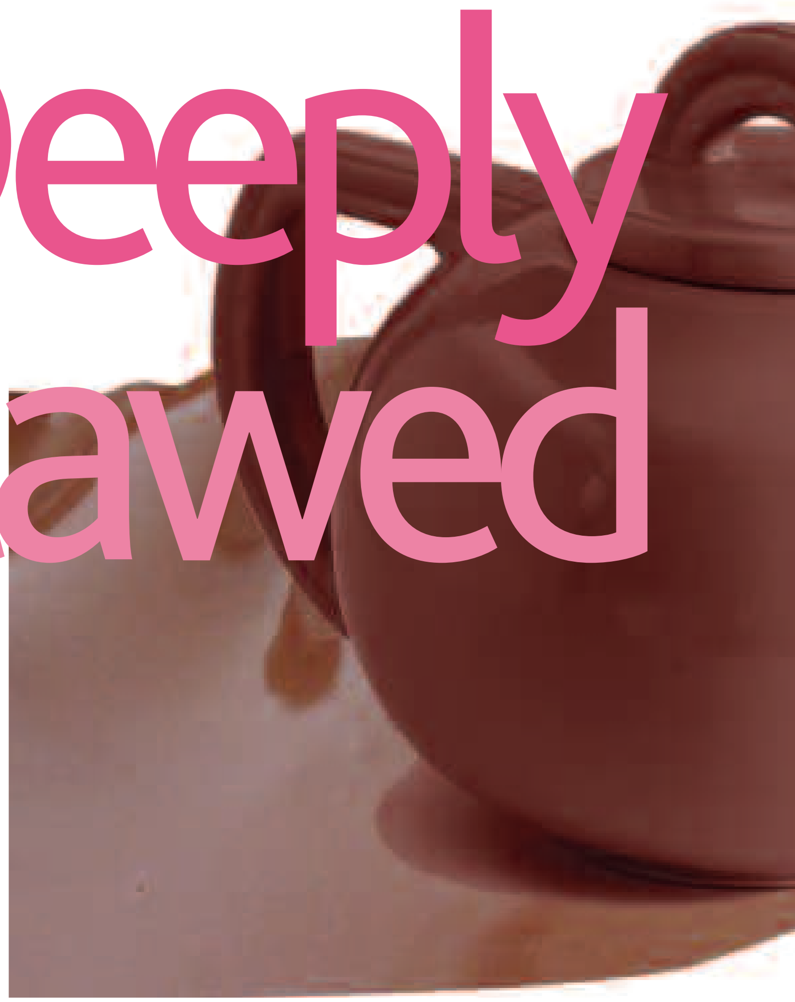
Deeply flawed



Executive summary

- Hedge accounting is a long, laborious process and time is needed both to ensure the document will satisfy the auditors and that the testing can be completed effectively.
- IAS 39 *Financial Instruments: Recognition and Measurement* is a mixed-model standard and as a result produces results which are contradictory.
- Treasurers are among a small band of people who actually understand IAS 39 accounting. This knowledge needs to widened.

Imagine an accounting standard full of inconsistencies, faults and contradictions. Imagine the difficulties that treasurers and other financial preparers would have in producing financial information in accordance with that standard. Imagine the problems that auditors, especially from the Big Four, who audit the world's major corporations, would have in finding a consistent way to approach the standard. Well, there's no need to exercise your imagination when IAS 39 *Financial Instruments: Recognition and Measurement* is in force. Talk to the preparers and auditors of financial statements and you'll be hard pressed to hear a good word for IAS 39.

Perhaps that isn't quite true. At the recent ACT conference "IAS 39: The reality – a hard or soft landing?", sponsored by Lloyds TSB Financial Markets, two points were made in its favour. First, IAS 39 doesn't represent a full fair-value model (a plus point only if you don't believe in fair value accounting, of course), and second, despite all its flaws, IAS 39 is better than its US equivalent, FAS 133 *Accounting for Derivative Instruments and Hedging Activities*, and is therefore the best standard on financial instruments in the world. But that isn't saying very much.

WHAT'S HAPPENING? Whether excoriated or endured, accounting for financial instruments under IAS 39 is happening now. At the ACT conference, Paul Wilkinson, Group Treasurer at Tomkins, tried to put the angst over IAS 39 into perspective. "It is only a rule book that reasonably bright people have to follow," he said.

At the time of the conference, in late April, the full effect of the first full reporting round for IAS 39 – the published reports and accounts for 31 December 2005 year-ends – was still awaited. However, according to Wilkinson, the jury is still out on whether the introduction of IAS 39 will have a hard or soft landing. "The standard will be ignored by lots of people provided that they can work back to the numbers pre-IAS 39," he said.

Peter Elwin, head of accounting and valuation at JPMorgan Cazenove, and one of the panellists at the conference, agreed that City analysts were pleased that the impact of IAS 39 was being stripped out. "It is helpful that companies are breaking out these fair-value movements," he said. "This is what people are encouraging them to do."

Wilkinson argued that the financial reporting system was shifting away from a traditional profit and loss-driven accounting system to balance sheet-driven fair-value accounting. The argument runs that fundamental change from a profit-based accounting to modified fair-value accounting has caused volatility in the profit and loss. So finance directors are, in essence, caught in the middle trying to deal with volatile profit and explaining the volatility both to fellow directors and to City analysts. It is an uncomfortable position and one which treasurers are often forced to share with their finance director.

THE HEDGE ACCOUNTING OPTION INTRODUCED INTO IAS 39 HAS RESULTED IN LESS COMPARABILITY AND CONSISTENCY BETWEEN ORGANISATIONS AND PERIODS, AND SIGNALLED THAT PROFIT-DRIVEN ACCOUNTING IS ALIVE AND WELL. IT IS ALSO PRACTICALLY UNWORKABLE.

TREASURERS AND ACCOUNTING EXPERTS CONTINUE TO HAVE HUGE RESERVATIONS ABOUT THE IAS 39 FINANCIAL REPORTING STANDARD. **PETER WILLIAMS** REPORTS ON THE ISSUES.

The other result of fair-value accounting is that more assets and liabilities are recognised on the balance sheet. There is a fundamental conceptual divide between fair-value accounting and profit-based accounting. You have to be on one side of the argument or another. In contrast, the hedge accounting option under IAS 39 was introduced, according to Wilkinson, to pacify the supporters of profit-based accounting.

The hedge accounting option introduced into IAS 39 has had three consequences. It has resulted in less comparability and consistency between organisations and periods; it has signalled that profit-driven accounting is alive and well; and it is also practically unworkable. Some treasurers have looked at the accounting answers for financial instruments produced under IAS 39 and found it hard to believe the results were correct.

The work for treasurers under IAS 39 seems to have fallen into two parts: first, assessing whether hedging structures were complying with the standard, and second, deciding on what was required to comply – an exercise concerned with documentation and effectiveness testing. This has not been easy, mostly because corporates lack systems. This has led to the manual input of data and discussion both within companies and with their auditors of the interpretation of the standard. It is clear that it has been a complicated and complex process.

PAPER TRAIL AND TESTING Trying to find out where hedge accounting applies requires a paper trail and much testing. Speaking at the ACT conference, David Marshall, Director of Treasury and Risk Management for John Laing, explained the impact of IAS 39 on the financials of John Laing. He said that the balance sheet had been significantly enhanced, with assets increasing by £240m and liabilities decreasing by £157m. Making those adjustments, according to Marshall, was relatively painless, taking approximately 10% each of the management time spent on IAS 39. On the other hand the income statement shrank by £100,000 as a result of IAS 39 and that adjustment took up the other 80% of management time. Marshall described the reaction to IAS 39 as a process of denial, outrage and attempted lobbying, followed by a realisation that changing the standard was a lost cause, and then working with auditors and increasing resources to produce the required results.

John Laing has interest rate, RPI and commodity swaps. Valuations for these swaps were obtained from the bank, from Reuters or the company's own internal data contained in spreadsheets. The documentation process started in 2003. The initial review by the company's auditors suggested that the documentation in the company's possession would not be adequate.

Therefore a prototype of acceptable documentation along with full testing analyses for one interest rate swap was developed and agreed with the auditors. This process, which took several months, then had to be replicated for around 200 swaps. In particular, Marshall warned that substantial documentation was required for commodity swaps.

Marshall explained that under the IAS each swap must be proved effective if hedge accounting was to be achieved. To do that the swap is compared with a "perfect" swap to generate an ineffectiveness percentage. Percentage effectiveness must be between 80% and 125% to achieve hedge accounting; otherwise all movements have to go through the profit and loss account. John Laing's swaps were in the 98%-108% range.

As a result of IAS 39, John Laing has implemented new procedures with IAS 39 documentation required for swaps on the day trading, and when projects are refinanced the documentation is reviewed to ensure that any changes do not unwittingly upset the hedge accounting in place. Marshall called the regime "draconian".

Of the 200 swaps, one error was found in the documentation during the course of the audit, which meant it failed the IAS 39 test. In the end no adjustment was needed as it was below the materiality level. "Auditors are now referees with no true and fair override," said Marshall. "100% accuracy is required. 99.5% is not good enough."

He also noted another side effect: finance professionals divided between those who understood IAS 39 and the rest, with treasurers doing the accounting on IAS 39. Marshall argued that knowledge of IAS 39 had to be passed onto all staff.

Despite all the work, he questioned the value of the standard, suggesting that a time-consuming and costly exercise produced a complex set of results for which shareholders had little use. The Big Four audit firms are also reportedly taking different approaches to the standard. Given that this is the first year of implementation, that is probably not surprising.

An auditor, Ken Wild, chaired the conference. He is Deloitte's National Director of Assurance and Advisory Services in the UK and a member of the International Accounting Standards Board's International Financial Reporting Interpretations Committee. Despite his ties with the IASB and IFRIC, he cheerfully admitted that IAS 39 was one flawed standard. But as IAS 39 was a mixed model rather than a full fair-value model – and Wild said he preferred the mixed model – he believed many of those inconsistencies were bound to arise as the standard was inherently contradictory.

The IASB has made clear its determination to improve accounting for financial instruments. As neither side of the conceptual accounting debate is likely to be reconciled to IAS 39 mark II by rewriting, redrafting or more flexible hedge accounting options, then it is unclear exactly what direction a revised standard will take. In the meantime, treasurers remain heavily involved in picking up the IAS 39 pieces.

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