talking treasury

talkingtreasury

CONFERENCE REPORT

Thursday 23 March 2006, Prague

Thought leadership on:

- Treasury Best Practice
- SEPA
- IFRS

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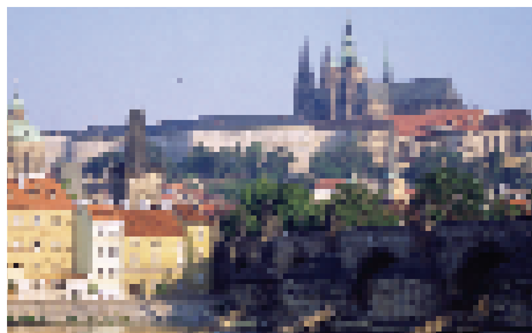
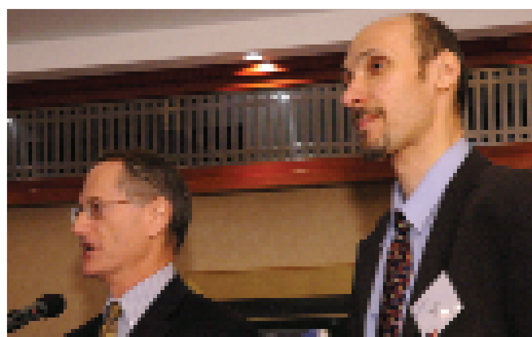


Richard Raeburn, John McAnulty



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Technical Director, ACT

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Introduction

On 23 March 2006 the treasury associations of the United Kingdom and the Czech Republic welcomed eighty treasurers from across Europe to Prague for the inaugural *talkingtreasury* forum. This provided participants with a chance to reflect together on how some of the major issues we face impact our strategies and objectives and to draw on the experience and knowledge of other treasurers.

The format of *talkingtreasury*, with its emphasis on panel and audience discussion, encouraged participation and helped focus on the key issues that matter to treasurers. We have published this report in order to provide a record of the debate and have supplemented it with further material where this contributes to an understanding of the topic. Cross references to other useful and related information sources are also provided to take the benefits of *talkingtreasury* beyond that of the more usual commercial conference.

The subject matters ranged from comparing and learning from treasury best practice, understanding the impact of IFRS and dealing with the implications of the likely future shape of payments in Europe. The common denominator was change; the ability of us all to embrace change which is a key driver of the added value we know is expected of treasury professionals.

Treasury associations are best placed to lead in the identification of the issues that matter most to all our members; the EACT (the European Associations of Corporate Treasurers), of which the ACT and the CAT are members, welcomes the *talkingtreasury* initiative. The country treasury associations that make up the EACT work actively together across Europe to ensure that the concerns of the corporate sector, especially as users of the financial markets, are properly taken into account in the development of regulatory, legal and best practice frameworks, particularly where these involve the EU.

We intend to build on the success of *talkingtreasury*, Prague by holding another forum in Amsterdam towards the end of 2006 and look forward to a further gathering of leading practitioners.

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Defining best practice in treasury

Chairman
David Blackwood, Group Treasurer, ICI

Panelists
Udo Giegerich, Senior Vice President – Group Treasury OMV
Georg Lambertz, Group Treasurer, RWE AG
Bjorn Carlbom, Head of Consulting Group, Phillips
Zdenek Radil, Chief Risk Officer, Czech Telecom

Different companies will inevitably adopt different approaches to running their treasury departments, but it must be accepted that, irrespective of the detailed operational methods selected, all treasury management needs to be aligned with the overall business objectives of the company – and what shareholders want. It is easy to devise an overriding purpose for the treasury policy such as 'ensuring continuity of funding availability' or 'managing financial risk' but such statements will need to be refined and set into a framework that starts with an overall objective. The priorities that might be set by the board could include:

- ensuring sufficient funding to meet the business plan cash flows;
- achieving lowest interest cost/least volatile interest cost;
- achieving highest eps/least volatile eps (earnings per share);
- protecting against breach of loan covenants; and
- maintaining target credit rating or key ratio, e.g. debt/EBITDA.

To achieve the agreed objectives, something more precise is needed to set down how these are to be met. This is the role of policies and strategies.

The basis for establishing core policies at ICI takes into account:

- balance sheet and rating;
- currency – transaction/asset/liability matching;
- operational risk transfer (insurance);
- interest rates;
- liquidity; and
- pensions – asset/liability matching.

The delegates at *talkingtreasury*, despite being from 16 different European countries, found that, in terms of treasury practice, there were many areas of common interest. For example, Czech Telecom's treasury and its issues were not dissimilar to those found in Western Europe; and their progression from local cash pooling back in 1996 to a wider cross border arrangement now was not surprising. Their biggest issue at the moment was hedge accounting principles – so, nothing different there either.

Treasury policy

OMV, the gas company, and Austria's largest listed company has devoted attention to creating the right framework for a coherent treasury mission and vision.

Its Group Treasury is the central treasury and risk management function for the group with responsibility for:

- defining the treasury and risk management policy;
- managing external debt and equity funding;
- optimising liquidity management and providing cash management services for group companies;
- providing asset and pension fund management;
- risk management; and
- insurance management.

The OMV website includes a section on their financial risk management (as shown) which could well be used as a textbook for a logical approach to the different areas within the scope of treasury.

Extract from OMV website: interest rate risk management

To manage interest rate risk, OMV monitors and evaluates the profile of its fixed income portfolio in terms of fixed and variable interest rates, currencies and maturities. Based on this evaluation, OMV has defined certain thresholds as well as a band and potentially uses derivative instruments in order to comply. The thresholds are:

- Fix/floating 50:50
- Currency mix 80% EUR, 20% USD
- Maturity: average of more than 6 years
- Cap on debt due within 12 months with a maximum of EUR 50m uncovered by committed lines.

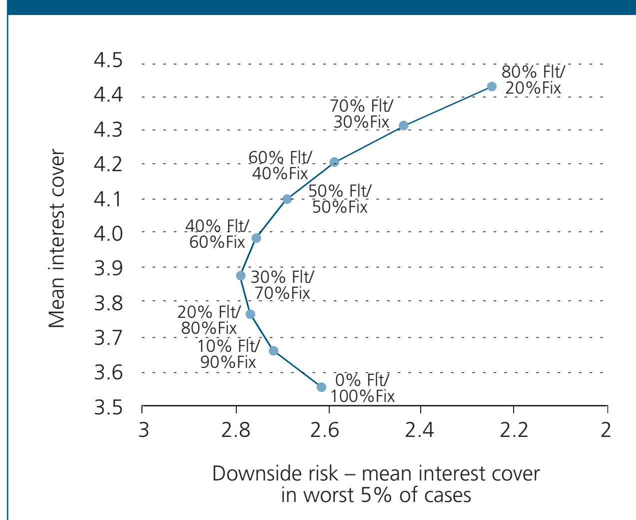
One approach to setting treasury policies, used by another company, is financial modelling and Monte-Carlo simulation applied to the whole business. The business plan is rebuilt to include all its economic dependencies including currency rates, interest rates, inflation rates and economic activity such as GDP. For any particular capital structure, with debt made up of fixed or floating, and a currency mix of debt, the plan model is run against a number of scenarios, typically for 1000 different runs. Normally, the creation of the scenarios is outsourced.

For each of the scenarios, the key ratios are calculated to determine how the business performs. For example, eps may be the most important indicator, or debt/EBITDA for a company nearing its debt covenant limits. The average outcome of all the scenarios can be plotted against the worst case downside, where the risk or downside may be defined as the mean of the worst 5% of outcomes. The entire process is then repeated with a different debt or capital or currency structure, and another plot of average outcome versus worst case is created.

This simulation builds up an efficient frontier of outcomes. In Figure 1, the fixed/floating rate mix of debt is being tested to see which performs best in terms of generating interest cover numbers. Moving from no floating rate debt up to 30% floating rate gives an improved interest cover and an improved riskiness as measured by the worst 5% case. Therefore, moving up to 30% floating is definitely beneficial. (Note that the direction of the variable on the x-axis is such that 'better' is to the left.) Increasing the proportion of floating rate debt above 30% increases the interest cover, but also increases the downside risk. Going from 30% to 40% gives a big step up in interest cover with only a very small change in riskiness so it is well worth doing; but going from 70% to 80%, although it improves interest cover, triggers a very marked increase in riskiness, so this might not be worth doing. The optimum point probably lies between 60% and 70%, but some judgement or resort to further analysis of the effects on other financial ratios would be advisable.

This modelling technique is a sophisticated form of sensitivity analysis. One company that makes a great play of using sensitivities is Bayer although they acknowledge that there are limitations in their approach.

Figure 1 *Varying the fixed/floating weighting (mean v mean of worst 5%)*



> **Extract from Bayer 20F**
>
> Sensitivity analysis is a widely used risk measurement tool that allows our management to make judgements regarding the potential loss in future earnings, fair values or cash flows of market risk sensitive instruments resulting from one or more selected hypothetical changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates or prices over a selected period of time. We use sensitivity analysis because it provides reasonable risk estimates using straightforward assumptions (for example, an increase in interest rates).

Banking relationships

For OMV, their banking relationships – with a well-defined group of 19 core banks – were important. Stimulated by comments from the delegates, the nature of bank relationships were explored, especially in terms of the possible conflict of interests when a relationship bank also acts for an acquisition bidder. Expectations as to the strength of relationships in times of stress were not high. It is hard to complain about fickle banks when corporates certainly will not make any promises about guaranteed future business. Banks have a duty to their own shareholders to optimise commercial returns and, in a bid situation, are likely to side with the party whose remuneration stream the bank feels is the more secure.

For RWE, having gained a credit rating, keeping the rating agencies informed about what is going on in their industry and company is an important relationship. The process of gaining a rating offered a twin benefit: the obvious one of assisting access to debt markets plus the added benefit of learning better about one's own organisation.

Currency hedging

Currency hedging must be a core part of any treasury operation and Philips had taken an approach which allowed for maximum automation. With 1,000 or more reporting units, their old set-up relied on businesses going through local approval procedures and sending in deal requests by fax to the centre where external dealing, one on one, could be done and the hedge reflected back to the unit. A vast number of steps were required and much paperwork was generated. After a complete revamp in 2002, Philips are now highly automated and all work is on an STP (straight through processing) basis. Exposures and forecast cash flows are now captured at the local units and transmitted to the centre via the web. Note the terminology here. Previously, it was buy/sell requests. Now, the nature of the exposure must be given. Exposures are accumulated and net external deals done using forwards. Committed exposures are 100% hedged, anticipated exposures six months out are hedged 30-50% and those at three months are moved up to a maximum of 70% cover. The percentages depend on the unit and the nature of the exposures and are not discretionary, so that the dealing needs can be fully automated.

Since such a net deal will not qualify for hedge accounting purposes, the FX banks are given the breakdown of amounts that make up the net deal. They then issue deal confirmations for the underlying component buy and sell deals as if dealt one on one. The centre transacts the corresponding internal back-to-back deals with the operating units. Thus, exposures are both identified and hedged at the business unit level, but the accounting entries are determined centrally.

Among the treasury audience in Prague, there was a strong feeing that it is impossible consistently to beat the market. So, treasury should have an approach to currencies that is totally non speculative and includes little room for any discretion. Forwards were the preferred hedging instrument, with options rarely being used.

Bayer does hedge transaction risk so that "a significant increase or decrease in the exchange rate of the euro relative to other major world currencies would not, in the short term, materially affect our future cash flows. Over time, however, to the extent that we cannot reflect these exchange rate movements in the pricing of our products in local currency, they could harm our cash flows." This states the nub of any hedging activity: its limited ability to provide permanent protection against rate moves. Inevitably, the hedging will only be smoothing out fluctuations; it cannot buck the long-term trend. If there is a permanent adverse shift in exchange rates, then delaying its impact is helpful in itself and, in addition, gives time for the company to protect itself by altering the fundamentals of its business with regard to purchasing policy, plant location, etc.

Other approaches to currency hedging

- OMV looks at the impact of currency fluctuations on cash flow and earnings over a one-year budget period.
- Rolls Royce has a substantial exposure to the US dollar; it has a policy to maintain relatively stable long-term foreign exchange rates and uses a variety of instruments to achieve this. "The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates. Forward cover is in the form of standard foreign exchange contracts and instruments on which the exchange rates achieved are dependent on future interest rates. The Group may also write currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate."
- By complete contrast, the UK company, Pearson, states that its "policy on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remains that these should be completed at the relevant spot exchange rate."

Most treasurers will agree that speculation on currencies is not acceptable; however, defining what constitutes speculation is not easy. Another way of expressing the same sentiment is to say that it is not the job of treasury to take a view on rates; but, for some, that might be to miss an opportunity. Techniques exist to introduce a controlled element of management of the rates achieved. Covering all exposures one year forward merely gives a year's delay to any exchange rate changes. Layering in hedges as done by Philips will smooth out fluctuations better and allows for the increased uncertainty of cash flows that are further into the future. On top of that, a degree of discretion or the use of options could be added, adjusting between using options or forwards, depending on the apparent over- or under-valuation of the currency. BMW, for example, uses an advanced methodology which involves using a currency valuation model to adjust the structure of its currency hedges.

Bjorn Carlbom, Georg Lambertz

Use of efficient frontier analysis
www.treasurers.org/thetreasurer/resources/2005/03/Mar05TTHennebry30-33.pdf

Getting the hedge tenor right
www.treasurers.org/thetreasurer/resources/2003/05/May03TTHirigoyen43-45.pdf

Layering FX hedges
www.treasurers.org/thetreasurer/resources/2004/10/19-21_Hirigoyen_Oct04.pdf

Use of options
www.treasurers.org/thetreasurer/resources/2004/12/34-37_Spot_Hirigoyen.pdf

Bayer: Quantitative and Qualitative Disclosures about Market Risk
www.investor.bayer.com/docroot/_files/berichte1032356037/form20-f1032522309/form20f2005filedmarch620061141670356.pdf and go to page 146

OMV risk management
www.omv.com/smgr/portal/jsp/index.jsp?p_site=AT and go to investor relations, risk management, financial risk management

The scope of treasury policy
www.treasurers.org/bookshop/resources/handbook06/treaspolicy05.pdf

Getting the most from the Single Euro Payments Area (SEPA) and the Payment Directive

Chairman
Maurice Cleaves, SVP & Regional Executive, Treasury Services Division, JPMorgan

Panelists
Bjorn Carlbom, Head of Consulting Group, Philips
Ulrika Carlsson, Director of EMEA Treasury, Cisco Systems
Gerard Hartsink, Chairman, European Payments Council
Vincent Herlicq, Treasurer, AGF Group

The Single Euro Payments Area (SEPA) project is possibly the biggest, most wide-ranging and most fundamental development in European cash management since Y2K combined with the introduction of the Euro. Once implemented, it should offer significant efficiencies in payment processing in Europe, not only in the raw per transaction charge, but also in the customer's all-in cost of paying or receiving funds. Yet, although banks in Europe are dedicating substantial time and effort to making this happen, their customers seem to be somewhat more ambivalent with (according to JPMorgan's research) only some 40% of bank customers actively reviewing their business practices now. Why should this be? Has the European Commission, in issuing the Payment Directive, misread the market in blind pursuit of an ideal? Or are customers about to miss a golden opportunity to get in on the ground floor of a fresh opportunity to enhance competitiveness?

It was a privilege to have Gerard Hartsink, Chair of the European Payments Council (EPC), explain the importance of achieving the planned 2008 initial start date for early adopters and the 2010 stage of reaching a critical mass of users. Equally valuable was the presentation by JPMorgan's Maurice Cleaves, outlining some of the potential benefits from the project.

The EPC is the group of banks working to implement SEPA in response to the EU's Lisbon Agenda, and is backed by the European Central Bank's (ECB's) endorsement of a "euro area in which all payments are domestic, where the current differentiation between national and cross-border payments no longer exists". Gerard pointed out that, although the headline focus was on high volume/low value payments (SEPA Credit Transfers and Direct Debits), the project extended to a single euro cash area (SECA) and a single euro credit card area (SEPA cards). He also made the point that since these were the major commercial cash collection and remittance tools, it was of paramount importance that banks' customers generally were involved in the SEPA build, and that the EPC would welcome their input.

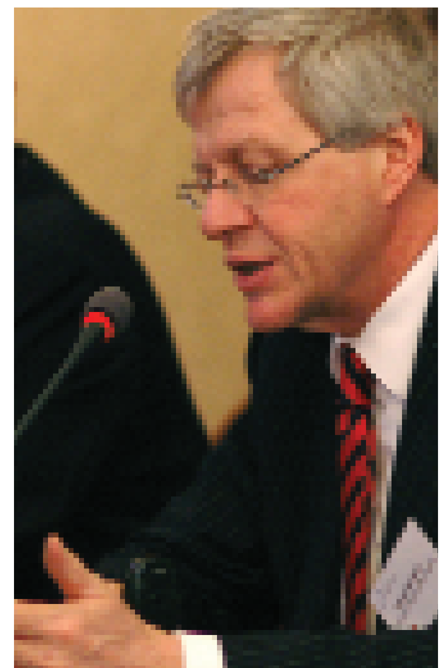
What should SEPA mean for the customer? In practical terms, the key deliverable from SEPA is that, for a business transacting Euro in Europe, it should simply be indifferent as to where payments or receipts were made. There would no longer be a need to establish the workarounds in systems, payment or receipt mechanisms, or bank or account selection, which are commonplace today. Instead, there would be a unified framework so that whatever works in one country will work overall; and there will be no barriers to managing cash across the entire area. Furthermore, once the common

The Payments Directive

The draft directive, also known as the New Legal Framework, has been published by the European Commission and is now going through the European Parliament. It aims to harmonise the legal framework for payments made anywhere in Europe and **in any currency**.

For payments less than Euro 50,000 or equivalent (but this might change), here are some of the significant points:

- Electronic credits or direct debits must be made at latest for value the day following the bank's acceptance of the instruction.
- Payments must be made in full with no deductions for charges – which therefore must be made separately.
- Banks must not take any float period, i.e. holding on to funds before giving good value – so banks will be obliged to give remitter and beneficiary the same value date.
- Payments will be made by reference solely to the account number (IBAN), i.e. this takes precedence over payee name.
- If the IBAN is correct then the bank is responsible for defective execution of a payment instruction and will be liable for any charges and interest of the customer.
- Refunds on direct debits must be requested within 4 weeks of payer receiving notification of payment. (This may be changed.)



Gerard Hartsink

SEPA credit transfer and direct debits

The SEPA schemes are being devised by the European Payments Council and are effectively a market-led initiative albeit prompted by the European Commission and European Central Bank. Here are some of the principal features:

- SEPA applies only to **electronic payments in Euros**.
- The scheme rules govern the narrow inter-bank payments arena. Although customer offerings will conform to this, banks may provide value added services.
- Credit transfers must arrive at the beneficiary bank by D+2 and must be available to the customer no later than D+3 where D is the day that the remitting bank accepts the payment instruction from the customer.
- Customer remittance data of up to 140 characters must be transmitted with the payment.
- Payments are to be made based on BIC and IBAN. There is no required check for any discrepancies with beneficiary name although beneficiary bank may delay payment if aware of any discrepancy.
- Logically incorrect, incomplete or incorrectly formatted payment messages will be rejected or made subject to repair charges.
- Direct Debit mandates are held by the creditor and sent in dematerialised form by the creditor bank to the paying bank with the first collection request and in the time window of D-14 calendar days to D-7. (Mandate procedures may change and in addition a new business to business scheme will be published in Autumn 2006.)
- Requests for direct debit refunds will only be allowed for up to 6 weeks from the payment.
- Unauthorised payments may be reclaimed for up to one year from the debit date.
- Pre-notification of payments are to be sent by the creditor to the debtor no later than 14 calendar days before due date.
- Early adopters will go live in January 2008 and full critical mass is expected by 2010.

framework was established, companies had the opportunity to rationalise their systems, knowing that what would work in existing markets would work in new ones.

What might be the efficiencies?

The European Commission in its proposed Payments Directive, or New Legal Framework, has set out benchmarks for value dating and pricing which would reduce the headline cost of paying and receiving cross-border, and eliminate bank float. So, the headline cost of transacting under SEPA would fall. However, not only do banks have their margins to maintain, but they are also being asked to make substantially all the up front investment in SEPA; so it would be unreasonable to assume that they would simply take the hit. Banks would likely increase their charges in other areas to compensate – but at least these should be visible (negotiable?) tariff charges rather than hidden gains arising from value dating or float.

However, there is an increasing appreciation among banks that transaction processing is a commodity. It is therefore appropriate that it should be subject to commodity pricing, and also appropriate that the processing itself should be done as efficiently as possible. SEPA reinforces and supports this point. To maintain profitability, therefore, banks have to look at providing creative, value-added services; and if corporates contribute to their development then the probability of such services succeeding in adding value should be substantially improved. Banks such as JPMorgan (the sponsor of the *talkingtreasury* forum) are clearly taking a positive approach and are viewing the new payments process as an opportunity to build value-added services for customers.

JPMorgan sees SEPA as part of a once-in-a-generation step change, linking it to a harmonisation of infrastructures and possibilities for e-invoicing. SEPA should give corporates a real opportunity to make efficiencies by streamlining systems. With a unified commercial payment and receipt infrastructure across Europe, only one interface needs to be designed between the corporate and its banks locally, rather than the country-specific interfaces that exist today. So, procedures can be rationalised, giving opportunities for more efficient system and database administration, data and payment processing, improved control, and a reduced error rate. ERP systems really can be 'enterprise-wide', and true straight-through processing should come a step nearer. The Treasury Industry's Transaction Workflow Innovation Standards Team (TWIST) initiative is looking at exactly this last point, to investigate how the corporate user can derive most from the SEPA-standard and similar interfaces.

Furthermore, Gerard reminded the session that the EPC is aiming to reduce the degree to which cash is used in Europe. Most would agree that despite its flexibility, cash is expensive to handle and inherently insecure. The SEPA initiative should, in the long run, enable cash-dependent businesses to gain efficiencies as the market encourages customers (and perhaps suppliers) to use more efficient electronic remittances.

What could go wrong?

At the most fundamental level, Gerard and the project team are confident that SEPA can be delivered on time, and that it will work. However, unless customers use it, the full benefits will not be realised.

Ulrika Carlson and Vincent Herlicq

There is a real risk that, like SWIFT 'standards', SEPA standards become open to interpretation at the customer/bank interface. For an organisation that wishes to take advantage of SEPA's efficiencies, this could mean that it becomes either more difficult to do so as numerous interfaces still have to be written from the ERP system to each bank locally; or that it is more difficult to move business due to the need to rewrite interfaces. Practitioners already recognise that multiple standards are a hindrance to corporate automation, and it is important that SEPA succeeds in achieving standardisation rather than further fragmentation.

SEPA is being led by the EPC. Although Gerard was at pains to point out that the end-user was encouraged to contribute to the design, it remains true that SEPA is being designed and led by banks. Unless customers make an active contribution to the debate (as the ACT and EACT among others are now doing), SEPA risks being substantially for the banks' convenience and of little use to the corporate customer. We should note that the EPC is involving 'public administrations' in the debate – but the needs of fiscal authorities and state-owned utilities are not necessarily correlated with those of the mainstream corporate community.

As far as the success of SEPA goes, there is a real risk of corporate apathy. By definition, businesses already have appropriate payment and receipt mechanisms in place in Europe, and the underlying infrastructures are set to remain in existence. Until SEPA is up and running, it is hard to perform a meaningful analysis to evaluate the costs and benefits of changing from existing systems. And "if it isn't broken, don't fix it". But there is a Catch-22 here: unless corporates invest time and effort now, there is far less chance that SEPA will work for them; but, until SEPA is in place, they will not know what it is capable of for sure. Meanwhile, on a day-to-day basis, corporates are dealing with more pressing issues than an apparently remote SEPA.

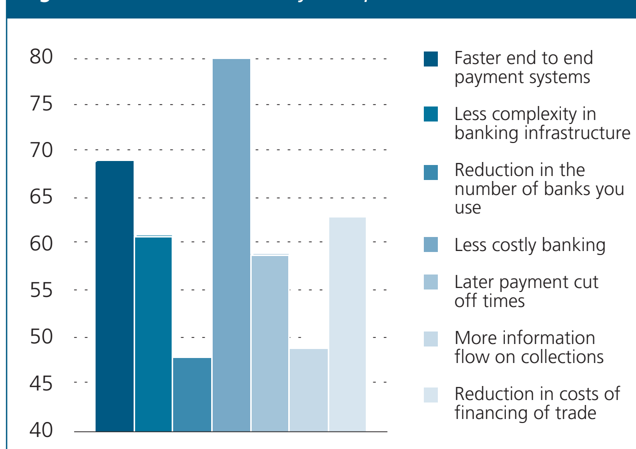
SEPA will, of course, only apply to Euro settlements in Europe. So, transactions in other currencies or domiciles will not be affected. It remains to be seen whether this will be a serious limitation on SEPA's usefulness, particularly on systems, interfaces and procedures. If using SEPA means tacking on yet another interface without dismantling others then this would erode the benefits, perhaps significantly. Alternatively, one could speculate that the payment schemes for other currencies in common use may, over time, tend to change to follow the SEPA specifications for Euro payments.

There was some debate over the potential EUR 50,000 cap in the Payments Directive which would mean that many corporate payments would not benefit from the mandatory rules on matters like charges, value dating and time cycles. Gerard confirmed that it seems likely that this will be relaxed and, in any case, the rules within the SEPA credit transfer and direct debit schemes would not include any cap – although it would have to allow some sort of differentiation on the protection for retail customers.

Next steps

- The EPC will be producing a comprehensive communication to explain SEPA in June, but, in the meantime, the ECB's 4th progress report provides a good briefing. The weblink is given below.
- Corporates and corporate treasury associations must maintain the dialogue with the EPC, to maximise the potential benefits of SEPA for users as well as the banks.
- Corporates should benchmark their current payment and receipt processes in the SEPA area on an all-in costed basis, and consider how these might be affected post-SEPA. They should also consider whether there are aspects of the SEPA design either which they require, or which mitigate against their taking advantage of the new infrastructure, and lobby for these either directly to the EPC or via their treasury association and the EACT. Further details of what corporates need to be doing to prepare for SEPA are in the article on page13.

Figure 1 *What benefits do you expect to derive from SEPA?*



ECB: Towards a Single Euro Payments Area – 4th progress report
www.ecb.int/pub/pdf/other/singleeuropaymentsarea200602en.pdf

SEPA ask the experts, Jan/Feb 2006 *The Treasurer*
www.treasurers.org/thetreasurer/resources/2006/01-02/janfeb06ttask10.pdf

McKinsey report on the profitability of payments in Europe and the potential effects from SEPA
www.mckinsey.com/clientservice/bankingsecurities/latestthinking/PP2_European_Payment_Profit_Pool_Analysis_Final.pdf

European Payments Council
www.europeanpaymentscouncil.org

How companies in Europe are responding to the implementation of IFRS

Chairman
John Grout, Technical Director, ACT

Panelists
Francoise Flores, IFRS Technical Advisor, EFRAG (European Financial Reporting Advisory Group)
Mark Kirkland, Global Head of Financial Risk and Cash Services, Philips Electronics

Adoption of IFRS, whether mandatory (for listed companies in the EU), voluntary or via the transition of local GAAP to IFRS, remains an issue that treasurers cannot escape. While the practicalities of implementation naturally exercise the time (and patience) of treasurers, delegates at *talkingtreasury* were challenged by the chairman to consider some of the broader aspects:

- Should entities pursue their economic interest, with accounting being a secondary issue?
- Given that the new accounting did not always reflect the economic substance of a transaction, should companies alter the economics of their behaviour in order to obtain the desired accounting treatment?
- Had the expected additional earnings volatility materialised? Was communication with investors proving manageable?
- With a timetable laid out for convergence with the US, is a move from a principles-based to a rules-based approach more likely? Was this of concern, given that people had already become familiar with IAS 39, which was largely rules-based?
- IAS 39 has seemed to be the main area of interest for treasurers; however, it is by no means the only area of IFRS implementation with which treasurers need to be familiar. The impact of other standards, notably IFRS 2 and IFRS 7 – and IASs 21, 27, 28, 31 and 32 – also need to be understood. For example, was the presentation of the cashflow statement under IAS 7 appropriate, specifically given the fact that there is no reconciliation to net debt?

Remaining IAS 39 issues: Philips

For Philips, which has reported under US GAAP for a number of years and has therefore developed considerable hedging expertise, the requirements of IAS 39 were less of a surprise but still presented significant challenges. Mark Kirkland explained how Philips manages its subsidiary transactional exposures in accordance with the Group's global FX policy. Subsidiaries are obliged to apply cashflow hedge accounting to all significant hedges; however, their responsibility was limited to identification of the exposures, with the hedging, documentation and accounting coordinated centrally, thereby eliminating errors at the subsidiary level and focusing expertise in one place. Indeed, the accounting could be automated and journals produced in shared service centres.

Despite achieving a satisfactory solution with respect to these exposures, Philips still faced a number of issues with respect to IAS 39 implementation which would be greatly aided by three amendments to the standard:

- The removal of the 80-125% effectiveness testing requirements. Any ineffectiveness currently impacts the P&L, a situation which would continue to be the case should the rule be removed. Furthermore, the fact that a hedge which is 80% effective is permitted while one that is 79% effective ceases completely to qualify as a hedge has no logic (80% just being an arbitrary figure). For example, a chocolate manufacturer may use cocoa futures to hedge physical purchases. The cocoa future may not provide an exact match against the type and quality of cocoa beans actually purchased and is therefore unlikely to fulfil the required effectiveness criteria, but the company will know this in advance and would still deem it as economically the correct hedge in the circumstances.
- For combinations of derivatives and non-derivatives to be permitted to be classified as hedged items, it being inconsistent that, when the two are economically identical, a fixed rate $ bond has a different accounting treatment to a Euro bond swapped into fixed rate $ borrowings. Emphasising the departure from economic

Francoise Flores

Extract from Cadbury Schweppes 2005 report and accounts re FX hedging

We seek to apply IAS 39 hedge accounting to hedge relationships (principally under commodity contracts, foreign exchange forward contracts and interest rate swaps) where it is permissible, practical to do so and reduces overall volatility.

Due to the nature of our hedging arrangements, in a number of circumstances, we are unable to obtain hedge accounting. We continue, however, to enter into these arrangements as they provide certainty of price and delivery for the commodities we purchase, the exchange rates applying to the foreign currency transactions we enter into and the interest rate that apply to our debt. These arrangements result in fixed and determined cash flows. We believe that these arrangements remain effective economic and commercial hedges.

The effect of not applying hedge accounting under IAS 39 means that the reported results reflect the actual rate of exchange and commodity price ruling on the date of a transaction regardless of the cash flow paid at the predetermined rate of exchange and commodity price. In addition, any gain or loss accruing on open contracts at a reporting period end is recognised in the result for the period (regardless of the actual outcome of the contract on close-out).

Whilst the impacts described above could be highly volatile depending on movements in exchange rates or commodity prices, this volatility will not be reflected in our cash flows, which will be based on the fixed or hedged rate. Therefore we make an adjustment to exclude these effects from our underlying performance measures.

sense, Philips had been obliged to borrow inefficiently so as to obtain the accounting presentation expected by the market.

- For hedge accounting to be made available for hedges of net positions, thereby removing the current requirement to enter into numerous contrived trades with banks which do not reflect the commercial and economic reality of the arrangements (i.e. that full treasury centre netting be permitted, reflecting the realities of how corporates aggregate and lay off exposures).

Remaining IAS 39 issues: views from the forum

Treasurers may ask themselves what they can do to influence the debate and, with this in mind, Mark Kirkland offered delegates an insight into the workings of the IASB's Financial Instruments Working Group, of which he is a member. The Working Group may have been formed with the best of intentions, however a feeling of frustration with the lack of progress and participation in ‘theoretical debates’ prompted some of the group’s members to request, and to hold, a meeting with Sir David Tweedie. It was clear that tinkering with IAS 39 to rectify one-off anomalies was not on the official agenda, but rather that the Working Group should be setting overall guidelines for an eventual complete review of the standard.

Those on the Working Group representing corporates had a brief to represent wider corporate views, and not just those of specific relevance to their own companies. With this in mind, participants at *talkingtreasury* were given the opportunity to identify IAS 39 issues of concern to them, with a vote to be taken to rank the issues by importance, thereby giving the IASB Working Group valuable guidance on where to direct their energies. While this provided an excellent opportunity to provide feedback which would perhaps go some way to influencing the debate, treasurers were encouraged to raise their concerns with such groups on an ongoing basis to ensure that issues of concern to them could be aired in the appropriate forum. During the summer of 2005, the ACT assisted in this process by canvassing its members’ views; these were summarised in a submission to the Working Group and may be viewed on the ACT’s website (link provided below).

Unsurprisingly, the wider debate on IFRS at *talkingtreasury* remained on the familiar ground of IAS 39, evidencing the fact that it remains the primary issue for treasurers with respect to IFRS implementation. A common theme of treasurer’s concerns is the fact that the standard permits economically identical transactions to be accounted for in different ways; this, in addition to being illogical, may more seriously be misleading to users of accounts. Common concerns of treasurers were:

- Difficulties in applying hedge accounting for commodity portfolio risk: one delegate stated that this gave rise to a need to shorten the time horizon of their hedges, thereby prejudicing what had been deemed the correct economic decision, and changing the hedging activity.
- Difficulties in obtaining hedge accounting on index-linked swaps: the difficulty in obtaining hedge accounting for vanilla debt plus an index-linked swap could give rise to a different accounting treatment from that for the economically identical issue of index linked debt.
- A desire to improve the application guidance on embedded derivatives: the guidance allows for contractual clauses specifying a third currency that is commonly used in such transactions to be deemed as closely related to the host contract and therefore not needing a separate valuation. However, the view was expressed that demonstrating this could prove difficult and that, consequently, some embedded derivatives were having to be valued separately.
- Net investment hedging capacity being restricted to book values, with no regard to the economic values being hedged: while a company might wish to carry debt in a foreign currency relative to the economic exposure of holding assets in that currency, the historical book value of those foreign currency net assets may mean that there is not the capacity to successfully hedge account for the desired level of debt, in which case an economically

Issue identified by *talkingtreasury*	Identified as main priority?	Important?
80-125% effectiveness testing	A few	100%
Hedge of combinations including derivatives	20	100%
Treasury centre netting	15	75%
Split of risk associated with hedges of commodities	1	100% of those impacted
Embedded derivatives and currencies	A few	50%
Hedges involving index linked debt instruments	1	100% of those impacted
Hedging of internal current accounts with subsidiaries	0	10%
Limiting hedging capacity to book, not market, value	1	20%

appropriate hedge would give rise to volatility in the Group P&L.

- Hedge accounting for current accounts between Group companies to reflect the economics of the arrangements: some corporates are still getting to grips with how net investment hedging under IAS 39 and accounting under IAS 21 interact and the current situation is generally unsatisfactory. IAS 21 covers any company entering into transactions in foreign currency, or which has foreign currency denominated subsidiaries with intra-group balances. When internal monetary balances satisfy certain criteria, they are deemed as forming part of the net investment in the foreign operation and any currency gains and losses are accounted for in Group equity. The rules with respect to this were clarified in an amendment issued by the IASB on 15 December 2005 (clarifying that the treatment also applied to monetary balances between subsidiaries and extending it to items denominated in a currency other than that of either of the parties). Adoption by the EC was recommended by EFRAG (European Financial Reporting Advisory Group) on 13 February 2006, however adoption by the EC is still pending.

A straw poll was conducted to determine first whether each of these issues was the main priority facing the delegates, and second whether, while perhaps not being the main issue, it was still of importance. The results are summarised in the table above.

The problems associated with the 80-125% hedge effectiveness rule and the hedging of derivative combinations attracted almost unanimous support, with the problems encountered with treasury centre netting and embedded derivatives also attracting the sympathy of delegates. The other issues were identified as being more specialised, but were deemed important to those delegates directly impacted.

EFRAG

EFRAG is involved in the process of European adoption of amendments to IAS 21 as mentioned above. EFRAG was created by the main parties interested in financial reporting in Europe, namely the users, the preparers and the accountancy profession, (supported by the national standard setters). It applies consistent endorsement criteria in exercising its role in advising the European Commission prior to European adoption of each new accounting standard. The first two of these (‘true and fair view’ and the requirement to be ‘understandable, relevant, reliable and comparable’) are both familiar concepts to many finance professionals. However, the third (‘European public good’) is a little less familiar.

The European endorsement procedure can take up to six months from the date on which the IASB approves a standard or amendment to the date on which it is endorsed by the EU. EFRAG will scrutinise any document prior to issuing its recommendation to the EC, and EFRAG’s involvement in the EU’s partial adoption of IAS 39 will be familiar to many treasurers. EFRAG may not be particularly well known but, for anyone with an interest in watching the evolution of accounting rules in Europe, its activity is crucial. Their critiques of all new standards are first class assessments by acknowledged experts – experts who are not lost in theoretical ideals but are firmly grounded on the practicalities and realities for users.

IAS 39 implementation experiences reported by ACT members
www.treasurers.org/technical/papers/resources/ias39financialinstruments.pdf

ACT Briefing Note: Communication with lenders about IFRS (Feb 2005), including a Summary of major difference between IFRS and previous UKGAAP
www.treasurers.org/technical/papers/resources/ifrs_guidanceactfeb05.pdf

FX options and accounting
www.treasurers.org/thetreasurer/resources/2005/12/Dec05TTSela36-38.pdf

IFRS changes that can affect treasury operations and reporting (but note that the IAS21 on funding loans has since been amended)
www.treasurers.org/thetreasurer/resources/2005/06/Jun05TTBRUCEUMBRICHT24-26.pdf

Example of EFRAG discussion paper
"Achieving consistent application of IFRS in the EU" (July 2005)
www.efrag.org/doc/4289_050727AchievingconsistentapplicationofIFRSintheEU.doc

SEPA – what should a corporate do?

Brendan Reilly
JPMorgan Treasury Services

As Europe moves towards a Single Euro Payments Area (SEPA), corporates should benefit, but the advantages will only be realised if they take action to become SEPA compliant and look at how they might take advantage of particular features of the SEPA Schemes. What should they be aware of and what should they be doing?

The biggest impact on corporates so far is the requirement to format their payments messages according to two existing SEPA Schemes: the Interbank Convention on Payments (ICP) and Credeuro. The full achievement of SEPA, from a corporate's perspective, will be based on the new Scheme rules, which were recently approved at the March Plenary of the European Payments Council (EPC).

Further to the EU Commission bringing into effect Regulation 2560/2001, the EPC set out the conditions as to how a euro payment in the EU could be achieved without deduction of charges and it established new pan-European inter-bank charging principles in its ICP.

If a corporate fulfils the ICP's requirements for its payments messages, it can be sure that the beneficiary will receive the funds in full, as well as a guarantee of the timeframe within which the beneficiary will receive those funds. In line with EU regulation 2560/2001, the requirements apply to all payments up to €50,000.

Impact of IBAN and BIC

There are two significant issues for corporates: adhering to the requirements of the ICP and the consequence of not formatting messages correctly. According to the ICP, the intermediary bank receiving the payment or the beneficiary bank is entitled to charge for the additional work resulting from transactions that do not meet the ICP's prescribed STP standards. Such charges, generally referred to as repair charges, can be applied by the receiving bank if:

- a message does not contain a valid IBAN in the correct field, or
- BICs are not used in fields 52A to 57A, or
- fields 23E or 72 contain text, or
- fields 26T or 77B are used.

Though the repair charges are sent to the originating bank, ultimately, these charges will be passed back to the corporate customer. The concern for corporates is that the ICP has not defined an amount nor an upper limit for a repair charge. To be fair, it would have been difficult for the EPC to tackle the level of repair charges since the area of pricing is generally fraught with anti-competition issues. Also undefined is the timeframe within which a repair charge can be sent (it could turn up three months after the message was sent, for instance) and a maximum time limit. To make matters more complicated, there is no definition as to the reasons a beneficiary bank must give, or the format in which they must be provided, when it sends back a repair charge.

In addition to the ICP, there is also a BIC and IBAN Resolution, which came into force at the beginning of 2006. This states that, for intra EU/EEA euro cross-border customer credit transfers, IBAN and BIC will be recognised as the only beneficiary customer account identifier and bank routing designation. If there is no valid BIC or IBAN in the payments message then, regardless of the amount of the payment, a bank can handle the transfer as a 'value added service'. In other words, a non-STP charge can be sent back. From the start of 2007, the Resolution states that banks will be able to reject any payment if it does not contain a BIC and IBAN. Therefore, from 2007, the implication for corporates is not simply one of repair charges; it potentially becomes one of interest costs, due to the beneficiary not receiving their funds on time. An interest cost could be significantly more expensive than a repair cost and so the importance of collecting IBAN and BIC information should not be underestimated.

What if the beneficiary says that they cannot provide IBAN and BIC details?

This is a frequently asked question and the answer is simple. If the beneficiary holds an account with a bank located in the

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EU in the business of effecting cross border payments, then, the following quote from EU Regulation 2560/2001 Article 5 applies: "With effect from 1 July 2003, institutions shall indicate on statements of account of each customer, or in an annex thereto, his IBAN and the institution's BIC".

It should be noted that EU Regulations are directly applicable to EU member states, unlike EU Directives which must first be incorporated into national legislation before they become effective.

Credit transfers

As part of the EPC's Roadmap towards achieving SEPA, a new credit transfer scheme will be created – the SEPA Credit Transfer Scheme – and it will address basic credit transfers. As of 1 January 2008, it is intended that the Scheme will replace Credeuro and the ICP. Of particular interest to corporates will be the Scheme's intention (at present) to be unlimited in value, to ensure that there are no deductions from the principal of the payment (so that the beneficiary receives funds in full), to ensure delivery of remittance data all the way through to the beneficiary, and to ensure wide reach.

In response to the requirement for more urgent transfers, the EBA will launch a Priority Payments Scheme. This will not be limited to payments settled through the EBA operated clearing systems and should ensure that the time between the receipt of the payment instruction and the credit to the beneficiary's account, provided that the rules of the Scheme have been adhered to, will be no longer than four hours. Given that the SEPA Credit Transfer Scheme is not limited in value, we are seeing the continued move away from the delineation between high-value and low-value payments to one between urgent and non-urgent payments.

Critical issue for corporates

The critical issue for corporates is to understand the ICP's IBAN message requirements and be able to adhere to them in the use of their database of records and payments processes. Here, banks can lend a helping hand. Banks should communicate with their corporate customers and provide them with formatting guides to translate the ICP requirements into what it means to them. More coherence is also needed in the event of a repair charge. JPMorgan, for example, charges customers that fail to meet the requirements of the ICP Scheme up front, so there is certainty of timing as well as certainty of the amount charged, as opposed to waiting to see how much the beneficiary bank charges and then passing it back to the corporate customer. In addition, JPMorgan provides monthly billing statements that give precise reasons as to why a payment failed to meet the ICP STP criteria; this enables customers to amend their data and to avoid making the same mistakes again. Taking action now will not only enable the avoidance of repair charges but also remove the risk of interest charges that could result after 2007.

Ivan Haco

For corporates, the interim period between 2007 and 2008 could represent a challenge. From 2007, IBAN and BIC are mandatory for euro cross-border customer credit transfers; however, domestic transactions can still operate using national account numbers. This will only represent an issue if one needs to make both a domestic payment and a cross-border payment to the same beneficiary, where the corporate's ERP system can only maintain one account number for the beneficiary. One of the solutions in this instance will be to use a bank that is capable of deducing a domestic account number from the IBAN. Then, the corporate need only concern itself with maintaining IBAN data. (JPMorgan is adding this capability into its Global ACH product set with effect from July 2006.)

From 2008, the intention is that domestic payment volumes should migrate to the SEPA Schemes. IBAN and BIC are mandatory components of the SEPA Schemes, i.e. if there is no IBAN or BIC then a payment or a direct debit cannot be effected through the Schemes.

SEPA: Some way to go

Though it improves the payments landscape across Europe, SEPA will not magically solve all the problems within the payments sector. In theory, post-SEPA, a corporate could open an account in France and make all its payments to beneficiaries in Spain through wire transfer or ACH. In reality, there may still be corporate taxation issues and central bank reporting (CBR) implications, for example, which could act as a barrier to a true SEPA.

CBR already represents an issue with most countries where it is required having a €12,500 threshold whereas the EU Regulation 2560 amount increased from €12,500 to €50,000 with effect from the start of this year – a clear inconsistency. In a true SEPA, one cannot continue with some countries imposing CBR requirements and others not.

Likewise, though the Scheme rules are being put into place at a high level, there is a clear separation between the Scheme and operators of the Scheme. The Scheme rules, therefore, are not intended to describe what the operators of the systems are going to look like or how they will change; neither do they explain how the infrastructure of Europe as a whole will change. These factors will be determined by

market forces; and while a single infrastructure that could be referred to as a pan-European ACH (PEACH) may not come into effect immediately, it is only a matter of time before it does through market forces. We have recently seen first effects of these market forces with the announcement of the memorandum of understanding to establish a merger being signed between Interpay Nederland BV (the Dutch ACH processor) and Transaktionsinstitut (a major German low value payment processor).

Going forward and action points

The action plan for how the Schemes will be implemented and supervised will be rolled out over 2006. The key role for banks is to make sure corporates feel as little pain as possible in achieving SEPA Scheme compliance and understanding. The responsibility of educating corporates about the SEPA Schemes is a collective responsibility between particular corporate industry segments, banks, infrastructures/ACHs and also the EPC.

Many small and medium-sized corporates deal mostly within their national borders so SEPA will not materially affect them until 2008 when the national ACH schemes will start the conversion to the pan-European schemes. SEPA will, however, make it easier for them to expand and transform their business cross-border through PEDD (Pan-European Direct Debit), for example. For larger corporates dealing cross-border, they will already be facing the changes required by the ICP and EPC Resolution in terms of IBAN and BICs.

There is no doubt that corporates will benefit from SEPA, not just in the creation of a clear choice of payments types, but also in the ability to simplify their liquidity and cash management structures, and in being able to ensure that remittance information is accurately transmitted and received. The advantages of SEPA, however, will only be realised if corporates take action in becoming SEPA compliant.

In summary, for a corporate to position itself effectively for SEPA in the near term, it should ensure that:

- BIC and IBAN details are clearly placed on all its invoices
- it obtains IBAN and BIC details for all its counterparts (not just those that are cross border), and
- it reviews its bank's capabilities in being able to provide information in formatting payments to comply with the ICP, and in being able to provide services that will facilitate the conversion of IBANs to domestic account numbers.

In the medium to long term i.e. to have in place from 2008 onwards, the corporate should start to review the issues:

- *How might it better utilise reliable remittance information?* The SEPA Credit Transfer Scheme provides for remittance information of up to 140 characters. While this will not meet all requirements, the fact that one can rely on the data being transmitted to the beneficiary holding their account with a Scheme member merits review. The review should apply to both accounts payable and accounts receivable processes.
- *How will it handle reject code information?* A feature of the SEPA Credit Transfer Scheme is that there will be defined rejection codes. Depending on volumes, consideration should be given to the handling of these error codes in an automated manner to improve efficiency in data management.
- *How will it migrate from existing national schemes to the SEPA Schemes?* At this point, a drop dead date is not envisaged for the national schemes. However, there will come a point when the national schemes will close when it becomes apparent that they are no longer cost effective. Therefore, a gap analysis will be necessary to establish key gaps/differences between the SEPA Schemes and the national scheme concerned. For example, the reclaim period for a direct debit will likely be different in the SEPA Scheme from that in the national scheme.
- *What will be the impact of bank XML adoption?* The communication standard between banks taking part in the Schemes will be XML. As corporates continue to want to move away from bank specific solutions, XML could provide a solution and it is likely that more banks will offer such solutions to their clients. The corporate should review the use of XML and the provision of banks solutions that facilitate XML communication between the bank and the corporate.

Overarching all of the above, should be a review of locations/entities to see whether further efficiencies can be achieved by taking advantage of a SEPA. However, for the time being, the reality is that other issues such as CBR and taxation differences will continue to complicate locational change decisions.

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