

## **IAS 39 Compliance: Ensuring Transparency and Credibility**

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*Gordon Chan, Marketing Director, Principia Partners, reports on the planning and implementation of IAS39 standard for hedge accounting, looking at treasury system considerations.*

With investor scepticism and regulatory scrutiny intensifying to record levels, transparency and credibility in financial reporting is more crucial than ever to corporate funding efforts worldwide. The proposed IAS 39 regulation for Financial Instrument Recognition and Measurement aims to generate a more consistent level of disclosure across European corporations, mirroring the FAS 133 financial accounting standard adopted in the United States.

In 2001, the European Commission proposed that all EU listed companies prepare their financial statements using IAS 39 accounting standards by Jan 1, 2005. Member nations may also require the use of IAS standards for unlisted companies in industries such as banking and insurance for statutory financial statements. Standardized accounting and disclosure practices across the European continent can help investors compare the performance of corporations in multiple countries by using a consistent financial reporting framework. This enables European companies to reduce the cost of raising capital and compete more aggressively for funds in the capital markets.

The EU proposal requires that by 2005, at least one year of comparative financial statements is available for evaluation. This effectively makes January 2004 the deadline for compliance. Companies seeking compliance will need to meet the following objectives by end of 2003:

- scope the project
- educate key staff members
- analyze trading and risk management practices
- review system requirements
- implement a solution

One key lesson learned from the FAS 133 experience in the US is that the act of analyzing every hedge in a company's portfolio as well as documenting and modifying trading, risk management and accounting practices is a time-consuming task that has to be performed while maintaining current operations. By the first quarter of 2002, companies should have initiated research and planning efforts.

Similar to the FAS133 standard, IAS 39 changes accounting treatment for financial instruments, including derivatives. Far-ranging in its scope, IAS 39 affects not only accounting, but also front office trading and risk management practices as well. Compliance with IAS 39 regulation will require not only modification of business practices, but integration and implementation of adaptive treasury systems as well. This article focuses on some of the major system issues and considerations companies may encounter in their efforts to meet the new standard.

### **IAS 39 in a nutshell**

In an effort to increase disclosure on company assets and liabilities, IAS 39 mandates that all derivatives be recognized on the balance sheet and measured at fair value. This implies that all gains and losses from financial instruments must be recorded even if they are not realized. Although derivative instruments are used for speculative purposes, most derivatives are typically used to hedge interest and currency risk. Thus, unilateral recognition for all derivatives can create huge volatilities in the income statement. For this reason, IAS 39 provides for hedge accounting guidelines where effective hedges can be exempt from inclusion in the income statement until its maturity or termination. In order to qualify for such treatment, companies must provide detailed documentation on hedge strategies and conduct regular hedge effectiveness testing. Qualification can be a huge undertaking affecting traders, risk managers, operations staff and accountants.

### **IAS 39 is more than an accounting requirement**

Why does IAS39 present such difficult system issues? At a minimum, IAS 39 requires the mark-to-market of derivatives. Assets and liabilities must be associated or linked with derivatives, which may be managed on a separate system. Thus, integration may be an issue. Finally, hedge accounting is complex requiring interpretation and implementation of new rules.

From trade origination in the front office to general ledger journal entries of the hedges, corporations must account for the financial instrument through its entire lifecycle. An IAS39-compliant system should meet the following criteria:

- value all assets, liabilities and derivatives
- produce documentation of hedging strategies
- provide effectiveness testing (prospective and retrospective)
- manage hedging relationships
- generate accounting entries

- easily accommodate modifications to new IAS requirements

The effort will require staff from different departments to fully appreciate enterprise-wide implications. In the past, only accounting and operations personnel needed in-depth knowledge of IAS guidelines, but now treasury departments and risk managers also need to understand the impact of the accounting rules. Here the traditional concepts of cost accounting must be mixed with fair value or mark-to-market accounting.

All financial instruments should be valued from a consistent model to produce meaningful hedge effectiveness test results. The system selected should be able to process a trade or hedge from trading through risk management to accounting entry generation, across a broad range of assets, liabilities and derivatives. Companies attempting to comply through loosely integrated disparate systems using different market data and models may incorrectly identify a good hedge to be ineffective. Such inaccuracies stemming from model noise or incongruous valuation methodologies are then passed through to the accounting system, contributing to income volatility, which may require tedious efforts to reconcile.

Additionally, the system should provide the ability to separate/analyze mark components to ensure hedge accounting is only applied to relevant portions of a hedged item. For example, a hedge instrument may be deconstructed based on changes due to credit fluctuations, the intrinsic value of option/embedded options or changes in the FX rate.

### **Managing operational risks: workflow and documentation**

IAS 39 compliance will require a company to review all existing financial instruments and associated hedges in order to determine effectiveness and proper hedge accounting. The treasury system implemented should provide basic methods of calculating hedge effectiveness and to adapt to possible changes in interpretations and standards. In addition, documentation of hedge strategies will require modifications and possibly more stringent controls on hedging practices. In this sense, IAS 39 compliance requires more extensive use of operational risk management techniques. Risk officers may choose to limit the types of hedge strategies employed or specify different effectiveness assessment methods for different structures. For example, IAS 39 hedge accounting does not allow for portfolio hedging. Companies accustomed to such routines will need to adopt new risk management practices and diligently monitor hedge activity across the firm. In addition to more tightly controlling system access and permissions, the system should facilitate user-defined workflow processes. For example, enabling users to select and test hedges from a pre-approved set of hedge strategies and effectiveness tests.

### **Managing sophisticated hedge allocations and strategies**

As companies strive to develop effective hedging strategies, the system should be flexible enough to enable dynamic linking of assets and liabilities with derivatives and accommodate de-designation of hedge allocations. Hedge strategies can range from simple to dynamic to complex. System ability to maintain hedge to hedged item link is critical because market conditions may render an existing hedge to be ineffective and new ones to be applied. As corporations gain experience and dexterity in complying with IAS39 guidelines, audit trails and controls are an essential part of the process. The system should provide comprehensive and flexible reporting for prospective and retrospective measurement of hedge effectiveness.

### **Flexible sub-ledger system**

Another key criterion in a company's evaluation of solutions is the robustness of the accounting system. Ideally, the IAS39 solution should feature an integrated sub-ledger system that automatically produces journal entries and updates account balances. For example, termination of a hedge or failure of an effectiveness test will require adjusting entries. For example, in a cashflow hedge, amounts booked in Other Comprehensive Income (OCI) will move from the balance sheet to the income statement. While strategies and allocations should be automatically executed, the sub-ledger should allow for manual entries. It should also enable integration with the corporate general ledger.

Finally, companies may have to produce accounting statements for multiple regulatory bodies. In lieu of managing multiple accounting processes or systems, companies should be aware of other regulatory requirements as they evaluate IAS 39 compliant solutions. The system selected should be able to handle IAS 39 compliance along with other requirements such as tax, statutory and management accounting. The ability to achieve this within a single Chart of Accounts improves time to value for accounting implementations and on-going maintenance, as well as avoids the duplication of tasks.

IAS compliance will ultimately provide the groundwork for improved and controlled decision-making for corporations and a standardized view of company financial health for shareholders, investors and analysts to evaluate. Given its wide-ranging effect, IAS 39 can also be viewed as an opportunity for firms to review financial risk management practices, improved communication across departments and to update operational controls.

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