Treasury and New Accounting Standards - There may be challenges ahead!

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1 March 2006, Cork

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Introduction

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Presentation Approach

- Assumption - IAS 39, IAS 32 / IFRS 7 and IAS 21 are relatively new to the audience
- Several presentations – accounting firms / banks – and background reading to absorb main principles
- Introduce concepts with some examples

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Parallels between the Euro and IFRS ?

- “When the change from national currencies to the euro came, no one liked it”
- “These things are like going through rapids, but the river afterwards is always calm”

Tommaso Padoa-Schioppa, Chairman of the IASB since 1/1/2006 as quoted by the FT on 30/1/2006

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IFRS => Corresponding FRS

IAS 39	FRS 26
IAS 32	FRS 25
IFRS 7	FRS 29
IAS 21	FRS 23

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IAS 39

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Challenges

- Technically demanding from both treasury & accounting perspective
- Large volume of rules and guidance re IAS 39 – runs from page 1635 to page 2003 in IFRS Manual
- Listed corporates / banks addressing issues for several years prior to implementation date
- Looked to experience with FAS 133 in US
- Opportunity for corporates to gain from IAS 39 experience when implementing FRS26

4 Categories of Financial Instruments

- Assets / liabilities* (including derivatives) at FV through profit or loss
  - Measure at FV with changes to P&L

  ** EU carveout largely addressed by new "Fair Value Option"*

- Held-to-maturity
  - Measure at amortised cost with premium / discount to P&L

- Loans and receivables
  - Measure at amortised cost with changes to P&L

- Available-for-sale financial assets
  - Measure at FV with changes to Equity

Accounting Mismatch?

- IAS39 provides that financial liabilities may be designated “as fair value through profit or loss”
- EU Commission carved this out in Sept 2004 for fear of abuse
- Result: mismatch with corresponding derivatives or financial assets at fair value through profit or loss
- Fair Value Option amendment to IAS39 in June 2005
  - Applies for periods commencing after 1.1.2006; can be applied earlier
  - Accepted by EU Commission
  - Eliminates a major source of volatility in P&L
  - May also reduce need for fair value hedge accounting

Key Changes From Irish GAAP

- Derivatives typically were included as note disclosures under Irish GAAP

- IAS39 requires derivatives to be included in the balance sheet at fair value with movements taken to P&L

- Hedge accounting exemptions in many cases allow a P&L result broadly similar to Irish GAAP

- Hedge accounting however brings significant complexity in relation to documentation and effectiveness testing

- Communication important – as a “commonsense” economic hedge may not qualify as an accounting hedge

Fwd. FX contract to pay foreign supplier

- FX cover put in place when liability to supplier incurred
  - Retranslation of creditor at reporting date should offset forward contract M2M change reported in P&L
  - Ensure procedures in place to perform calculations accurately
- FX cover put in place to hedge forecasted purchases
  - “Cash flow hedge”
  - Must be highly probable
  - Must put documentation in place at hedge inception
  - Must ensure that hedge is effective
  - M2M changes are reported in equity and recycled to P&L when the forecasted purchases occur
- FX cover put in place to hedge a firm commitment
  - “Fair value” hedge: documentation, effectiveness etc
  - FV of firm commitment on balance sheet
  - M2M change on forward also reflected on balance sheet
  - Both offset in P&L

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Cash flow hedge

- Hedge documentation at inception should include:
  - Risk management objective & strategy
  - Type of hedging relationship
  - Identification of hedged item: amount, timeframe, price, rationale for why highly probable
  - Identification of the hedging instrument
  - Description of prospective / retrospective tests
  - Method of recycling into P&L

- Hedge designation is essential to reduce / avoid ineffectiveness

- Document retrospective testing
  - At subsequent reporting dates
  - On eventual maturity
  - A history of retrospective ineffectiveness would question future designations

Fair Value Hedge of Fixed Rate Debt

- Debt is carried at amortised cost – could not be fair valued due to EU carve out*
- M2M changes on interest rate swap (IRS) to P&L => significant potential P&L volatility
- "Fair value" hedge accounting allows a significant degree of the swap volatility to be "adjusted" against the carry cost of the debt
- Documentation critical – accurate designation of hedged risk
- Effectiveness testing at inception and at each reporting date
- Ineffectiveness will arise – upfront designation and subsequent testing methodologies can reduce ineffectiveness

* *June 2005 "Fair Value Option" permits debt to be carried at fair value but hedge accounting may result in lower P&L volatility*

Effectiveness Testing and Measurement

- Hedged risk designation – credit margin
- Testing – 80% to 125% corridor
- Period by period or cumulative testing
- Statistical (e.g. regression) or dollar offset
- Regression may give more stable result – law of small numbers
- Effectiveness measurement at reporting date
- Ongoing documentation of testing / measurement
- Systems and procedures

IAS 32 / IFRS 7

IAS 32 / IFRS 7

- IAS 32 - Financial Instruments: Disclosure & Presentation
- IAS 30 – Disclosures in Financial Statements of Banks and Similar Financial Institutions
- IFRS 7 – Financial Instruments: Disclosures
  - Applies to banks and corporates
  - Replaces IAS 30
  - Replaces the disclosure requirements of IAS 32
  - Presentation requirements of IAS 32 remain unchanged
  - Effective for periods commencing after 1.1.2007
  - Early adoption to avoid two changes to disclosures?

IAS 32 – Presentation Requirements

- Defines financial instrument, financial asset and financial liability
- Liabilities and equity to be separately presented
  - Substance governs classification

    e.g. preference shares with mandatory redemption = debt
- Compound financial instruments
  - Present financial instrument and equity components separately

    e.g. convertible debt = debt + share warrant
- Interest, dividends, gains, losses on financial instruments
  - Recognise in P&L
- Offsetting financial assets and liabilities
  - Entity must have enforceable right and intend to settle net

Objective of IFRS 7 Disclosures

..is to enable users to evaluate:

- Significance of the entity’s financial instruments
- Risks arising from its financial instruments
  - during the period and at the reporting date
  - how the entity manages those risks

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IFRS 7 – Significance..

- Balance Sheet
  - Categories of financial assets & liabilities
  - Financial assets / liabilities at FV through P or L
  - Reclassification between categories
  - Derecognition; Collateral; Allowance for credit losses
  - Compound financial instruments with multiple embedded derivatives; Defaults and breaches
- Income statement and equity
  - Items of income, expense, gains or losses
- Other
  - Accounting policies
  - Hedge accounting – detailed disclosures
  - Fair value

IFRS 7 – Nature and extent of risks..

- Qualitative disclosures re risk arising from financial instruments
  - Exposures and how they arise
  - Objectives, policies, processes for managing risks; methods to measure risk
  - Changes in above from previous periods
- Quantitative disclosures
  - Summary quantitative data – based on information provided internally to key management
- If not apparent from above, also disclose
  - Credit risk, liquidity risk, market risk
  - Concentrations of risks

IAS 21

IAS 21 Points to Note

- Detailed guidance re Functional Currency
  - Determined principally by its primary economic environment
  - Determines FX gains / losses
  - Can present accounts in Presentational Currency
- Net investment in Foreign Operation
  - Amount of reporting entity's interest in net assets of that operation with exchange differences recognised in equity on consolidation
  - Can include long term receivables and loans (monetary items)
  - FX gain / loss on such monetary receivables recognised in "company only" accounts
  - Careful attention to rules to ensure that this FX eliminates on consolidation …. foreseeable future ….direct ownership chain
- Goodwill and and fair value adjustments arising on acquisition form part of net assets of the foreign operation

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