

# IAS 39 and IFRS 7: Financial Instruments: Accounting and Disclosures

## Corporatetreasury solutions

What are IAS 39 and IFRS 7?

Who do IAS 39 and IFRS 7 affect?

What are the key impacts of IAS 39 and IFRS 7,  
and why should I be worrying about those?



Most large companies in the European Union have been reporting since 2005 under International Financial Reporting Standards (IFRS) for their group financial statements.

This has been the biggest change to financial reporting in 25 years. A number of large companies are still struggling to embed IFRS into their accounting, reporting and monitoring systems. The challenge now is to automate further the IFRS reporting processes, reduce manual intervention and improve the quality and reliability of figures. This is particularly valid in the financial instruments area, both from accounting (IAS 39) and disclosure (IFRS 7) standpoints. IFRS 7 is a new IFRS standard which becomes applicable for annual periods starting on or after January 1, 2007. IFRS 7 requires extensive narrative and quantitative disclosures covering inter alia the company's policies for managing financial risks, the exposure and usage of financial instruments and derivatives. New detailed information is required in the areas of market, credit (including trade receivables) and liquidity risks. The preparation of IFRS 7 disclosures will necessitate close cooperation between financial reporting, treasury/commodity risk and business controlling departments.

IAS 39, the standard on financial instruments (which underwent a number of amendments since its original publication) is revolutionary. For companies that are significant investors, borrowers or users of derivatives, the standard has raised wider issues than any previous standard in any area of accounting. For first-time adopters the standard changes the way they account for financial instruments and will involve substantial changes to systems, processes and documentation.

What is IAS 39?

IAS 39 includes requirements for:

- All derivatives to be recognised on balance sheet at fair value;
- All hedging relationships to meet stringent criteria for hedge accounting to be applied; the use of deferral hedge accounting for macro and portfolio hedges is severely restricted;

# IAS 39 and IFRS 7: Financial Instruments: Accounting and Disclosures

- Changes in the value of derivatives that qualify as hedges to be recognised either in income (for fair value hedges), along with an offsetting adjustment from the underlying hedged item, or in reserves (for cash flow hedges);
- Changes in the value of derivatives that do not qualify as hedges to be recognised immediately in income with no offsetting adjustment raised;
- Bifurcation requirements which will affect derivatives embedded in other transactions (eg: options embedded in sales contracts);
- Classification and measurements of financial assets. Financial assets are to be classified as one of the following four categories: financial assets at fair value through profit and loss, available for sale (these categories are held at fair value), held-to-maturity investments or loans and receivables (these categories are carried at cost / amortised cost);
- Classification and measurement of financial liabilities. Financial liabilities are to be classified as one of the following two categories: financial liabilities at fair value through profit and loss and other financial liabilities.

## What are the key impacts of IAS 39 and IFRS 7?

The impacts of IAS 39 and IFRS 7 are varied and include:

*Traditional hedging strategies may not qualify for hedge accounting:* IAS 39 has already forced many businesses to rethink the way they manage their risks. Many old hedging strategies, such as the use of macro hedging (pooling a range of risk items, then hedging the overall risk) or netting (offsetting in a treasury centre equal but opposing risks of subsidiaries), may be severely restricted and may not qualify for hedge accounting.

*Income versus Equity Volatility in your Reporting Statements* Earnings volatility will arise from the use of derivatives in hedging relationships that do not fully meet the hedge accounting requirements of IAS 39 and from residual ineffectiveness in otherwise effective hedges. Equity volatility will arise from the use of derivatives to meet the cash flow hedge requirements. You will need to evaluate your appetite for volatility in an absolute sense and your relative appetite for income and equity volatility.

*Changes to the content of the P&L account and balance sheet* IAS 39 requires the balance sheet to be grossed up to reflect the fair values of derivatives and certain financial assets and liabilities. The additional income and net asset volatility may impact loan covenants and may affect the way shareholders and analysts look at your business.

*New rules for de-recognition of assets and liabilities* The removal of assets and liabilities from balance sheet is subject to strict requirements. The ability to conduct certain activities through special purpose vehicles will require advance planning and understanding of the standard's requirements.

## *Extensive quantitative information requirements (IFRS 7)*

In addition to the existing requirement to disclose the fair values of financial instruments, IFRS 7 introduces the following significant quantitative information disclosure requirements:

- Carrying amounts and fair values of financial instruments by type of financial instrument ("classes" under IFRS 7) and IAS 39 measurement categories;

- Analysis of the exposure to credit risk on financial assets, including trade receivables;
- Ageing balance of financial assets past due (this will mainly cover trade receivables in practice);
- Maturity schedule for the cash flows on financial liabilities, including payment legs of gross settled derivatives;
- Sensitivity analysis of IFRS Equity and P&L to changes in foreign currency, interest rates and other financial risks;
- Additional disclosure if situation at year-end is unrepresentative of the normal exposure to financial instruments.

## *New demands on your business' systems*

IAS 39 and IFRS 7 present significant challenges for your business and treasury systems. If your business has a diversified investment portfolio or uses derivatives to hedge risk it is likely that the structure of your existing systems are not up to the task. Systems need to be enhanced to calculate the fair value of derivatives, apply the rules for monitoring hedge effectiveness, to track hedging relationships and provide the new disclosure information required by IFRS 7 on market, credit and liquidity risks.

## **PricewaterhouseCoopers - IAS 39 and IFRS 7 Advisory Services**

PricewaterhouseCoopers has worked with a vast range of corporates at many different stages of preparedness for IAS 39. Our recent projects include assisting major banks and multinational companies in Europe. Our IAS 39 services include:

- Awareness briefings - for senior business, financial and treasury managers;
- Impact assessments - on existing hedging operations, financial statements and systems;
- Evaluation of alternative hedging strategies (including modelling, simulation); and, most importantly
- Implementation support - changes to policies, procedures, systems and controls.

## **Our experience**

In Europe, the Corporate Treasury Solutions Group comprises over 150 professionals, with a broad range of complementary treasury, banking, technology, taxation, accounting and program management skills. Our team has worked with many of the worlds leading corporations to support change in treasury practices and has an enviable track record of successful solution-based project work.

## **Contact details**

For more information on our IAS 39 advisory services, please contact the following:

Austria	Gerhard Margetich	+43 1 50 1 88 1522
Belgium	Olivier Cattoor	+32 2 710 4118
Finland	Tuukka Lahkela	+35 89 2280 1333
France	Vincent Le Bellac	+33 1 56 57 1402
Germany	Folker Trepte	+49 89 5790 5530
Italy	Riccardo Bua Odetti	+39 02 6672 0536
Netherlands	Pieter Veuger	+31 20 568 6099
Sweden	Göran Engvall	+46 8 555 331 98
Switzerland	Iwan Ogink	+41 58 792 2747
UK	Yann Umbricht	+44 207 804 2476

<http://www.pwc.com>