Reporting of financial instruments

Accounting firms are acting behind the scenes to try and get financial institutions to eliminate the practice of not placing special purpose entities used in securitisation on the statement of financial position.

Australian companies appear to be reluctant, according to senior technical experts who declined to be named, to place securitisation vehicles on the financial position (balance sheet) despite the fact there is a gradual movement in Europe to bring vehicles that historically lived out of sight into public view on the main financial statements.

This is one of the hurdles the business community in Australia and various practitioners are struggling to clear in the lead up to the adoption of international financial reporting standards for financial years beginning on or after 1 January 2005. One of the problems in Australia, which is a country that has no comprehensive guidance, is the interpretation of international guidance on special purpose entities has been divergent, causing interpretational disputes between the accounting firms at the top end of town.

The Australian Securitisation Forum wrote a letter to the International Accounting Standards Board last year in an effort to emphasise that the interpretation of the relevant interpretation of what is now the International Financial Reporting Issues Committee on special purposes entities should be amended to clarify the requirements dealing with securitisation vehicles.

“We strongly recommend that rather than attempting to introduce specific rules for SPEs within IAS 39, the underlying principles and guidance in SIC 12 should be appropriately amended,” the ASF submission states. “Considerable uncertainty and concern exists in relation to the application of SIC 12 within the Australian securitisation industry.” The ASF takes the view the IASB should deal with securitisations in a separate pronouncement rather than embed it in the general standard on financial instruments. Forum members also raised general concerns about the derecognition provisions in the exposure draft that has been the subject of great debate both in Europe and other parts of the world.

“We believe that the (admittedly simplified) proposed new approach [on derecognition] is not clearly better and not more robust than the existing approach,” the ASF notes. “In particular, we are concerned that the introduction of the “continuing involvement” test is not consistent with current accounting concepts or the generally accepted move towards financial components accounting for financial instruments.”

Increasing the visibility of and consistency of accounting for ‘off-balance sheet’ vehicles used in securitisation is only one of the issues being thought through by the accounting profession that relate to the interpretation of the literature on financial instruments that has been generated by the IASB.

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One of the sticky problems in accounting for financial instruments in Australia has been the proliferation of resetting preference shares that have caused great debate amongst accountants over classification.

Some of these instruments have been built by merchant banking organisations to fit into the category of equity rather than debt. It is publicly acknowledged by all accounting experts, such as PricewaterhouseCoopers partner Jan McCahey, that the changes contained within the suite of international accounting standards will force many of these instruments to be reclassified.

Major Australian companies have attacked the exposure drafts on financial instruments in their submissions to the international accounting standard setter. Telecommunications giant Telstra says the exposure draft on financial instruments is strange in parts where it allows similar instruments to be treated differently depending on the hedge classification that applies.

“There appears to be a choice between taking the results of fair value hedges to balance sheet or profit/loss, which appears strange. We may have misread or not interpreted correctly the intent of the standard in this regard; clarification on this aspect is recommended,” the Telstra submission notes.

“The document suggests that loans held to maturity are outside scope. If we are therefore hedging such an instrument with a derivative this will cause an unbalanced position to be reported, as we would be marking-to-market the derivative and not the corresponding underlying exposures which are being directly hedged.”

Telstra is also concerned about the fact that transactions that have resulted in the creation of off-balance sheet structures are presently not grandfathered in the exposure draft.
“In terms of derecognition, our interpretation is that the provisions envisaged will make it harder to achieve off-balance sheet structures and the provisions would not be grandfathered.”

Telstra does, however, say it is comfortable with the fair value accounting requirements existing in the exposure drafts because of their similarity to US generally accepted accounting principles.

The Commonwealth Bank of Australia argues elements of the proposals outlined in the exposure drafts on financial instruments are far too simplistic. “We believe certain of the requirements are too far reaching at this stage and create business consequences beyond the domain of accounting. In particular, the new hedging proposals, when applied to the Commonwealth Bank, adopt a very simplistic approach to risk management,” the CBA asserts.

“This will lead to a backward step, from the current level of sophistication of portfolio risk management, to one that largely operates on an individual matching of hedge transactions. The result will be a very simplistic, cumbersome and costly approach to risk management that would be more applicable over 20 years ago when risk management techniques were in their infancy."

These changes in reporting financial instruments are requiring the education of various constituents in the Australian market place as well as the retraining of auditors at all levels in accounting practices. The major accounting firms have spent the past month on roadshows to brief clients and others on the adoption of international accounting standards.

This article was supplied by Tom Ravlic. Tom Ravlic is a financial journalist who has spent the past seven years covering the accounting profession, accounting and audit standard setting and corporate governance. His work has appeared in various publications including *Business Review Weekly*, *Personal Investment* (now *Personal Investor*), *The Age*, *CFO Magazine*, the *Australian CPA*, the *Company Director Journal* and the newsletters of the internationally renowned Lafferty Group. In addition to his freelance commitment to a wide range of publications, Tom has recently accepted an appointment to be editor of *Chartac Accountancy News*, published by Melbourne-based publisher Crown Content.

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