

Introduction

The background to this book

Only a few years ago, the last thing on a structured financier's list of worries was how to account for the structure. The accounting rules were 'flexible' to say the least, if in fact any rules existed at all. Not many structured finance, specialised funding or treasury professionals had ever entertained the idea that accounting would affect economic bottom-line business decisions. For a start, there was no need to ascertain whether or not hedge accounting would be available after it had been decided to economically hedge an exposure (it was just assumed that accounting would follow the economics); nor was there a need to ascertain whether or not preference shares issued to a special purpose vehicle were to be classified as debt or equity. Additionally, no one worried about a deal affecting income statement volatility where it was economically feasible.

Economically, not much has changed with regard to most of these transactions. Tax arbitrage opportunities between individual entities, between tax jurisdictions and exposure to different capital markets still form the basis of most of these deals. There has been little shift with regard to gaining competitive financing at the best available rates. If the transaction works, it is still a hugely profitable business; equally so for the entity that receives the cheaper finance, the provider of the finance (mostly due to tax concessions) and the structured finance dealer.

Yet, somewhere between the economic reality of a transaction and the old way of accounting for such a transaction, things have changed dramatically. There has been a revolution in accounting, especially in the financial instruments field. More complex rules have replaced the long-established accounting principles; prudence has been replaced by neutrality; the income statement has now become volatile ground; and, for the first time in many years, accounting has started to significantly influence economic decisions.

Some of the ways in which procedures have changed include the following.

- Transactions are scrutinised for their effect on equity and income statement volatility limits based on accounting measures. It is not enough to be able to economically hedge a transaction. Before a financier is able to execute the transaction, it needs to be shown that the economic hedge also qualifies for hedge accounting. Accounting sign-off has moved from being a rubber stamp confirming that the systems and people can cope with the transaction, to being a process that confirms that the technical accounting issues have been addressed, that the deal will not increase income statement volatility unnecessarily, and that the best accounting alternatives have been incorporated into the deal structure.
- Accounting and disclosure requirements are now forcing entities to show in their annual accounts many deals that would previously have been off-balance sheet. Customers can now see the margins that they are paying compared to the rest of the industry. Similarly, investors

can see the fair value and the terms and conditions of derivative positions entities have entered into, and therefore obtain a longer-term view on the risk an entity is exposed to.

- Increased complexities in the area of hedge accounting have forced many entities who do not want mixed measurement bases of accounting (fair value versus amortised cost) to rethink important inputs into deals. Sometimes, this means even letting opportunities go by simply because the accounting consequences are not favourable. Increasingly, evidence emerges suggesting that accounting has a greater impact on economic decisions than previously, and this will probably continue for the foreseeable future. Whether this is the tail wagging the dog is debatable, but for now, at least, it is the reality that we all have to deal with.
- The input from technical accountants has significantly increased and accounting risk management has become a specific part of the product development process. It is useless spending hundreds of hours on a deal only to find out later that the accounting does not work and that major changes are necessary. The accounting procedure needs to be considered at every step and it needs to become an integral part of structuring the deal. For this to happen, the front office practitioners need to be able to identify the main accounting issues and have a broad background on the impact of these issues.

Who should read this book?

This book is largely aimed at structured finance, specialised funding and liquidity, and treasury specialists, as well as accountants in these fields. The book aims to extract from the two thousand or so pages of the accounting rules and regulations the essential parts that would be most relevant to structured deals and present the issues and solutions in a way that the practitioner can easily understand. The approach is direct and sets out complex issues in a simple and understandable way. This book has not been written to provide an exhaustive list of accounting rules and regulations, which in most cases would be irrelevant. However, it has been written to provide a practical guide for a specialist who needs to understand the most important accounting risks within a proposed transaction as the transaction is structured.

Of course, as the title suggests, the basis of accounting used in this book is International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). However, in each chapter a summary is provided of the main differences between IFRS and US GAAP (Generally Accepted Accounting Principles).

The structure of this book

The book sets out a number of specific areas in accounting that could be relevant in a structured finance or specialised funding deal – especially where derivatives are involved. The book has been structured in such a way to help you navigate your way around as easily as possible. Most of the chapters are divided into seven main sections.

1. **Introduction.** This provides specific practical examples of situations (assets, liabilities, actions and so on) that might exist as part of the proposed transaction you are about to undertake and which will be dealt with in the chapter. When you have identified a similar type of situation in the proposed transaction, you are directed to read the appropriate section in the

chapter for an understanding of the consequences. For ease of use, a quick reference table is included in each chapter showing you where to look within the chapter for information on your situation.

2. **Background to the accounting rules.** This section provides an overview of the most important accounting rules and principles relating to the topic and sets the stage for the rest of the chapter.
3. **Main issues.** In this section there is a more detailed drill-down into the specific issues that might be present in a transaction. It delves into specifics, often expanding on the background and highlighting how the rules set out in the background section should be practically applied. It is also in this section that specific exceptions will be highlighted. Where appropriate, this section has been subdivided for ease of use and reference purposes.
4. **Frequently asked questions.** The FAQs deal with smaller, specific issues that could be transaction-specific and would not usually be found in every deal. Some of the FAQs expand on matters raised in the main issues or background sections, while others provide an insight into some of the more frequent problems that have been highlighted in the market in recent times.
5. **Summary comparison with US GAAP.** The aim of this book is to provide IFRS-based practical guidance. The US GAAP section therefore does not go into detail on accounting under the US rules, but merely highlights the most significant differences. A US GAAP user can therefore identify whether a significant difference does exist and, if so, refer to the US GAAP rules to gain a better understanding of the difference.
6. **Practical implementation.** As this book is a practical guide, towards the end of certain chapters you will find practical examples that highlight a more complex issue or provide a better insight into the way the rules should be interpreted. The examples have all been designed to be easily understood.
7. **Important references to IFRS.** This section can be considered a 'last resort' section. If more detailed information is required, it refers you back to the original IASB standards including Application Guidance (AG), showing where in the accounting standards the specific issues are addressed.

Other features of the book include the following.

- A basic checklist in Chapter 13 (on writing a technical accounting opinion). This checklist is important because it also enables you to navigate your way around the book.
- Throughout the text there are links (called 'Linked references') to other sections or chapters of the book. This is especially helpful as the accounting standards are intertwined and one standard often has an impact on another.
- Specific references to the FAQ sections are made throughout each chapter. These are used where a question dealt with in the FAQ section has a specific bearing on the issue under discussion. This also allows you to ascertain when to use the FAQs to help you further and when it is not necessary.

How to use this book

When using this book, it is suggested that you follow these five steps.

Step 1: Is there an issue you are not sure how to deal with and need to follow up? Check the table of contents and study the chapter titles

The chapter titles clearly indicate the main issue that each deals with. If you come across an issue when a transaction is being structured and you are unsure how to solve it, you should refer to the quick reference table in the relevant chapter. By looking through the table you should be able to see whether the issue is dealt with in that chapter. It is also useful to read through the background section to that chapter.

Step 2: Refer to the checklist

When a transaction is contemplated and the main ideas are formulated (that is, before any specifics have actually been agreed or decided upon), locate the checklist in Exhibit 13.1 on writing a technical opinion. Tick off the possible accounting issues that might need to be addressed. The checklist refers you to specific chapters within this book. It is also recommended that you refer to the 'Quick reference' table at the beginning of each chapter. This should tell you whether or not your issue is dealt with in the chapter. It is also useful to read through the background section to that chapter.

Step 3: Look at the main issues section in the chapter

When an issue has been identified and you have located the correct chapter (either from looking through the quick reference table at the beginning of each chapter or from reading the background), the next step is to read through the main issues section. The quick reference table might guide you to a specific subsection under the main issues section, in which case you should consult these after reading the background section.

Step 4: Follow up using the linked references and FAQs

If there are specific links to issues dealt with in other chapters or relevant FAQ references, follow up on these. They have been specifically created to ease navigation through the book without you having to read entire sections that might be irrelevant.

Step 5: Glance through the practical examples towards the end of the chapter

All the examples have headings that provide you with an idea of the issues dealt with. It is always helpful to have a look at these and make sure you have understood how to apply the principles discussed in that chapter to a specific issue.