Financing decisions with a view to their accounting implications

Accounting implications are often not considered by companies when making financing decisions. This article illustrates important issues in this regard based on a selection of examples.

Companies take financing decisions for a variety of economic reasons. Consequently, there are a variety of financing alternatives that can have a major impact on corporate ratios depending on their accounting treatment. It is therefore of great importance to consider all accounting implications when taking financing decisions.

Bank loans are traditionally used as a financing instrument. This form of financing frequently requires the provision of security or compliance with operational *covenants*. *Promissory notes* are increasingly used by SMEs. *Bonds* are another possibility. Bonds offer greater independence compared to loans with regard to long-term capital as well as tax and corporate legal considerations. Another financing instrument is a variation of the bond – the *convertible bond* – which, in addition to the rights of the bond, securitises the issuing company's option of converting bonds into equity instruments. A further instrument used for financing at industrial enterprises is the sale of receivables through *factoring* programs to improve short-term cash flow and to outsource credit risk. In this case also the contractual arrangement has a direct impact on the balance sheet and income statement, which is explained in the following paragraphs for factoring and all other forms of financing.

To ensure the continuous payment of interest on floating-rate loans issued, banks increasingly incorporate interest rate floors into these agreements in order to avoid the problem of negative interest rates. If, in such a case, interest rates are hedged by the company with derivative financial instruments (such as interest rate swaps), the hedging instrument should also be equipped with an appropriate interest rate floor. Failure to do so would result in inefficiencies in hedge accounting due to deviating contract parameters between hedged item and hedging instrument, which would increase the volatility of earnings.

When issuing bonds it must be verified whether these are structured financial instruments that include embedded derivatives in addition to the basic instrument. One such example would be a contractually agreed repurchase option, in which case it must be examined whether it needs to be recognised separately from the host contract in accordance with IAS 39. The host contract must be accounted for in accordance with other appropriate standards (IAS 39.11). The derivative on the other hand is classified as *held for trading* as a separate financial instrument and recognised at fair value through profit or loss. This approach may result in deviations in the income statement. On the other hand, the separated derivative leads to an additional hedging instrument that qualifies for hedge accounting.

Convertible bonds are accounted for by separating the debt instrument and the conversion option. The debt instrument is recognised in accordance with IAS 39. The conversion option is either recognised in equity pursuant to IAS 32 as the difference between the total proceeds from the issue of bonds and the calculated present value of the liability component of the convertible bond, or as an embedded derivative pursuant to IAS 39 separated from the host contract as *held for trading*.

With regard to factoring, a distinction is made between the accounting treatment of non-recourse and recourse factoring: non-recourse and recourse factoring are defined based on derecognition of the receivable and the transfer of material risks and rewards. In non-recourse factoring, the entire receivable is sold and thus derecognised, while in recourse factoring, the receivable although sold in accordance with civil law cannot be derecognised by the seller due to the retention of risks and rewards. The credit risk retained by the company, for example due to a guarantee provided by the seller of receivables, furthermore has the effect that a financial liability to the factoring company has to be recognised.

Financing is a key instrument of corporate management. As is demonstrated by the above examples, the selection and contractual arrangements for financing instruments may have extensive accounting implications, which must be taken into account by management early on in their financing decisions. Therefore, comprehensive and early analysis of financing alternatives is advisable. We are available as an experienced partner, ready to assist you together with our experts.