

# Changes of the Volvo Group's financial reporting in 2005 as consequence of adopting International Financial Reporting Standards ("IFRS")

# Background to IFRS adoption

- In the spring 2000, the European Union set a strategic target to become the world's most competitive and dynamic economy.
- A highly efficient capital market was seen as an important prerequisite to achieve this target.
- Comparable financial statements for listed companies and thus common financial reporting standards was seen as one tool to improve the efficiency of the capital market.
- EU legislation in June, 2002: The consolidated accounts of all listed companies within the European should be prepared in accordance with IFRS as from 2005.
- >20 new accounting standards adopted under Swedish GAAP year 2000 to 2003 => has limited the impact of the IFRS adoption.
- IASB runs several convergence projects with FASB (main issuer of US GAAP). => more accounting changes to be expected after 2005.

## Significant changes of financial reporting policies in 2005:

- IAS 39, Accounting for financial instruments & hedge accounting
  - Derivative financial instruments & hedge accounting
  - Investments in shares
  - Other financial assets and liabilities
  - Derecognition of financial assets
  
- IFRS 3, IAS 36 & 38, Business combinations and goodwill
  
- Other, including transition effects and presentation issues
  - IAS 38, Capitalization and amortization of product and software development prior to 2001.
  - IAS 19, Actuarial gains and losses to be zero at Jan 1, 2004.
  - Classification of investments in marketable securities.
  - Income statement with VFS fully consolidated.
  - Consolidation of temporary investments.
  - Other.

# General transition rules



- General rule: Restatement of 2004 financial statements as if IFRS had been applied historically.
- Main exceptions:
  - IAS 39 => applied prospectively from Jan 1, 2005.
  - IAS 19 => actuarial gains and losses set to zero at Jan 1, 2004.
  - Goodwill => no reversal of goodwill amortization prior to Jan 1, 2004.
  - Business Combinations => No requirement to prepare new "acquisition balances" of historical acquisitions (before date of transition).

# Communication of IFRS transition effects and restatements

- 2004 year-end report issued on February, 10, 2005:
  - 2004 annual report issued in March, 2005.
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1. Transition effects to balance sheet & equity, Jan 1, 2004.
  2. Restatement of 2004 income statement.
  3. Transition effects to balance sheet & equity, Jan 1, 2005.  
(1 & 2, plus transition effects from adopting IAS 39)

## IAS 39, Financial instruments and hedge accounting

- Revised version of IAS 39 issued in December 2003.
- Heavily debated and criticized, mainly due to market valuation of derivatives and strict rules for hedge accounting.
- Carved-out version of IAS 39 endorsed by the European union during autumn 2004. No impact for Volvo of carve-outs.
- Several exposure drafts of further changes of IAS 39 to be decided upon during 2005, for example hedging of intra-group transactions in foreign currencies.

## IAS 39, Derivative financial instruments and hedge accounting

- Major consequence of IAS 39:  
All derivative financial instruments to be reported on-balance sheet at fair value. No more “off-balance sheet instruments”.  
Will generally increase volatility both in the income statement and in the balance sheet.
  
- Method to avoid volatility in income statement = Hedge accounting.
  - Fair value hedges => volatility against value of hedged item
  - Cash flow hedges => volatility against equity
  - “Equity hedges” => volatility against equity
  
- In order to qualify for hedge accounting, companies must meet strict requirements regarding documentation of:
  - Risk management objective and strategy
  - Identification of hedging instrument and hedged item and risk
  - Efficiency testing

# IAS 39 Derivative financial instruments and hedging transactions

Volvo uses derivative instruments mainly in the following areas:

- Hedging of forecasted commercial cash-flows (currency risks)
  - ➔ Hedge accounting can most likely be achieved.  
(Exposure draft to be approved by the IASB in 05Q1)
  
- Management of financial assets (interest rate risks)
  - ➔ No hedge accounting but limited volatility.
  
- Hedging of funding transactions (currency and interest rate risks)
  - ➔ Hedge accounting can not be achieved.  
Volatility expected in the financial net of the income statement.
  
- Transition effect January 1, 2005:
  - 1) Derivatives reported at fair value
  - 2) “Basis adjustment” for hedged loans



# IAS 39 Investments in shares

- Investments in shares, except investments in associated companies, to be reported in the balance sheet at fair value (quoted market price for listed shares).
- Remeasurements debited or credited to equity, unless if a value decrease is deemed “other than temporary” when an impairment loss should be charged to the income statement.
- Transition effect January 1, 2005:  
Investment in Deutz AG remeasured to quoted market price.

# IAS 39 Other financial assets and liabilities

- Financial assets to be classified as either:
  - Held for trading: Fair value, remeasurements in income statement
  - Originated loans and receivables: Amortized cost
  - Held to maturity: Amortized cost
  - Available for sale: Fair value, remeasurements in equity
  
- Financial liabilities reported at amortized cost, unless if fair value hedge accounting is applied when hedged risk should be reported at fair value.
  
- Transition effect January 1, 2005:  
Recognition of unrealized gains on marketable securities.

# IAS 39 Derecognition of financial assets

- Derecognition of financial assets, i.e. receivables.
- Criteria under Swedish GAAP:  
Receivables derecognized when legal title of receivables is transferred to an external party.
- Criteria under IAS 39:  
Receivables derecognized when substantially all risks associated with the receivables have been transferred to an external party.
- Dealer inventory financing arrangements with risk sharing.
- Transition effect January 1, 2005:  
Recognition of receivables and “loans” in balance sheet.

# Business combinations and goodwill (IFRS 3, IAS 36 & 38)

- No more amortization of goodwill (i.e. intangible assets with indefinite useful lives).
- Annual impairment tests to be performed for “cash-generating units”.
- Stricter requirements to allocate purchase price in business combinations to other intangible assets than goodwill, for example technology, trademarks, customer registers etc.
- Restatement of 2004 income statement:  
Reversal of goodwill amortization reported under Swedish GAAP.

# IAS 38, Capitalization and amortization of product and software development prior to 2001

- Capitalization and amortization of product and software development under Swedish GAAP as from 2001. No retroactive application permitted according to transition rules.
- IFRS transition rules: No exception regarding retroactive application for IAS 38.
- Retroactive capitalization and amortization of product and software development prior to 2001.
- Transition effect January 1, 2004: Net carrying value reported as intangible asset versus equity.
- Restatement of 2004 income statement: Increased amortization.

# IAS 19, Actuarial gains and losses set to zero

- Volvo adopted RR 29 (=IAS 19) in 2003.
- IFRS transition rules: Unrecognized actuarial gains and losses should be zero at IFRS transition date, January 1, 2004.
- Transition effect January 1, 2004: Unrecognized actuarial gains and losses credited or debited to equity.

# Classification of investments in marketable securities

- Swedish GAAP: Investments in marketable securities classified in balance sheet as liquid funds.
- “Liquid funds”:
  - Low revaluation risks
  - High liquidity
- Example: Investment in highly liquid bonds with fixed interest rate terms, combined with interest-rate swap (fixed to variable).  
Substance: Low revaluation risk and high liquidity.  
IFRS: Two financial instruments classified separately. Maturity date of bond to be considered.
- Transition effects:  
Investments not qualifying to be classified as “liquid funds” reported as short-term or long-term interest bearing investments.

# Income statement with VFS fully consolidated

- Current presentation format:  
Income statement with VFS reported according to the equity method.
- IFRS presentation format:  
Income statement with VFS fully consolidated.



# Consolidation of temporary investments

- Swedish GAAP:  
Temporary investments not consolidated.
- IFRS:  
All subsidiaries consolidated, including temporary investments.
- Transition effects & 2004 restatements:  
Consolidation of LB Smith distribution business.

# Other

- Share-based payments
- Discontinued operations and non-current assets held for sale