INTERNATIONAL ACCOUNTING: PROPOSED CHANGES TO IAS 39 – MEASUREMENT ISSUES: DIE ÄNDERUNGSVORSCHLÄGE DES IASB[1]

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Abstract

This paper deals with the subsequent measurement of financial instruments under IAS/IFRS. After giving an overview of the general approaches to the subsequent measurement of financial instruments and some background on the development of IAS 39, this paper first deals with the current provisions of IAS 39. The paper then presents and discusses the proposed changes to subsequent measurement as suggested by the Exposure Draft on proposed amendments to IAS 32 „Financial Instruments: Disclosure and Presentation“ and IAS 39 „Financial Instruments: Recognition and Measurement“ (ED) issued in summer 2002. Especially the issue whether those proposed changes may alleviate the need for the use of the specific hedge accounting provisions of IAS 39 will be discussed.

In summary, the reasons for some of the proposed changes in subsequent measurement are sometimes far from being convincing. While, for example, the changes in designation may overall be welcomed, especially the removal of reversals of impairment for available-for-sale financial instruments departs significantly from the treatment of impairment in other IAS and leads to inconsistencies within IAS 39. In general, with respect to hedge accounting the IASB is well short of target. Even minor changes which could ease the implementation of the standard without touching the fundamental concepts were obviously not even considered (e.g. lowering the ex ante hedge effectiveness level.required, introducing the short cut method, removal of the restriction of portfolio/index hedging etc.).

I. Introduction

In Croatia and in Germany the International Accounting Standards (IAS) have become increasingly important over the last years. In Croatia the Croatian Accounting Act fully recognises IAS for both domestic and foreign companies.[2] In addition, the Zagreb Stock Exchange requires IAS for listings. In Germany § 292a of the German Commercial Code allows German companies to present their conso-

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[1] The paper is an updated and extended version of the presentation held at the XXIII. Scientific Kolloquium Fachhochschule Pforzheim/Ekonomski fakultet u Osijeku in Porec, Croatia; it is based on an article co-authored with Daniela Klotzbach, KPMG Deutsche Treuhandgesellschaft, Banking & Finance Assurance, Frankfurt/Main.

[2] However, to be used in Croatia, IAS have to be first printed in the National Gazette of the Republic of Croatia. See IASB, Use of IAS around the world (A-F), "Croatia".

lidated financial statements under IAS (or alternatively US-GAAP) under certain conditions. In addition, the presentation of consolidated financial statements using IAS (or alternatively US-GAAP) is required for a listing in certain stock exchange segments. In the near future, the use of IAS will further increase due to the European Union's strategy of promoting IAS.[3] As one of the results of this new strategy all companies in the European Union which issue securities to a regulated securities market are required to report their consolidated financial statements under IAS starting in 2005.[4]

With the general importance of IAS growing, also the analysis and critical discussion of its requirements should attract increased attention. It is well known that financial accounting may not just reflect the effects of economic transactions but may also influence the decision-making of users to achieve or avoid certain accounting effects. This seems especially true for such a complex Standard as IAS 39 (revised 2000) "Financial Instruments: Recognition and Measurement" which is highly criticized e.g. for its overly rigorous rule-based treatment of hedging transactions and its ignorance of internal contracts.[5] The impact of these rules on management decisions is highlighted, for example, by a common comment of the head organizations representing the German Businesses:

"Both German banks and other industries have repeatedly pointed out that the central weaknesses of the existing standards on accounting for financial instruments lie in the restrictive and economically nonsensical use of hedge accounting and in the treatment of internal contracts. Those rules are totally at odds with companies' risk management policies, whose objective is to hedge net risk exposures. We firmly reject any departure from this modern and efficient risk management methodology in the interest of compliance with accounting standards. Accounting should follow risk management - not vice versa."[6]

After giving an overview of the general approaches to the subsequent measurement of financial instruments and some background on the development of IAS 39, this paper first deals with the current provisions of IAS 39. The paper then presents and discusses the proposed changes to subsequent measurement as suggested by the Exposure Draft on proposed amendments to IAS 32 „Financial Instruments: Disclosure and Presentation" and IAS 39 „Financial Instruments: Recognition and Measurement" (ED). Especially the issue whether those proposed changes may alleviate the need for the use of the specific hedge accounting provisions of IAS 39 will

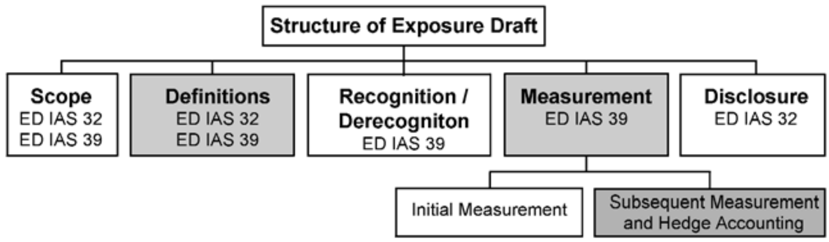
[3] See European Commission (2000).

[4] See European Community (2002).

[5] See, for example, EFRAG (2002).

[6] Gemeinsamer Arbeitskreis des Bundesverbandes deutscher Banken, der Bundesvereinigung der deutschen Arbeitgeberverbände, des Bundesverbandes der deutschen Industrie, des deutschen Industrie- und Handelskammertages, des Gesamtverbandes der deutschen Versicherungswirtschaft für Fragen der Rechnungslegung (2002).

Figure 1: Proposed Amendments to IAS 39 and Areas Discussed in the Paper



The paper focusses on Subsequent Measurement (grey shaded areas)

However, significant hanges also in other areas, e.g.

- Scope: Financial Guarantee Contracts, Loan Commitments, Commodity Contracts
- Definitions: Equity/Liability
- Recognition / Derecognition: Switch from mixed control / risk rewards approach to continuing involvement

be discussed. Figure 1 indicates the areas of the Exposure Draft on Amendments to IAS 39 subject to subsequent discussion (shaded in grey) and highlights some other important amendments.[7]

II. Background – Subsequent Measurement of Financial Instruments

Three different approaches for the subsequent measurement of financial instruments can be distinguished :

Historical Cost Approach

Under the historical cost approach the subsequent measurement of financial instruments follows the usual cost treatment traditionally applied to non-financial assets and liabilities. All financial instruments are basically measured at (amortized) cost. However, financial assets which are not held for the long term are measured at the lower of cost or market, similarly financial liabilities are measured at the higher of cost or market. Regardless of the intent of how long the enterprise intends to hold a financial asset, any impairment is to be recognized in net income. Negative fair

7 For a more detailed review of the proposed amendments see Kropp/Klotzbach (2002), Lüdenbach (2002) and Pape/Bogajewskaja/Borchmann (2002).

values of free-standing derivatives are recognized as expenses, positive fair values remain unrecorded. Under specific hedge accounting provisions the subsequent measurement of financial derivatives which are used for hedging purposes follows the treatment of the related hedged items: Their changes in fair value are either not recognized at all or are only taken into consideration when measuring the hedged item.

The described historical cost approach is used, for example, by German GAAP although the hedge accounting provisions are not set by law but have been developed by users and the accounting profession on the basis of the fundamental principles of German-GAAP.

Full Fair Value Approach

Under the full fair value approach the traditional accounting treatment for assets and liabilities is not longer applicable for financial instruments. Instead, any financial instrument – financial assets as well as financial liabilities - are measured at fair value[8] with changes in fair value being recognized in net income.[9] Any risk of incollectibility is to be included in the fair value measurement and therefore any changes in this risk are automatically reflected in net income. In addition, when hedging the fair value of a hedged item with a derivative, the changes in fair value of both instruments will tend to offset, therefore, there is no need for specific hedge accounting provisions.

The full fair value approach was suggested by the Joint Working Group of Standard Setters (JWG) in its “Draft Standard and Basis for Conclusions Financial Instruments and Similar Items” in December 2000.[10] The Draft Standard was widely opposed for several reasons. At least four of them should be mentioned:[11] First, the use of fair value of all financial instruments seems problematic with respect to the reliability and comparability of financial statements since there are no market-standards for the measurement of several financial instruments. Second, the full fair value concept has severe implications for long-term financial investments like long-term loans: The market assessment of credit risk may be highly volatile thereby inducing an unwanted and unfounded volatility of net income. Third, the fair value measurement of liabilities has counterintuitive effects on net income: Any deterioration of the creditworthiness of the enterprise is reflected by an increase of the net income of the enterprise. Fourth, under the full fair value approach there is no place

[8] Fair value can be defined as in IAS 32.5: “Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

[9] See, for example, Willis (1998).

[10] See Joint Working Group of Standard Setters (2000). For background information see Pape/Breker (1999) and Breker/Gebhardt/Pape (2000).

[11] See, for example, Schildbach (1999). See also Kley (2001) and Chisnall (2000).

for alternative hedging concepts founded in financial theory - like cash flow hedging for corporates - which are not aimed at minimizing the changes of fair value of a hedged item, but at smoothing the variability of future cash flows.

The Mixed-Model / Management Approach

In the Mixed-Model-Approach all financial instruments are classified into different categories of financial instruments at the date of acquisition. The classification is based to some extent on the intention of management; therefore the approach is sometimes also labeled "Management Approach". To some categories of financial instruments – usually loans, certain securities and almost all liabilities - the historical cost approach is applied. Changes in fair value are irrelevant to these financial instruments, only impairment losses on the mentioned financial assets are to be recognized. Financial instruments which are held for generating profits from trading, i.e. from short-term fluctuations in price or dealer's margin, are classified as "held for trading". For such trading instruments the full fair value approach is required. Financial assets which are tradable but which were not acquired for trading purposes are measured in the balance sheet at fair value but with fair value changes recognized in net income until the asset is sold or an impairment loss is to be recognized. Financial derivatives are always regarded as held for trading under this approach unless specific provisions for hedge accounting apply. Under those provisions the changes in fair value or cash flows of derivatives are matched with the changes in fair value or cash flows of the hedged items to the extent that the hedge is effective with regard to the risk(s) being hedged.

This Mixed-Model-Approach is used, for example by US-GAAP. The subsequent measurement of non-derivative financial instruments is dealt with in several standards depending on the type of financial instrument. Traded securities, for example are dealt with in SFAS 115. The subsequent measurement of financial derivatives – including hedge accounting – is dealt with separately in SFAS 133 and 138.

When at the end of 1998 IAS 39 „Financial Instruments: Recognition and Measurement" was issued, this marked the - temporary - end of a comprehensive project on financial instruments[12] and the completion of the "Core Set of International Accounting Standards" as being agreed on with IOSCO.[13] It took almost 10 years with two Exposure Drafts and a Discussion Paper to arrive at IAS 39 which demonstrates the difficulties in standard setting for financial instruments. IAS 39, however, could only be issued when the IASC took resort to the US-GAAP provisions for the accounting for financial instruments mentioned above, resulting in a mixed-model-approach following the US-GAAP rule-based tradition instead of the principle-based approach usually used by IAS. At the time of issuance IAS 39

[12] See the Introduction to IAS 39, esp. sections 2-12.

[13] For a discussion of the events leading to IAS 39 see Glaum/Förschle (2000), p. 1529.

was therefore deliberately labeled as an Interim Standard since the IASC then hoped that the JWG – in which the IASB took part - would develop a comprehensive, probably more principle-based approach for the accounting of financial instruments. The complexity of IAS 39 is highlighted by the IASC's decision to set up an IAS 39 Implementation Guidance Committee (IGC) issuing implementation guidance for the first time in IAS history and the subsequent issuance of more than 200 implementation guidances.

Due to the intense opposition to the JWG's Draft Standard on Financial Instruments issued, the IASB had waited in vain for a comprehensive Standard on financial instrument accounting to remove IAS 39. In July 2001 the IASB therefore decided to amend IAS 39 without touching on the fundamental principles of the Standard, i.e. the mixed model and the provisions on hedge accounting.[14] Together with the amendments to IAS 32 the IASB therefore issued in July 2002 an Exposure Draft with amendments to IAS 39 which intend to[15]

- ease the application of IAS 39 by incorporating the implementation guidance issued by the IGC,
- eliminate some inconsistencies,
- provide some clarification on specific issues by adding interpretation and
- converge – where possible - to US-GAAP treatments.

The amended IAS 39 is likely to stay in place for some time.Die Hauptstreitpunkte seit Beginn der Diskussion um die bilanzielle Erfassung und Bewertung von Finanzinstrumenten lassen sich auf zwei Fragen zurückführen: Zum einen, wann darf ein Finanzinstrument ausgebucht und der damit verbundene Erfolg realisiert werden, und wann ist in Verbindung mit der Ausbuchung ein anderes Finanzinstrument einzubuchen (Derecognition)? Zum anderen, wie sind Finanzinstrumente – insbesondere auch originäre – zu bewerten?[16] Based on its quoted firm view of IAS 39's current rules on hedge accounting German business is totally disappointed with the Exposure Draft of proposed amendments to IAS 39: The IASB deliberately upheld its regulations regarding hedge accounting (and internal contracts).[17] However, it also proposed far-reaching changes with respect to the subsequent measurement of financial instruments which intend to reduce the need for using the specific hedge accounting provisions of IAS 39.

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[14] See IAS 39(ED)ED IAS 39, C6.

[15] See IAS 39(ED)ED IAS 39, C7 f.

[16] See IAS 39(ED)ED IAS 39, C9.

[17] The IASB does not even like to discuss any changes to IAS 39 which are not proposed by the amendment, see ED IAS 39, Introduction, § 7.

For possible alternative hedge accounting rules see ASB (2002).

III. Subsequent Measurement of Financial Instruments under the current IAS 39

1. General Measurement Provisions

Under the current provisions of IAS 39 (revised 2000), the subsequent measurement of financial instruments follows their classification upon initial recognition. Financial assets are classified into one of four categories (see figure 2), financial liabilities are classified into one of two categories (see figure 3).

Financial assets and financial liabilities "held for trading" are subsequently measured at fair value with fair value changes recognized in net income.[18] Financial assets classified as "Loans and Receivable originated by the Enterprise" or as "Held-to-Maturity-Investments" and financial liabilities classified as "Other Liabilities" are subsequently measured at amortized cost.[19] Financial assets which cannot be classified into one of the three aforementioned categories for financial assets are to be classified as "Financial Instruments available-for-sale". They are subsequently measured at fair value, but with fair value changes being directly recognized in equity until they are sold.[20] Upon the disposal of the financial instrument available-for-sale the changes in fair value previously recognized in equity are transferred to the income statement ("recycling").[21] The option to recognize fair value changes of financial instruments available-for-sale in net income which had been available on first-time-application of IAS 39[22] was usually not used by enterprises since this treatment had to be consistently applied to all financial instruments within the available-for-sale-category.[23] As an exception, if in rare circumstances the fair value of a financial instrument cannot be reliably measured, such a financial instrument is subsequently to be measured at cost even if it is classified in a category requiring fair value measurement.[24]

Derivative financial instruments which are not accounted for as hedging instruments under the specific hedge accounting provisions of IAS 39 are always deemed to be held for trading and must be subsequently measured as financial assets held for trading (positive fair value) or financial liabilities held for trading (negative fair value).[25] In order to prevent circumventions of this requirement for derivatives, under certain conditions so-called hybrid financial instruments which represent a

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[18] See IAS 39.69 and IAS 39.103(a)

[19] See IAS 39.69(a)-(b) and IAS 39.73 and IAS 39.93

[20] See IAS 39.69.

[21] See IAS 39.103-104. Die Ausübung des Erstanwendungswahlrechts ergebniswirksamer Verbuchung von Fair-Value-Änderungen wurde i.d.P. überwiegend nicht genutzt.

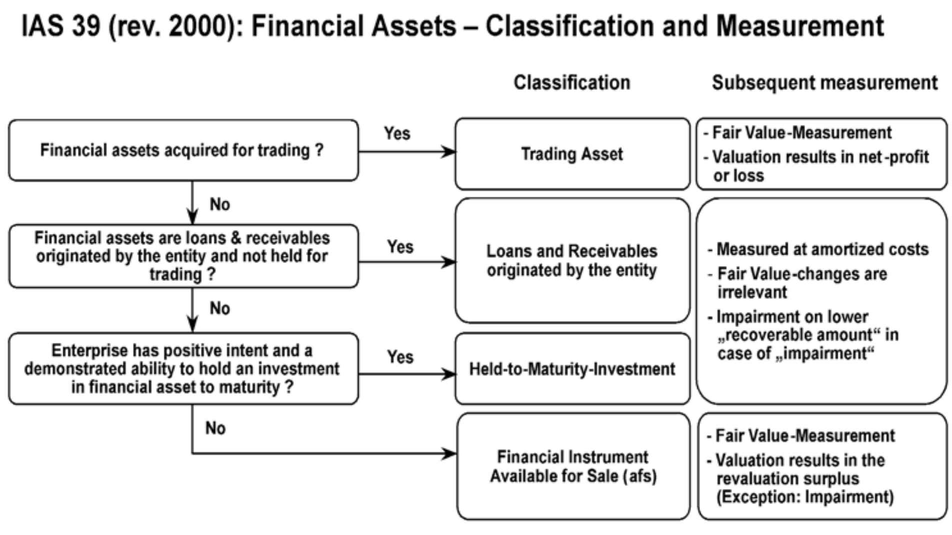
[22] See IAS 39.103(b)(i) and 39.104.

[23] See IAS 39(ED)ED IAS 39.C56.

[24] See IAS 39.69(c)

[25] See IAS 39.10, IAS 39.93 and 39.103(a).

Figure 2: Subsequent Measurement of Financial Assets – Current Practice



portfolio of a non-derivative financial instrument and a derivative must be separated into their components for accounting purposes.[26] While the non-derivative financial instrument, the host contract, is to be classified into one of the non-trading categories, the derivative(s) are separately accounted for as derivative financial instruments as held for trading. Of course, such a separation is unnecessary if the hybrid instrument must be classified as held for trading.

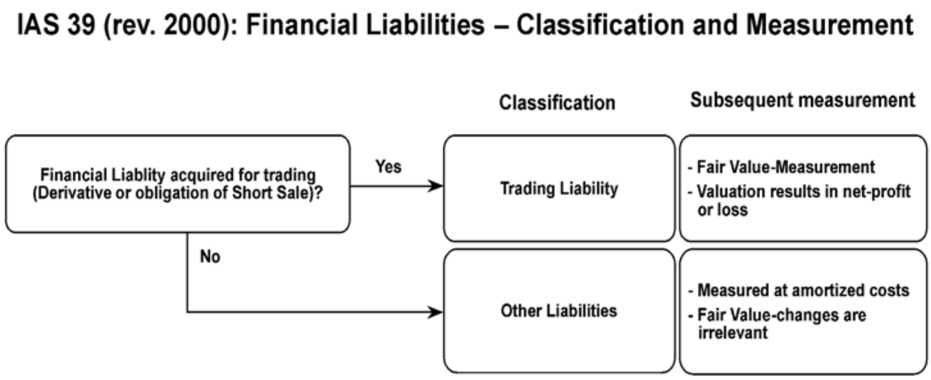
With respect to financial instruments which are not classified as held for trading and which are denominated in foreign currency, the provisions of IAS 21 are to be applied. Both, financial assets representing claims (e.g. loans and receivables and bonds) and financial liabilities, denominated in foreign currency are monetary items which are to be measured at the exchange rate of the balance sheet date with exchange rate gains and losses to be included in net income[27] if those items are not forming part of a net investment in a foreign entity.[28]

[26] See IAS 39.22-25.

[27] See IAS 21.11, 21.15 and IAS 39.94.

[28] See. IAS 21.17-18.

Figure 3: Subsequent Measurement of Financial Liabilities - Current Practice



2. Impairment

For all financial assets which are not subsequently measured at fair value with fair value changes included in net income, the two-step impairment provisions of IAS 39 apply.[29]

In the first step, the enterprise has to check for objective evidence of impairment. The examples introduced by IAS 39.110(a)-(f) for objective evidence for impairment relate to financial distress and insolvency. In addition, IAS 39.110(g) refers to the historical loss experience of the enterprise for its loan portfolios and therefore introduces the possibility of determining impairment also on a portfolio basis. All indicators, however, primarily relate to financial claims, but not to equity financial instruments.

In the second step, after having determined that there is objective evidence for impairment, the recoverable amount has to be determined with any impairment loss being recognized in net income. For equity financial instruments available-for-sale, the recoverable amount equals their fair value[30] and can often be determined by a quoted price. Any (negative) amount being recorded directly in equity due to revaluations to fair value has to be taken out from equity and must be included as an impairment loss in net income. For debt instruments available-for-sale the recoverable amount is to be determined by discounting the expected cash flows by the appro-

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29 See IAS 39.109-119.

30 See IAS 39.118.

priate current discount rate.[31] In this case, the difference between the acquisition cost (net of any principal repayment and amortization) and the recoverable amount has to be taken out from equity and to be included as an impairment loss in net income. In the case of financial assets subsequently measured at amortized cost, the recoverable amount must be calculated by discounting the expected cash flows with the original effective yield in the asset and any difference to the carrying amount of the asset is to be included in net income as an impairment loss.[32]

If, due to an objectively verifiable event occurring after the write-down, the recoverable amount is higher than previously calculated, the recognized impairment is to be reversed to the new recoverable amount with the reversal being recognized in net income. The amount of reversal must not result in a carrying amount exceeding the amortized cost which would have been recorded had the impairment not been recognized.[33]

3. Hedge Accounting

Under IAS 39 two forms of hedge accounting must be distinguished:[34] fair value hedge accounting und cash flow hedge accounting.

By using fair value hedge accounting, recognized assets and liabilities can be hedged against fair value changes by a hedging instrument, usually derivatives.[35] On the level of journal entries, the subsequent measurement of the derivative remains unchanged: The derivative is still being treated like a financial instrument held for trading. The matching of gains and losses of the hedged item is achieved by recognizing the changes of fair value of the hedged item with respect to the risk being hedged. By recording so-called fair value adjustments on the hedged item which are recognized in net income, the otherwise applicable subsequent measurement of the hedged item is dispensed.

By using cash flow hedge accounting, the variability of future cash flows due to changes in market prices can be hedged.[36] Hedged items may be the future cash flows from recognized assets and liabilities, from currently unrecognized binding contractual arrangements (firm commitments) and from non-contracted, planned transactions if these transactions are highly probable to occur (forecasted transactions). Although firm commitments technically represent fair value exposures, they are, however, currently recorded as cash flow hedges.[37] On the level of journal

[31] See IAS 39.111. and 39.118

[32] See IAS 39.111 and 39.113.

[33] See IAS 39.114 ans IAS 39.119.

[34] See IAS 39.137-141. For Net Investment Hedges IAS 39 is just detailing some conditions for hedge accounting. The basic concept of Net Investment Hedging is embodied in IAS 21.17-19.

[35] See IAS 39.153-157.

[36] See IAS 39.158-163.

[37] See IAS 39.140.

entries, the derivative is still recognized at fair value at the balance sheet, however, the effective portion of the cash flows changes of the hedging instrument are recorded directly in equity, only any ineffective portion is to be recognized in net income. The portion recorded directly in equity must be eliminated from equity and recognized in net income in the same period when the cash flows of the hedged item are recognized in net income.[38] However, if the hedged transaction results in the recognition of an asset or a liability, the portion recorded in equity must be eliminated and included in the initial measurement of the asset or liability being recognized (basis adjustment).[39]

Both types of hedge accounting under IAS 39 are applicable only if very restrictive conditions e.g. on documentation and hedge effectiveness[40] are met.[41] In addition, there are detailed and very restrictive requirements for hedged items and hedging instruments.[42] These requirements often result in undue cost and effort just to comply with accounting provisions. In addition, as quoted in the introduction they also have severe impacts on the enterprise's processes and operations.

IV. Subsequent Measurement Issues in the Proposed Amendments to IAS 39

1. General Measurement Provisions

1.1. Proposed Changes

According to ED IAS 39.10 und 17 enterprises would be enabled to classify also financial instruments which they do not hold with a trading intent as financial instruments held for trading at recognition (see figures 4). This represents basically an option for enterprises to classify any financial instrument as a financial instrument held for trading. Since ED IAS 39.18A requires a separate presentation of such financial instruments apart from those with the actual trading intention as „financial instruments at fair value (through net income)“ or a similar line item in the balance sheet, the IASB de facto introduces a new category for financial assets and a new category for financial liabilities. In addition, financial liabilities would need to be designated as held for trading if the enterprise intends to repurchase them in the near future or if they form a part of a portfolio together with other instruments which is managed together and for which in the past active trading took place (see figure 5).[43]

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38 See IAS 39.162.

39 See IAS 39.160.

40 See IAS 39.142(e) and IAS 39.146-152.

41 See IAS 39.142-144.

42 See IAS 39.122-135.

43 See IAS39(ED).18.

Apart from eliminating the first-time choice for recognizing the changes in fair value of available-for-sale financial instruments in net income,[44] the IASB sees the following advantages in opening up the trading category:[45]

- Inconsistencies of the mixed-model can be eliminated.

  In some circumstances financial assets and financial liabilities which are linked are currently measured under different subsequent measurement provisions – one item is measured at cost, the other at fair value. Hedge accounting – apart from hedging currency risks – is impossible under the current hedge accounting provisions which allow only derivatives to be used as hedging instruments in non-currency hedges.[46] According to the IASB, by opening up the trading category such accounting mismatches can be eliminated.
- Easier accounting for hedging relationships

  IAS 39 will still apply restrictive conditions on hedge accounting. However, by opening up the trading category for each financial instrument, any financial asset and any financial liability may be designated as held for trading. In doing so, for both, the hedged item and for the hedging instrument (if not anyway required if the hedging instrument is a financial derivative), there is no need to resort to the hedge accounting provisions for fair value hedges.[47] Both instruments are subsequently measured on the same measurement basis resulting in an offset of the corresponding fair value changes.
- Reduction of otherwise necessary separations of embedded derivatives

  Due to the possibility to designate any financial instrument as held for trading, also hybrid contracts which are not held for trading purposes can be classified as held for trading. An otherwise required separation of a hybrid contract into its component parts, the host contract and the financial derivative(s) can therefore be avoided since the separation is not required for hybrid contracts held for trading.[48]
- Reduction of accounting errors due to wrong designation

  Currently the correct designation into either the category held for trading or the other categories is critical for the determination of net income: Classifying a financial instrument wrongly into the trading category inevitably leads to a distortion of net income. This consequence of a mixed-model can be eliminated by opening up the category held for trading. The potential for error is reduced to a wrong presentation in the balance sheet since according to ED IAS 39.18A financial instruments designated as held for trading but not actually held for trading purposes are to presented under a separate line item in the balance sheet.

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[44] See IAS 39(ED)ED IAS 39.C61.

[45] See IAS 39(ED)ED IAS 39.C58.

[46] See IAS 39.122.

[47] See IAS 39(ED)ED IAS 39.C59.

[48] See IAS 39(ED)ED IAS 39.C60

Figure 4: Subsequent Measurement – Proposed Changes for Financial Assets

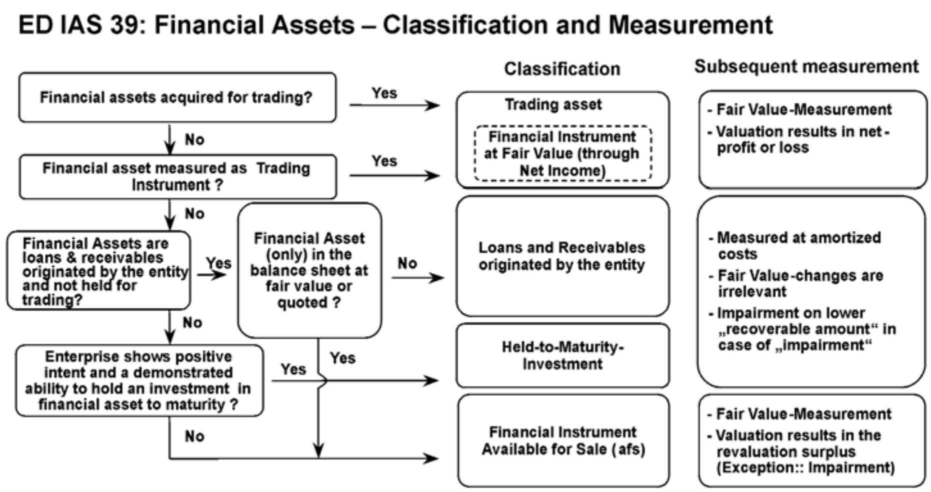
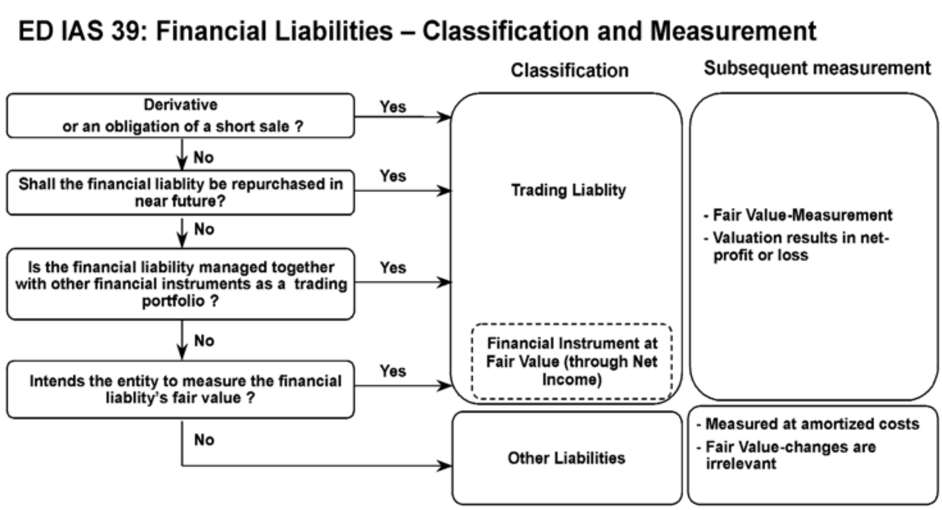


Figure 5: Subsequent Measurement – Proposed Changes for Financial Liabilities



The opening up of the category held for trading is supplemented by changes in the designation of financial asset as available for sale (see figure 4). Currently, debt financial instruments – whether issued as loans or securities – which are acquired directly from the issuer must be designated as loans and receivables originated by the enterprise unless they need to be classified as held for trading.[49] The missing differentiation between loans and tradable securities has been criticized in the past[50] and usually leads to technical problems in implementation since IT-systems differentiate financial instruments often based on their legal form, but not the type of acquisition. The Exposure Draft now requires the designation of financial assets which are quoted in an active market as available for sale financial instruments. In addition, each financial instrument which is acquired directly from the issue may be classified as available for sale unless it is held for trading purposes.[51]

1.2. Critical Comments

In evaluating the proposed changes one should first carefully investigate the arguments brought forward by the IASB.

With respect to the opening up of the classification as held for trading for each financial instrument independent of any trading purpose, especially the arguments regarding the elimination of accounting mismatches and the easier accounting for fair value hedge relationships look attractive at first sight. However, looking on these arguments more carefully, some doubts occur.

Measuring financial assets and financial liabilities at the same measurement basis may be advantageous. However, accounting mismatches can only be avoided by measuring both on an at cost basis. When measuring financial assets and financial liabilities on a fair value basis with changes of fair value included in net income some room for distortions remain since the risk factors being included in the fair value measurement are not identical. There is one risk factor influencing the valuation of financial liabilities which is usually absent when measuring the corresponding asset: the enterprise's own credit risk. In measuring fair value of an enterprise's liabilities changes in the fair value due to changes in the markets valuation of the enterprise's credit risk must be included in fair value measurement. This results in the counterintuitive effects on net income which were a central criticism at the JWG's Draft Standard suggesting full fair value measurement for all financial instruments:[52] Negative changes in the enterprise's own credit risk are recognized as gains in the enterprise's income statement (for a more detailed explanation see

[49] See IGC-10-11-a.

[50] See, for example, the Basle Committee on Banking Supervision's comment on Question 10-11 of the implementation guidance, BIS (2000).

[51] See IAS 39(ED)ED IAS 39.10 and 20.

[52] See Kley (2001), p. 2259, Schildbach (1999), p. 181 f. and Hitz/Kuhner (2000), p. 901.

Figure 6: Fair Value Measurement of Own Credit risk

Counterintuitive accounting for financial liabilities, example:

An enterprise is issuing a quoted bond on 30 September 2003 withan notional amount of € 100 mio at an issue price of 100%. On 30 September 2004 the quotation of the bond decreased to 90% due to a deteriorating creditworthiness of theenterprise, only.

Currently, under the amortized cost treatment for "other financial liabilities" the change in the enterprise's creditworthiness is not recognized.

Under the proposed changes, the issued bond could be classifiedas "held for trading". The subsequent decrease between the issue price and the quotation on 30 September 2004 (= € 10 million) is a fair value change which has to be recognized in net income:

issued bond	€ 10 million		
		trading income	€ 10 million

A deterioration of creditworthiness results in an income item for the enterprise!

figure 5).[53] This effect is usually not offset by corresponding losses on the enterprise's linked financial assets.

The issue of measuring the enterprise's own credit risk is also present in fair value hedging relationships, therefore questioning also the second argument favoring the proposed opening up of the category held for trading. In addition, there are some severe restrictions: First, the hedged item and the hedging instrument must both be designated as held for trading upon initial recognition.[54] A later transfer of a financial instrument into the category held for trading is not admitted. Second, contrary to fair value hedge accounting, the hedge relationship must stay in place since a transfer of a financial instrument out of the category held for trading is also not admitted.[55] If, for example, a financial asset is designated as held for trading for "hedging purposes" and is being hedged with a financial derivative, changes in fair value may almost offset, the hedge relationship however, can only be ended by selling both instruments. Third, a financial instrument being designated as trading must be remeasured at fair value in its total, no components of the instrument or its risks can be left out in valuation. On the contrary, if this instrument could be designated as a hedged item in a fair value hedge, only identifiable components may be hedged[56] and consequently valued in applying the fair value adjustment with

[53] See Willis (1998), pp.857 ff. and SFAC No. 7, par. 78.

[54] See IAS 39(ED)ED IAS 39.10.

[55] See IAS 39.107 and IAS 39(ED)ED IAS 39.89B.

[56] See IAS 39.128 sowie IAS 39(ED)ED IAS 39.128 und IAS 39(ED)ED IAS 39.C57.

respect to the risk being hedged.[57] The difference can be demonstrated by a simple example: Let us assume the enterprise would like to hedge the interest rate risk of a corporate bond held in the available-for-sale category. Under hedge accounting provisions the corporation may just hedge the risk of a benchmark interest rate (e.g. a swap rate) and therefore recognize as fair value changes only those changes related to the change in the benchmark rate, leading to an almost offset with a corresponding interest-rate swap being used as a hedging instrument. If instead the bond is designated as held for trading, the full fair value of the bond – including any fair value changes due to changes in the bond's credit spread – must be recognized.

Overall, on a closer look the arguments brought forward with respect to the avoidance of mismatches and the easier accounting for hedging relationships are not overwhelmingly convincing. In addition, the opening up of the trading category allows differing accounting treatments for similar transaction and is therefore at odds with the IASB's general approach of reducing options in accounting policy. Nevertheless, the advantages of the proposal should still outweigh its disadvantages. However, the preparers of financial statement should be aware that an increased use of this de facto new category will encourage the IASB in moving forward with the JWG's full fair value approach in the subsequent measurement of financial instruments: Opposition against a future exposure draft arguing for full fair value measurement will look less convincing if preparers start to use the new category.

Whereas the extension of the trading category raises at least some counterarguments, the suggestions for the extension of the category available for sale must definitely be welcomed: It leads to a more practical solution as the current designation provisions.

2. Impairment

2.1. Proposed Changes

The proposed changes of impairment provisions relate to several aspects. With respect to the required objective evidence of impairment, the IASB is supplementing IAS 39 by indicators for impairment of equity investments. Negative changes in the technological, economic, legal and market surrounding of the enterprise which indicate that the acquisition cost may not be recovered are qualified as indicators of impairment. This also includes a significant and prolonged decline in the market price of the investment.

In addition, the IASB more clearly defines the measurement of impairment on a portfolio basis. Assets already being identified as being impaired are to be excluded from the portfolio measurement and must be evaluated separately.[58] On the

[57] See IAS 39.153(b) bzw. IAS 39(ED)ED IAS 39.153(b).

[58] See IAS 39(ED)ED IAS 39.112.

contrary, assets already being identified as not being impaired remain in the portfolio and are evaluated for impairment on a portfolio basis[59] since on such a basis indicators for impairment may apply earlier than in individual measurement.[60] In order to ensure the comparability of financial statements and reduce the possibilities for earnings management, the IASB formulates detailed requirements on the determination of the recoverable amount for portfolios.[61] The portfolios must display similar risk characteristics for which a set of criteria is developed resulting in a high segregation into a set of different sub-portfolios.[62] For each of these sub-portfolios the determination of the recoverable amount must be deducted from historical default experience which, however, is to be adjusted to current conditions (e.g. change in unemployment rate, property prices etc.).[63] In case of missing data "peer group" data may be used. In discounting the expected cash flows the average original effective yield must be reduced by the expected default rate implied in the original effective yield[64] in order to avoid the recognition of an impairment loss already immediately after the acquisition of the corresponding assets.[65]

With respect to the reversal of impairment losses, the IASB proposes a far reaching change: Contrary to the current provisions, impairment losses resulting from financial assets designated as available for sale and financial assets which are carried at cost because their fair value is not reliably measurable cannot be reversed.[66] The IASB justifies this change with difficulties in objectively determining the date when an impairment should be reversed.[67] In addition, this change would lead to a convergence with SFAS 115.16.[68]

2.2. Critical Comments

The suggested amendments regarding the determination of impairment losses on a portfolio basis look overall reasonable although the detailed provisions outlined by the IASB are complex and do not seem to reflect current practice.[69] However, banks and similar financial institutions may need the underlying information anyway in complying with Basle II in applying an Internal Rating Based-

59 See IAS 39(ED)ED IAS 39.112.

60 See IAS 39(ED)ED IAS 39. C74.

61 See IAS 39(ED)ED IAS 39. C75.

62 See IAS 39(ED)ED IAS 39.C86-C87 and ED IAS 39.113A and 113C.

63 See IAS 39(ED)ED IAS 39.C88.

64 See IAS 39(ED)ED IAS 39.113D.

65 See IAS 39(ED)ED IAS 39.C81-C85 and IAS 39(ED)ED IAS 39.C89-C92.

66 See IAS 39(ED)ED IAS 39.116.

67 See IAS 39(ED)ED IAS 39.C93.

68 For this motive see IAS 39(ED)ED IAS 39.C105.

69 See especially IAS 39(ED)ED IAS 39.B33.-B36.

Approach. On a conceptual basis, the suggested correction of the original effective yield by the original expected losses implied in that rate should not be restricted to the portfolio measurement of credit risk. A similar reasoning applies to the determination of the recoverable amount of an asset which is individually identified to be impaired. Accordingly, the current provision in IAS 39.111/ED IAS 39.111 to discount the expected cash flows of such an individual financial asset by the historical effective yield should be correspondingly reformulated.

The suggested prohibition of reversals of impairment losses of available-for-sale financial assets and of financial assets which are carried at cost because their fair value is not reliably measurable is inconsistent with IAS' general approach to impairment.[70] Furthermore, the proposed amendment leads to an inconsistency within IAS 39 since an impairment on the same debt financial instrument may be reversed or not reversed depending on the category in which it is classified: An impairment on a held-to-maturity investment or a financial instrument designated as loans and receivables originated by the enterprise must be reversed, an impairment on the same financial instrument designated as available-for-sale must not be reversed. Therefore, it is difficult to see why the amendment should represent an improvement over the current provisions which require a reversal.

3. Hedge Accounting

3.1. Proposed Changes

The current hedge accounting provisions of IAS 39 remain essentially untouched by the proposed amendment. The proposed changes with respect to the accounting for hedges of firm commitments and to basis adjustments almost only affect presentation issues.

Whereas firm commitments are currently technically accounted for as cash flow hedges, the IASB now suggests to treat them as fair value hedges.[71] As a result fair value adjustments have to be recognized on an item which is not already recognized on the balance sheet. The IASB acknowledges this effect but argues that a non-recognition of the firm commitment just represents an initial measurement of zero and therefore does not inhibit the recording of subsequent fair value adjustments when being hedged.[72] The proposed change would also represent a convergence to US-GAAP since under SFAS 133 hedges of firm commitments are already being treated as fair value hedges.[73]

In a further move to achieve convergence to SFAS 133 the IASB also proposes to remove the requirement to record basis adjustments on cash flow hedges resul-

70 See, for example, IAS 2.31, IAS 16.37 and IAS 38.76 which all provide for a reversal.

71 See IAS 39(ED)ED IAS 39.137 und 140.

72 See IAS 39(ED)ED IAS 39.C97.

73 See IAS 39(ED)ED IAS 39.C98.

ting in the recognition of an asset or a liability from IAS 39. Conceptually, the IASB raises doubt whether the capitalization of hedging results within the initial measurement of the asset or liability is justifiable.[74] Under the proposed change the hedging result would remain in the separate component of equity from where it would be released to net income in the same period(s) in which any effects from the hedged item (e.g. amortization) are recognized in net income.[75]

3.2. Critical Comments

Although US-GAAP preparers may welcome the suggested convergence to US-GAAP which eliminates reconciliation items, the amendments - although not really essential for hedge accounting under IAS - do have some critical implications.

Conceptually, the altered treatment of firm commitments is far from being convincing: In its arguments the IASB seems to mix up recognition and measurement provisions. Only by using this trick, fair value adjustment on non-recognised items can be justified. It is to be hoped that this removal of the borderline between recognition and initial measurement is not being applied to other areas in IAS.

The removal of basis adjustment principally implies practical problems which are acknowledged by the IASB.[76] Whereas the current basis adjustments lead to a de facto automatic synchronization of income and expenses, a removal of basis adjustments requires additional calculations in order to arrive at the necessary offset. If, for example, the contracted purchase of an engine for production purposes in foreign currency is hedged against currency movements, the result of the currency hedge is reflected in a basis adjustment on initial measurement when the item is recognized on the balance sheet. The basis adjustment automatically affects the amortization to be recorded. Under the proposed amendment, the hedge result would remain in the separate component of equity when the engine is recognized at the currency amount of the date of recognition. Also the amortization of the engine would be calculated on the currency rate at recognition. In order to achieve an offset, the hedging result must be released from equity by using a schedule mirroring the useful life and the amortization policy used for the engine. This indirect approach is not only more burdensome for preparers but also more apt to accounting errors than the current approach.[77] For reasons of practicality, the IASB should therefore perhaps better stay with the current approach.

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[74] See in more detail IAS 39(ED)ED IAS 39.C103.

[75] See IAS 39(ED)ED IAS 39.160.

[76] See IAS 39(ED)ED IAS 39.C102.

[77] One can use also another example demonstrating this risk: How should an enterprise remove hedging results from the separate component of equity for hedges of inventories for which usually cost formulas are used?

4. Final Remarks and Suggestions

The proposed amendments to IAS 39 are responding to the needs of preparers of financial statements to ease the implementation of this complex standard on the recognition and measurement of financial instruments. The reasons for some of the proposed changes in subsequent measurement are sometimes far from being convincing. While the changes in designation may overall be welcomed, especially the removal of reversals of impairment for available-for-sale financial instruments departs significantly from the treatment of impairment in other IAS and leads to inconsistencies within IAS 39. The non-essential changes in hedge accounting are either conceptually unconvincing or include major accounting risks in practical implementation. In general, with respect to hedge accounting the IASB is well short of target. Even minor changes which could ease the implementation of the standard without touching the fundamental concepts were obviously not even considered. Such changes to the hedge accounting provisions of IAS 39 could have included, for example:[78]

Lowering the ex ante hedge effectiveness from "almost fully effective"[79] to highly effective in a range of 80% to 125% analogous for the range being defined for the assessment of hedge effectiveness ex post;[80]

Introducing the short-cut-method as being defined in SFAS 133[81]

Removal of the restriction of portfolio hedging[82], at least with respect to index-hedging[83] and

Introducing the possibility of a bifurication of compound derivatives, i.e. the segregation of a derivative into its components[84] in order use just one of the components as a hedging instrument.

In summary, even without considering the fundamental problems addressed by German business quoted in the introduction which are touching on the fundamentals of IAS 39, the disappointment of business with the proposed amendments to IAS 39 is quite understandable.

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78 For a more detailed explanation of these changes see Kropp/Klotzbach (2002).

79 See IAS 39.146.

80 This change would be highly important for commodity hedges since non-financial instruments cannot be hedged with respect only to portions (except for FX risk), see IAS 39.129.

81 See SFAS 133.65, 133.68, 133.114 and 133.132.

82 See IAS 39.132.

83 Under the current hedge accounting provisions a portfolio of German blue chips cannot be hedged by using a DAX-future contract, see explicitly IGC-132-1.

84 See IAS 39.144.

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