Banking & Capital Markets

Can financial instrument accounting be simplified?

PricewaterhouseCoopers

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Introduction

The International Accounting Standards Board (IASB) recently published a range of proposals to 'improve and simplify measurement and hedge accounting'[1] in its discussion paper, 'Reducing complexity in reporting financial instruments'.

With the paper marking an important first step in plans to replace IAS 39 with a principles-based standard, which may use fair value to account for all types of financial instrument, Andrew Hawkins and John Hitchins, of PricewaterhouseCoopers[2] assess the practical implications and how companies can help shape the developments ahead.

1 IASB media release to mark the launch of its discussion paper, 'Reducing complexity in financial instruments' – 18.03.08
2 PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom).

Background

Institutions must choose from a number of distinct and sometimes irrevocable classification categories at the start of the contract

IAS 39 Financial Instruments: Recognition and Measurement is 'difficult to understand, interpret and apply', said the IASB at the launch of its 'Reducing complexity in reporting financial instruments' consultation in March 2008.[3]

Few would disagree that a standard expected to cover almost all financial assets and liabilities, including derivatives, equities, loans and borrowings, would present a range of accounting challenges. Institutions must choose from a number of distinct and sometimes irrevocable classification categories at the start of the contract, with the designation affecting how the instrument is valued and presented (see Table 1), and hence the pattern of reported earnings. The importance of this choice is heightened by 'tainting' rules, under which an entire 'held-to-maturity' portfolio of debt securities would need to be reclassified and fair valued if the holder subsequently opts to sell an individual asset. Certain assets may also be subject to complex impairment tests.

Table 1: Contract classification under IAS 39

Category	Measured at	Changes in carrying amount (unless part of a designated hedge relationship)	Impairment test required?
Financial assets and liabilities at fair value through profit or loss (including held-for-trading, those designated to this category at inception and all derivatives)	Fair value	Income statement	No
Loans and receivables (financial assets)	Amortised cost	Income statement	Yes
Held-to-maturity investments (financial assets)	Amortised cost	Income statement	Yes
Available-for-sale financial assets	Fair value	Equity	Yes
Other financial liabilities	Amortised cost	Income statement	N/A

Source: PricewaterhouseCoopers

3 IASB media release to mark the launch of its discussion paper, 'Reducing complexity in financial instruments' – 18.03.08.

The recent turbulence in the financial markets has brought the debate over the efficacy of IAS 39 to the fore

The particular concerns of many banks centre on the stringent hedge accounting rules. These include meeting an ongoing '80–125%' effectiveness test to permit hedge accounting treatment to be applied to match gains and losses of the hedging derivative with the underlying instrument. Failure to qualify can mean that hedging instruments held to mitigate risk and volatility could actually exacerbate the fluctuations in the income statement.

The recent turbulence in the financial markets has brought the debate over the efficacy of IAS 39 to the fore. This includes the validity of management judgements and 'mark-to-model' evaluations in illiquid markets and the difficulties of valuing instruments in markets that in some cases have come to a virtual standstill. As the market difficulties continue, temporary declines in value of effectively untradable assets such as mortgage-backed securities may become mixed with credit related impairments in the same instruments. Broader concerns centre on whether marking to market can lead to earnings fluctuations that do not necessarily reflect the underlying drivers of value ('accounting noise') and may even undermine investor sentiment. Others would counter that such volatility is inherent in certain aspects of banking business and fair value opens a window onto risks and movements that under cost-based accounting would remain opaque.

Reducing complexity

According to the IASB... Measuring all financial instruments in the same way would therefore make reported information easier to understand and facilitate comparison

In its discussion paper, 'Reducing complexity in reporting financial instruments', the IASB offers a range of intermediate solutions on the road to an ultimate fair value approach, which are designed to simplify the application of IAS 39, impose greater consistency and hence improve the comparability of financial statements.

The paper has also been issued for consultation by the US Financial Accounting Standards Board (FASB) as part of the IASB/FASB memorandum of understanding ('Road map for convergence between IFRS and US GAAP'). The discussion paper forms part of a wider agenda of reform, which has included proposals for 'codifying, clarifying and simplifying' fair value measurement under a harmonised approach modelled on current US accounting practice ('exit price').[4]

According to the IASB, the primary cause of the complexity in IAS 39 is the variety of valuation designations. Measuring all financial instruments in the same way would therefore make reported information easier to understand and facilitate comparison between different entities and periods. Using fair value for all types of financial instruments would, in particular, eliminate the need for classification, impairment testing, transfers between categories, separate accounting for embedded derivatives* and fair value hedging* (cash flow hedging would be retained).

While requiring fair value for all types of financial instruments is the IASB's preferred long-term objective, the Board acknowledges that this may not be feasible in the short term and therefore proposes ways in which IAS 39 could be modified in the interim:

1. Amending existing requirements

- Eliminate held-to-maturity category; and/or
- Eliminate available-for-sale category; and/or
- Require fair value through profit and loss for instruments traded in active markets, while others would be accounted under existing arrangements.

4 IASB discussion paper on 'Fair value measurement' – 30.11.06.
*May still be required for nonfinancial instruments

By extending fair value through profit and loss, it could also lead to greater volatility in the income statement

These amendments could ease the difficulties of classification and largely remove the tainting and impairment rules. However, they are likely to increase the number of instruments being fair valued and hence heighten potential volatility in the profit and loss (P&L) account. Other issues that will need to be addressed include the definition of fair value and how changes in the fair valuation should be presented in the income statement.

2. Replace the existing measurement requirements with a fair value principle, with some optional exceptions

- Instruments with highly variable cash flows such as derivatives and equities would be fair valued.
- Instruments with fixed or slightly variable cash flows such as interest-bearing bonds could be held at cost.

This option would have the practical advantage of being consistent with the IASB's long-term objective of fair value measurement. However, it would require significant changes in the short term. By extending fair value through P&L, it could also lead to greater volatility in the income statement. The ease of application would depend on the relative clarity of the criteria for the optional exceptions.

3. Simplify hedge accounting

- Eliminate hedge accounting.
- Simplify fair value hedges through a fair value option for instruments that would otherwise be hedged items.
- Recognise gains and losses on designated hedging instruments outside P&L.
- Recognise gains and losses on all financial instruments outside P&L.
- Simplify existing requirements. The following table sets out the suggestions and their related implications.

To justify any interim modifications, the current consultations and review would need to conclude that the change would provide more relevant and understandable information for users

Table 2: Simplifying hedge-accounting requirements

Suggestion	Implication
Designation is irrevocable	Reduces flexibility and is a key advantage over an irrevocable fair value option
Partial hedges are prohibited	Reduces the frequency in which hedge accounting can be used
Eliminate 80–125% retrospective effectiveness test	Increases the number of hedging relationships and provides greater flexibility
'Similar items' test for portfolio hedges is relaxed or removed	Increases the number of hedging relationships as hedge accounting would reflect the way that entities manage economic risk
Reclassification of gains and loss for cash-flow hedges is stated at inception of hedge and will be recognised in profit or loss, regardless of whether the forecast transaction occurs as planned	Less complex and reduces the need to track individual gains and losses; however, mistakes in forecasting would cause volatility in profit or loss

Source: PricewaterhouseCoopers

The discussion paper recognises that change for change's sake may not be advisable. In a meeting to discuss their memorandum of understanding on 21 April 2008, the IASB and FASB concluded that it would be 'better to do nothing than to continue with a suboptimal solution'. To justify any interim modifications, the current consultations and review would need to conclude that the change would provide more relevant and understandable information for users, while being consistent with the long-term objectives and not imposing needless costs.

Recognising concerns

Explanatory information would be needed to ensure that the statements are transparent and understandable

The IASB believes that universal application of fair value in the long term would help to ease uncertainty and provide a common basis for comparison. It also argues that this approach would be more economically relevant. This includes reflecting the price that would be received if an entity needed to sell an asset, as well as taking account of any anticipated future losses. In relation to liabilities, fair value would reflect current estimates of the settlement obligation in the event of immediate transfer. It would also ensure that entities with the same credit rating would report liabilities at comparable amounts.

However, the IASB acknowledges certain concerns about the use of fair value. The first centres on whether reporting changes in fair value in the income statement is always relevant as movements often reflect short-term market fluctuations that are beyond management's control. The Board also recognises that such evaluations could be unreliable or at least misleading as the reported gains and losses may never be realised. It accepts there may be difficulties in estimating fair values when there is no active market-based information to draw on. This places heavy reliance on management judgement, which can be subjective and therefore hard to validate and compare. It also demands particular supervisory expertise and understanding, which may not be widely available in some jurisdictions. Finally, it acknowledges that there are widespread concerns about the appropriateness of recognising unrealised gains through fair valuing liabilities.

In addressing these concerns and paving the way for a move to fair value, the IASB has pledged to look at how changes in fair value should be presented in the income statement and what explanatory information would be needed to ensure that the statements are transparent and understandable. More broadly, progress is likely to be dependent on a clear definition of what constitutes a financial instrument and how fair value should be measured.

Alternative perspectives

While fair value may reflect the short-term risk and reward profile of trading activities, it may be less relevant to the long-term investment perspectives within the banking book

In assessing the relative merits of these proposals, it is important to ask whether the differences in designation and valuation are indeed the paramount causes of complexity under IAS 39 and therefore whether fair valuation of all financial instruments would necessarily improve financial reporting.

Although uniformity may enhance comparability, it could be argued that it would fail to take appropriate account of the wide scope and inherent complexity of banking business. In particular, while fair value may reflect the short-term risk and reward profile of trading activities, it may be less relevant to the long-term investment perspectives within the banking book. Recent markets have also shown that fair values are not always a reliable guide to future cash flows. Discounts applied to some securities in the market have differed significantly from valuations based on discounting the underlying cash flows to maturity. There is also the broader issue that moving all financial instruments onto a fair value basis may simply shift accounting complexity from the balance sheet to the income statement. This issue is recognised in the discussion paper, but the paper does not include any proposals as to how results would be presented if all financial instruments were measured on a fair value basis.

Analysts, investors and other users of accounts naturally want intelligibility and comparability. However, uniformity may not necessarily be the best way to achieve this. Users' demands for relevant, reliable and transparent indications of the underlying trends in performance may still be better met through a mixed cost and fair value approach that reflects the particular characteristics of the instrument and business model in question. Those that support the continuation of the mixed model believe the focus should be on simplifying the existing model rather than wholesale change, for example reducing the level of detailed rules around hedge accounting.

The IASB appears to have conceptual misgivings about hedge accounting, which are reflected in the stringency of current rules. However, hedging is an important mechanism in controlling risk and managing the business. It should be possible to maintain a mixed model, while easing some of the more onerous and costly rules, through a principles-based approach that reflects the underlying economics.

Better disclosure will be critical in tackling the complexity and uncertainty associated with IAS 39. This includes clear explanation of the basis of classification and valuation, along with the rationale for the underlying assumptions and their susceptibility to risks and market variables.

Make your views count

"Everything should be made as simple as possible, but not simpler"

The IASB is inviting comments on the discussion paper and suggested alternatives by 19 September 2008. We hope as many banks as possible take up the opportunity to respond. While some areas of debate may appear to be technical accounting issues, the outcome could have critical implications for the credibility of reported earnings at a time when banks are under heightened market scrutiny. Any interim solutions will lay the ground for more fundamental long-term changes.

Reducing complexity as part of the move to a more principles-based approach will be widely welcomed. However, banks need to consider whether simplification based on greater, and eventually, uniform use of fair value might risk trading consistency and comparability for economic relevance – as Einstein said, "everything should be made as simple as possible, but not simpler".

If you would like a full copy of the discussion paper or would like to comment, please visit www.iasb.org. If you would like to discuss any of the issues outlined in this paper in more detail, please speak to your usual PricewaterhouseCoopers representative or one of the authors listed on this page.

John Hitchins
+44 20 780 42497
john.hitchins@uk.pwc.com

Andrew Hawkins
+44 20 721 25270
andrew.d.hawkins@uk.pwc.com

For additional copies, please contact Russell Bishop at PricewaterhouseCoopers on +44 20 7213 3921 or at russell.p.bishop@uk.pwc.com

Designed by studioec4 19584 (09/08)