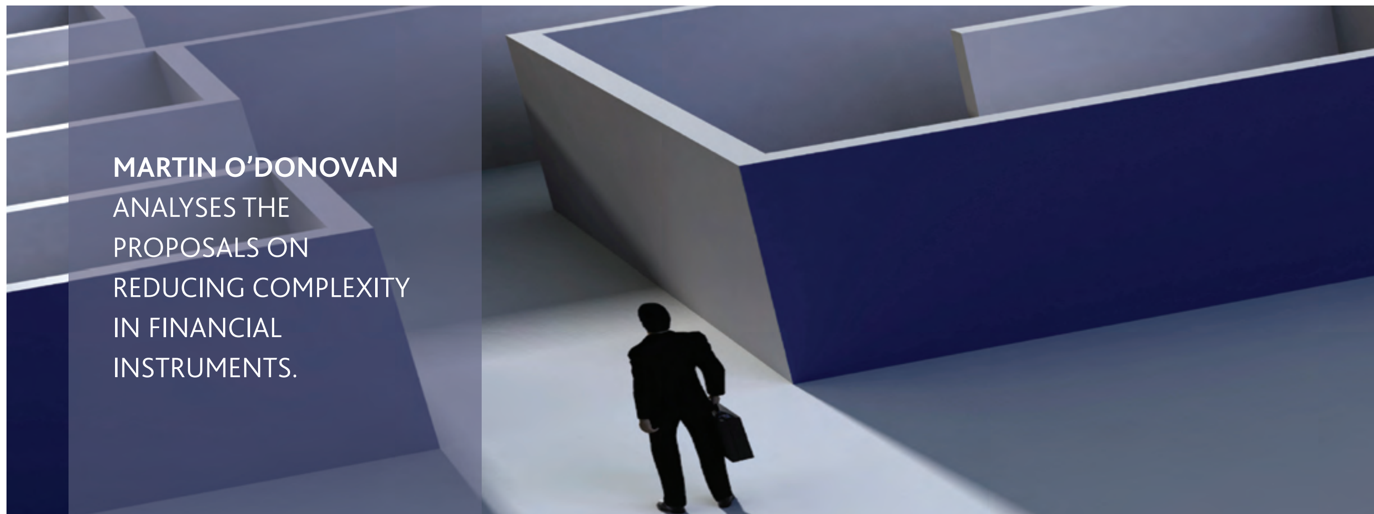
Reducing complexity in IAS 39



MARTIN O'DONOVAN ANALYSES THE PROPOSALS ON REDUCING COMPLEXITY IN FINANCIAL INSTRUMENTS.

All will agree that IAS 39, the accounting standard for financial instruments, is complex, but finding an alternative is no easy matter. After years of acknowledging that something must be done the International Accounting Standards Board (IASB) has issued a discussion paper considering ways to reduce complexity in the reporting of financial instruments. The paper deliberately restricts itself to the problems arising from the many ways by which financial instruments are measured as well as hedge accounting. Derecognition and presentation and disclosures are not within its scope.

Given that the IASB is very much in favour of full fair-value accounting, it starts from the assumption that fair value would be a good measurement attribute that in the long term should apply to all financial assets and liabilities. Certainly, when you consider the range of valuation and measurement methods that currently exists, some form of rationalisation is desirable.

Given the difficulties of moving to a single fair-value measurement of all financial instruments, the IASB puts forward some interim solutions. First, changes to the measurement of some instruments; and second, an attempt to simplify hedge accounting or even to eliminate it entirely.

Executive summary

- The International Accounting Standards Board has started the formal process of considering the possibilities for reducing complexity in IAS 39. Its discussion paper sets out thoughts on the way financial instruments are measured and some ideas for simplifying hedge accounting. However, behind the openness to change, the board remains firmly wedded to the long-term aim of extending the application of fair values.

MEASUREMENT

Approach 1: Amend the existing measurement requirements. Currently, IAS 39 has four measurement categories for financial instruments: financial instruments at fair value through profit or loss; held-to-maturity investments (held at amortised cost); available-for-sale financial assets (gains and losses go to equity until realised); and loans and receivables (amortised cost).

The proposal here is to eliminate the held-to-maturity and available-for-sale categories. An alternative idea given is to leave the categories and accounting as they are except that instruments traded in an active market would be measured at fair value along with all derivatives.

The IASB seems to like its accounting standards to have some sort of intellectual purity. It is uncomfortable with accounting treatments being different depending on management intentions. But in the IASB's own conceptual framework for accounting, it holds up the usefulness and relevance of information as objectives.

If the accounts are to be meaningful, surely it is important for the user to understand whether the intention of management is to be a trader seeking short-term profits or a longer-term holder, generating profits from holding rather than trading the asset. Currently, if a held-to-maturity asset is in fact disposed of early, it taints the whole of that basket of similar items so that they cannot get the held-to-maturity treatment. A minor simplification would be to eliminate held-to-maturity and allow asset by asset inclusion with the loans and receivables category where there are no tainting rules.

Despite its name the available-for-sale category is used for minority stakes in other companies held for strategic reasons. Market values can be hard to obtain and extremely volatile; is it really relevant to be recording these variations in the profit and loss (P&L) account?

Approach 2: Replace the existing measurement requirements with a fair-value principle that has some optional exceptions. The IASB paper proposes a general fair-value measurement for all financial instruments with some exceptions that could be measured using a cost-based method if the cashflows were unlikely to be particularly variable (for example, fixed-rate-interest instruments), whereas those with highly variable cashflows (such as equity instruments or derivatives) would remain at fair value.

This approach seems to offer little change from the current setup and introduces its own complexity as to which treatment applies to which instrument.

At an earlier stage in its rethinking of IAS 39, the IASB set up a

Financial Instruments Working Group with participants from both users and preparers. The non-financial corporates in this group came up with a proposal that might be regarded as preferable for treasurers. All financial assets (except loans and receivables) and financial liabilities (except short-term non-interest-bearing trade payables) would be at fair value. However, for each asset or liability the entity would elect prospectively for gains and losses to go to P&L or reserves. Changes in designation would be allowed, but to prevent abuse any amounts already deferred would be recycled to P&L over the remaining life of the asset/liability.

SIMPLIFICATIONS TO HEDGE ACCOUNTING The paper makes the very reasonable observation that a wider application of fair-value accounting would mean fewer occasions where fair-value hedging was required, because more items would be offset naturally. However, in cashflow hedging the idea is that some sorts of future, and as yet unrecognised, cashflows are hedged, so it is appropriate to delay the recognition of gains and losses on the hedge until the period in which the cashflow arises. Thankfully, the IASB recognises the need to retain cashflow hedges. It does not address any changes in net investment hedges.

The IASB floats the idea of a complete elimination of hedge accounting, but judging from the minimal discussion of this it looks as if it realises this would be going too far. The paper puts forward two possibilities: to eliminate (and possibly replace) existing hedge accounting requirements; or to maintain and simplify existing requirements.

ELIMINATING FAIR-VALUE HEDGING The IASB puts forward three alternative ways to remove existing fair-value hedge accounting:

1: Substitute a fair value option for instruments that would otherwise be hedged items, and which are not automatically at fair value, such as non-financial assets and liabilities. Extending the fair-value option would allow more items to be brought in at fair value and so automatically offset against each other through the P&L, which could be helpful. If the new idea has similar rules to the current fair-value option it would be less flexible than current hedge accounting, since the fair-value option is available only at inception, is irrevocable and must be applied to the whole asset or liability. This proposal might be workable if it were more flexible, but if this were done and rules introduced around it, we would be back to the current fair-value hedging concept with little reduction in complexity.

2: Permit recognition outside earnings of gains and losses on financial instruments designated as hedging instruments (similar to cashflow hedge accounting). This approach would have the benefits of not affecting the carrying amount of the hedged item and of keeping the measurement attribute of the hedged item the same whether it were hedged or not. This could be an interesting idea. However, if the fair-value movements in the hedged item were still going to P&L but gains and losses on the hedged item were initially recognised in other comprehensive income, then some mechanism would be needed to allow a reclassification to earnings to offset the effect. This hardly reduces complexity.

3. Permit recognition outside earnings of gains and losses on financial instruments. This suggestion has the following features:

- All (or at least many) financial instruments would be measured at fair value.
- Gains and losses on derivatives, instruments held for trading and instruments designated in their entirety at initial recognition to be measured at fair value would be recognised in earnings.
- For other financial instruments, entities would be permitted to recognise all unrealised gains and losses or unrealised gains and losses attributable to specified risks in either earnings or other comprehensive income, subject to one exception related to own credit risk. An entity could also choose to report a specified percentage of the gains or losses on these financial instruments in earnings and the remainder in other comprehensive income.
- For items in this category the choice would be made at inception but would be revocable and on changing designation the amounts so far taken to reserves would be reclassified to earnings in some systematic way over the remaining life of the instrument.

Simplification of existing hedging

Suggestion	*Implication*
Make the designation of hedge accounting irrevocable.	Reduces management's flexibility. The arbitrary results would surely make the accounts less transparent to users.
Prohibit hedge accounting for partial hedges.	Many hedging strategies use partial hedges to increase effectiveness, so its removal would be unhelpful.
Eliminate the quantitative retrospective effectiveness test but require a prospective qualitative test.	Increases the likelihood of getting hedging accounting, so potentially helpful.
Relax or remove the similar items test for portfolio hedge accounting.	Helpful in getting a hedging treatment that reflects how some manage economic risk on a portfolio basis.
The timing of reclassification of gains and losses to profit or loss for cashflow hedges should be stated at the inception of the hedge and be recognised in profit or loss regardless of whether the forecast transaction occurs as planned.	Removes the need to demonstrate at the outset that the cashflows are highly probable. Less complex and reduces the need to track individual gains and losses. However, mistakes in forecasting would cause volatility in profit or loss. There would be less need for stringent effectiveness testing.

Proposal 3 is essentially that made by the IASB's Financial Instruments Working Group. It removes the need for any effectiveness testing but it may turn out that when considering the details there would need to be rules and tests as to what gains and losses were permitted to be taken to other comprehensive income and which to earnings, akin to an effectiveness testing. Overall, this proposal brings more items into a fair-valuation treatment, but allows more flexibility on the accounting, so it does have merits.

MAINTAINING AND SIMPLIFYING EXISTING HEDGE ACCOUNTING Another possible approach to changing hedge accounting requirements is to maintain and simplify the existing hedge accounting requirements, as described in the table above.

Do not expect changes any time soon: the discussions will inevitably continue for a long time yet. As more and more fair values find their way into P&L, the problems of artificial volatility will be exacerbated, but the eventual outcome may depend on whether the opponents of the 'artificial stability' from using a cost-based measurement basis are persuasive.

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