TECHNICAL MATTERS

IAS 39

Subhash Abhayawansa and Dr Indra Abeysekera explain the complexities and challenges of the international accounting standard on financial instruments

IAS 39 Financial Instruments: Recognition and Measurement revolutionised the way in which public listed companies present their financial instruments, such as derivatives and other contracts. Prior to IAS 39 and FAS 133, the literature covering financial derivatives was inconsistent and inadequate. FRS 13, issued in the UK in September 1998, moved the disclosure of financial instruments forward there, but it was widely accepted that more needed to be done over recognition and measurement. The US has no Generally Accepted Accounting Principle (GAAP) for commodity hedging. Financial derivatives were traditionally accounted for using historical cost accounting. Since many financial derivatives did not attract an initial cost, the presentation was limited to a note in the financial statements that did not reveal companies' real exposure.

IAS 39 brings derivatives that used to be off-balance sheet on to corporate financial statements and so increases transparency. It abolishes the common synthetic instrument accounting practice which netted hedges in the balance sheet and presented the hedge item and hedge instrument together as a single instrument.

The standard prescribes principles for recognising and measuring financial assets, financial liabilities and contracts for non-financial items, including financial derivatives and derivatives embedded in non-derivative contracts, except for certain specifically excluded items (IAS 39.2). Accordingly, all derivative instruments need to be carried at fair value on the balance sheet (eg through marking to market) with any changes in the fair values being recognised in the income statement on a periodic basis. Unless a derivative qualifies for hedge accounting, gains and losses in the hedging instrument cannot be offset against gains and losses in the value of the hedged item. Stringent criteria must be met for a derivative to benefit from hedge accounting. This is why most derivatives used for hedging are classified as held for trading and do not qualify for the preferred accounting treatment. The requirement to mark a derivative to market value without doing the same for the corresponding hedged item creates artificial volatility in reported earnings. So the standard brings treasury performance to the forefront of financial reporting.

IAS 39 further incorporates substance over form for classifying debt and equity. Importantly, the standard requires a review of quasi capital financial instruments in order to identify who has the contractual obligation, or the discretionary right, to deliver the financial asset. For instance, redeemable preference shares with a fixed coupon need to be reclassified as debt rather than equity. This has a major impact on debt covenants and firms' ability to leverage.

Another change is the introduction of embedded derivatives. Contracts that don’t appear to be financial instruments may have financial instruments embedded in them. The standard requires the derivative to be separated from its host contract and presented at fair value. If it’s not separable, the entire contract should be treated as held for trading (IAS 39.11). Firms must therefore scrutinise all their contracts to locate derivatives embedded in them. They may also need to reconsider new contracts to ensure that they do not contain embedded optionality.

IAS 39 specifies that all financial assets and liabilities are initially recognised at fair value. However, subsequent measurement of these items depends on whether they are categorised as: financial assets or liabilities at fair value through profit and loss (ie held-for-trading financial instruments and instruments designated on initial recognition); available for sale financial assets; held-to-maturity investments; loans and receivables; or financial liabilities (not held for trading). The need to classify financial assets and liabilities is an issue for the banks and corporate entities that hold debt securities. If an entity sells a significant amount of an investment, particularly held-to-maturity investments, even as a consequence of a one-off event, all its other investments must be reclassified as available for sale (IAS 39.46(b)).

The standard is intended to discourage companies from using ineffective hedging techniques to smooth results artificially. The complex rules may discourage companies from using derivatives for hedging because they fear volatility. Commentators argue that the standard restricts the use of some creative, but effective, hedging techniques, as it is difficult for such instruments to satisfy the effectiveness test compared with straightforward “vanilla” instruments.

According to the effectiveness test, the method of measuring hedge effectiveness needs to be documented up

Firms must now scrutinise all their contracts to locate any derivatives that are embedded in them
management objective and strategy, and hedged risk should all be documented. You cannot designate a hedge retrospectively. This forces risk managers to focus on the process of risk management, so the standard reinforces risk management principles, guidelines and practices. It should also mean that risk managers offer more insight into the hedging instrument’s positions on a regular basis and on its impact on the income statement and balance sheet.

The need to classify existing hedges, amend hedging techniques or revise hedging strategies to qualify for hedge accounting, designate hedging relationships, assess the effectiveness of hedges and identify derivatives embedded in contracts places a huge strain on systems and risk management practices. A further complication is that sources from which fair values are derived (for non-exchange traded derivatives) must be acceptable to auditors and available at each reporting period.

Companies may require systems that provide mark-to-market valuations at each reporting date, hedge effectiveness testing, hedge relationship tracking and derivatives accounting. Those that are unable to implement such systems either have to eliminate or reduce the use of derivatives and embedded derivatives that would lead to an undesirable risk/reward profile with large exposures to interest rate and currency risks.

Multinational corporations that used to enable subsidiaries to execute hedges with the corporate treasury, so that they could net off their positions and enter into hedges with third parties for those net positions, may need to consider separate hedges with third parties for each risk item. This requires links with many parties and may be cumbersome. Implementing hedge accounting for financial derivatives under IAS 39 also requires a huge investment in staff, computer systems and education. In the UK alone public companies spend more than £500 million trying to comply with paragraph 88 of IAS 39 (see references).

The standard identifies three types of hedging relationships, all of which try to ensure that a hedge instrument impacts profit or loss at the same time as the hedge item. With regard to a fair value, hedge gain or loss is recognised in the operating statement for both the hedged item and hedging instrument. Cash flow hedges and hedges of net investment in foreign operations are accounted so that the gain or loss on the effective portion of the hedging instrument is recognised directly in equity and any ineffective portion through profit or loss.

The effectiveness test requires three types of quantifications to be performed each reporting period, including prospective and retrospective assessments and a measurement of actual ineffectiveness. These may require stochastic modelling techniques.

There is still great disparity in the ways firms measure effectiveness. A study by Fitch Rating revealed a lack of consensus over application of FAS 133. Companies such as Fannie Mae, which adopted the “short cut” method, had to disclose massive losses after regulators became involved. The testing requirement has also discouraged smaller hedges from managing risk.

Subhash Asanga Abhayawansa is a PhD student and Dr Indra Abeyesekera is a senior lecturer at the University of Sydney (indraa@econ.usyd.edu.au).