MEMO/04/265

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IAS 39 Financial Instruments: Recognition and Measurement - Frequently Asked Questions (FAQ)

(see also IP/04/1385)

How are decisions taken in the European Union to adopt International Financial Reporting Standards (IFRS)?

The IAS Regulation[1] lays down the procedure for making International Financial Reporting Standards (IFRS), formerly known as International Accounting Standards (IAS), mandatory under Community Law. Only those standards which are adopted according to this procedure are subsequently enforceable throughout the European Union.

Once a standard has been agreed, it is up to the European Union to decide whether to make that standard mandatory or not in the European Union. The decision is taken under the so-called endorsement process, which works as follows:

In accordance with the IAS Regulation, once a standard or interpretation has been adopted by the International Accounting Standard Board (IASB)[2] and by the International Financial Reporting Interpretation Committee (IFRIC) respectively, EFRAG (the European Financial Reporting Advisory Group)[3] assesses it technically and submits that assessment to the Commission. EFRAG is an independent private body whose task is to provide, at the Commission's request, advice on the technical soundness of new standards. It is composed of academics, analysts, auditors, industry representatives and users.

The Commission then submits its proposal to the European Parliament and the Accounting Regulatory Committee (ARC), which is composed of representatives of Member States and chaired by the Commission. The role of the ARC is to assist the Commission in the endorsement of international accounting standards and interpretations. If there is a qualified majority of Member States in favour of the Commission's proposal in the ARC and once the opinion of the European Parliament is known, the Commission formally decides on the applicability of international accounting standards and interpretations within the European Union.

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[1] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002, OJ L 243, 11.09.2002 (website: http://europa.eu.int/comm/internal_market/accounting/ias_en.htm)

[2] http://www.iasb.org/about/index.asp

[3] http://www.efrag.org/

What exactly did the Commission decide when adopting IAS 39?

At the meeting of 1 October 2004, a qualified majority of Member States in the Accounting Regulatory Committee (ARC), were of the opinion that the European Commission should adopt IAS 39 with two "carve outs". The European Parliament also supported this solution. On ***19 November,*** the Commission adopted a Commission Regulation endorsing IAS 39 *Financial Instruments: Recognition and Measurement,* with the exception of certain provisions on the use of the full fair value option and on hedge accounting. The Commission did not replace any of the provisions contained in the standard and neither did it add anything. It simply removed, or carved out, certain provisions.

What is hedge accounting?

Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.

A hedging instrument is a designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

a) exposes the entity to risk of changes in fair value or future cash flows and
b) is designated as being hedged

According to IAS 39.86 hedging relationships are of three types:

c) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.
d) cash flow hedge: a hedge of the exposure to variability in cash flows that:
   i. is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and
   ii. could affect profit or loss.

(c) hedge of a net investment in a foreign operation as defined in IAS 21.

A hedging relationship qualifies for hedge accounting if, at inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

What is the full fair value option?

The full fair value option permits entities to designate irrevocably on initial recognition **any** financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the 'fair value option'). The IASB's principal reason for introducing this option was to resolve certain practical issues associated with IAS 39's mixed measurement model - in particular, those relating to the measurement of debt instruments that fund portfolios of financial instruments that are held for trading. In such cases, the changes in fair value of the debt that is funding the trading portfolio provide a natural economic hedge against changes in fair value of the trading instruments.

Consequently, allowing entities to measure these debt instruments at fair value would remove a certain amount of income statement volatility that might otherwise be present were the debt to be measured at amortised cost. The 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 (IAS 39.9).

Why did the Commission carve out these provisions?

The two issues were carved out because the Commission considered that the related provisions are not yet suitable for adoption and require further revision. The two carve outs were not based on any arguments related to the "true and fair view principle" under the European Accounting Directives or the European public good, as mentioned in the IAS Regulation.

The carve out of the full fair value option was based on observations from the European Central Bank and prudential supervisors represented in the Basel Committee. The IASB took these observations into account when issuing an Exposure Draft in April 2004 in order to limit the scope of the full fair value option. However, the IASB has not taken yet a final position. In addition, Article 42a of the Fourth Company Law Directive (Directive 78/660/EEC) does not allow full fair valuation of all liabilities. The main category of liabilities excluded from fair valuation is companies fair valuing their own debt.

The carve out of certain hedging accounting provisions reflects criticism by many European banks that the current version of IAS 39 poses a major problem for operating their risk management practises. According to these banks, the limitation of hedges to either cash flow hedges or fair value hedges and the strict requirements on the effectiveness of those hedges, prevent the continuation of risk management techniques, such as hedging a portfolio of core deposits, which are currently accepted by banking supervisors. Many European banks argue that IAS 39 in its current form would force them to carry out disproportionate and costly changes both to their asset/liability management and to their accounting systems and that it produces unwarranted volatility.

Why did the Commission not carry out a consultation before the adoption of the carved out version of IAS 39?

Despite a long discussion in the past neither, standard setters nor EFRAG were in a position to find a consensus on this standard. Had this been the case, the Commission would not have had to carve out certain provisions of the standard. Technical discussions lasted for almost three years with no solutions in sight. Since there has been no satisfactory outcome to date and the January 2005 deadline is approaching for all listed companies to apply IFRS, the Commission had to act.

The Commission has received many technical comments on these carve outs and asked EFRAG to assess whether the carve outs envisaged by the Commission are technically workable. The carve outs provided for in IAS 39 are fully in line with the comments made by EFRAG in a letter dated 26 September 2004. The Commission hopes that these carve outs will be temporary – pending the completion of work by the IASB.

Will these carve-outs set a precedent for similar situations in the future?

The two carve-outs are both exceptional and temporary. It is not the Commission's preferred solution, but it was the only one available under the circumstances. The Commission believes that appropriate solutions must be found as soon as possible and that everyone involved in this process should do their utmost to ensure that similar situations do not arise in the future. The Commission expects that the IASB will adopt improvements to the full fair value option in December 2004 and improvements to the hedge accounting provisions in autumn 2005. All other things being equal, it will move to endorse these improvements as soon as possible.

Is the Commission setting a precedent with the carve-outs, which will encourage other lobbying groups in the future?

No. The Commission prefers full endorsement of any international accounting standard. The circumstances surrounding the endorsement of IAS 39 were exceptional.

Do the carve-outs mean that the Commission has become a standard setter? Does the Commission have the authority to do this under the IAS Regulation

The Commission is not a standard setter and has no intention of becoming one. The Commission has neither re-written the standard, nor has it added a single word to the standard. However, the Commission adopted a solution leaving out certain parts that are not mature and suitable. The parts cut out are legally distinct and separable. The IAS Regulation gives the Commission not only the right but also the responsibility to act in this way.

In general, the system laid down in Article 3 of the IAS-Regulation is designed so that adoption or non adoption of standards by the Commission should take place as a whole. However, a standard may in reality cover two or more accounting subjects which are entirely autonomous, distinct and separable. If the Commission were to adopt such a norm "as a whole", the Commission would be unduly bound by the scope of the standard chosen by the IASB. The Commission can therefore decide on the partial application of a standard where such a standard covers several accounting areas which are distinct and separable. On the other hand, if a standard would become meaningless without the provisions carved out and would therefore no longer be operational, partial adoption cannot take place.

Can first time adopters who apply IAS 39 as endorsed in the European Union take advantage of the exemptions laid down in IFRS 1?

Yes, companies that prepare for the first time their financial statements in accordance with international financial reporting standards (IFRS) and apply IAS 39 in the version annexed to this Regulation should be considered as "first time adopters" in accordance with IFRS 1. The purpose of IFRS 1 is that costs for the transition towards full IAS/IFRS should not outweigh the benefits for the users of financial statements.

This reasoning continues to apply in the case of moving towards full application of IAS/IFRS as endorsed under the IAS Regulation. Accordingly, references in IFRS 1 to IAS/IFRS, which was adopted by Commission Regulation (EC) No 707/2004, have to be understood as references to IAS/IFRS as adopted on the basis of Regulation (EC) No 1606/2002. This has been explicitly laid down in Article 1 (2) of the Regulation on IAS 39 – rather than only in the preamble to the Regulation - in order to give legal clarity to the financial market.

Will companies have to prepare two sets of accounts, one applying the full set of IAS for stock exchange purposes, one with "European IAS"?

They are not required to do so. However, it is up to each company to choose whether it wishes to issue another set of accounts as well as accounts based upon endorsed IAS, for instance using full IAS or US GAAP. However, since the carve-outs are a temporary solution, the Commission would not recommend this course of action.

What should a company state in its accounting policies, when it applies the carved-out version of IAS 39? Does the company have to refer to IFRS or to IFRS as adopted by the European Commission?

Companies that apply the carved out version of IAS 39 should refer in their accounting policies to IFRS "*as adopted by the EU*". They should accordingly explain their accounting policies in their financial statements. This principle was already explained in the Commission's "Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting" as released in November 2003[4].

Accordingly, the auditor should refer in its auditor's report to the basis on which the accounts have been prepared and is hence in a position to give an unqualified opinion.

Can Member States either permit or require companies to apply the full version of IAS 39 in respect of the hedge accounting carve-out?

Yes. The **hedge accounting carve-out** relates essentially to the manner in which hedge effectiveness is applied. Since the EU Accounting Directives do not contain provisions on hedge accounting, Member States may therefore require companies to comply fully with the hedge accounting provisions of IAS 39, including those that have been carved out. In doing so, Member States should take account of the reasons for this carve out – namely, to address concerns particularly of those banks that are operating in a fixed interest rate environment. Member States may only act in this way as long as the Commission has not adopted a revised standard covering these issues or has not explicitly rejected its adoption on the basis of the criteria in Article 3 (2) of the IAS Regulation such as going against "the true and fair view principle".

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[4] Source:
http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#comments, page 5.

As the carve-out has been decided only on procedural grounds awaiting future improvements of IAS 39, Member States are entitled to require companies to apply the full hedging requirements of IAS 39, thus prohibiting the use of the carved-out provisions on hedge accounting.

Some commentators have suggested that the relaxation of the hedge accounting provisions make the standard "seriously deficient" and "not credible"

No existing national GAAP in any of the Member States contains any hedge accounting provisions. Yet no one contends that these systems of national GAAP are seriously deficient, flawed or lack credibility.

Therefore the carve-out solution introduces for the first time some basic structure on derivative accounting and is a significant step forward. Technically speaking, companies still have to demonstrate periodically to their auditors and to prudential regulators that their hedge accounting is "highly effective".

Can Member States either permit or require companies to apply the full fair value option under IAS 39, despite the fact that it has been carved out by the Commission?

No. Since the **full fair value option** is contrary to Article 42a of the Fourth Company Law Directive, a Member State cannot permit or require its full use. Article 42a, which was introduced into the Fourth Company Law Directive by the Fair Value Directive (Directive 2001/65/EC) and which should have been written into national law by Member States by 1 January 2004 by the latest, restricts the types of liabilities that may be subject to valuation at fair value. It does not allow the fair valuation of all liabilities of a company. The main category of liabilities excluded from fair valuation is that of own debt. A Member State can also permit or require companies to fair value liabilities under Article 31 of the Insurance Accounts Directive (Directive 1991/674/EEC)[5]. Article 31 allows insurance companies, in the case of unit-linked contracts, to value liabilities – where the policyholders bear the investment risk or where benefits are determined by a certain index – according to the value of the underlying units, assets, share index or reference value.

Is there a danger of artificial volatility because assets and liabilities are valued on different basis?

The Commission is aware that the carve out is not an ideal solution, and the removal of the fair value option for liabilities only (the full fair value option is possible for assets) might, indeed, cause temporarily some artificial accounting volatility in certain situations. This is why the Commission is pressing the IASB to complete its work in December 2004

[5] In the balance sheet, a special item needs to be included for "technical provisions for life-assurance policies where the investment risk is borne by the policyholders (Article 6, point D of Directive 1991/674/EEC). Furthermore, the specific prudential valuation rules concerning life assurance under Article 25 of Directive 2002/83/EC state that where benefits provided by a contract are directly linked to the value of units in a UCITS, to assets contained in a fund, to a share index or some other reference value, the technical provisions in respect of those benefits must be represented as closely as possible to those units, assets, share index or reference value.

However, for example in the case of unit-linked products, the Insurance Accounting Directive will help to overcome this problem. This Directive allows fair value measurement of both assets and the related liabilities.

Should the Commission not carve out also the assets?

The carve out was limited to liabilities in order to enable European companies to report as much as possible in conformity with current international accounting standards. As a consequence, companies may apply the fair value option to liabilities within the boundaries of the Fourth Company Law Directive. Moreover, the limitations of the fair value option regarding financial assets, as imposed by Article 42a of the Fourth Company Law Directive, are properly reflected in the revised version of IAS 39. In this respect IAS 39 is in conformity with current European accounting law. Therefore there is no need to carve out the respective provisions.

However, European companies should take particular care to apply the full fair value option to financial assets that are not traded in active and liquid markets – such as those held in the loan book – in a way that leads to reliable measurement.

But the full fair value option is an integral part of IAS 39. How can it be carved out without causing serious damage to the standard as a whole?

The full fair value option was introduced to IAS 39 only in December 2003. Banks and other companies have been applying IAS 39 and publishing accounts without the full fair value option for years.

Moreover, the full fair value option is optional by its very nature. Therefore it is clear that it can be separated from the mandatory parts of the standard.

How does the Commission respond to concerns that the US SEC would not accept IAS financial statements as a basis for reconciliation to US GAAP in cases where a company applies IAS 39 as adopted by the European Commission

For the time being, European companies applying IFRS have to reconcile to US-GAAP whether they use full IFRS or IFRS as adopted by the European Commission. Since there is no full fair value option in US GAAP, there can be no grounds for asking for additional reconciliation on this issue from listed companies that must apply IFRS from 1 January 2005.

On hedge accounting, a company listed in the US may elect to apply the carved out provisions since there are no contradicting rules in the Accounting Directives. In any event, since the hedging provisions under IAS 39 are substantially different to those under US GAAP, companies would normally have to reconcile the effects of hedge accounting – whichever course is followed.

For this reason, the Commission considers that first time adopters applying IFRS as adopted by the European Commission should be eligible to benefit from the new SEC proposal that would permit foreign private issuers for their first year of reporting under IFRS to file two years rather than three years of statements of income, changes in shareholders' equity and cash flows prepared in accordance with IFRS, with appropriate related disclosure.

What are the next steps that the Commission will take?

The Commission's objective is to reach as soon as possible a position where it can adopt in full an amended IAS 39. As for a revised fair value option, the Commission expects a definitive solution from the IASB in December 2004. Accordingly, the Commission could adopt a corresponding revised version of IAS 39 as early as April/ May 2005. The Commission will also review the applicability of IAS 39 once the provisions relating to hedge accounting have been amended by the IASB, and at the latest by 31 December 2005.

What is the Commission's response to concerns over mismatches under IAS 39 between accounting for assets and liabilities in the insurance sector?

The Commission is aware that there is a mismatch issue between assets and liabilities in the insurance sector, which will be dealt with in the Phase II of the Insurance Project. In addition, the International Working Group on Insurance that has recently been established by the IASB will examine the application of IAS 39 with respect to insurance companies. The Commission will evaluate the situation after having seen the outcome of this working group.