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The smart way to manage financial risk

IAS 39 - Under the Hood

Issue 1

In keeping with our commitment to develop a comprehensive risk management solution, Visual Risk will be providing a series of regular articles on the new IAS39 Accounting Standard. The aim of the articles is to initially build an understanding of the Standard from the ground up, with later articles looking at more complex issues. Each article will highlight the implications of IAS39 compliance for treasury and hedge accounting systems

Why IAS 39?

This Standard has arisen, in part, due to the proliferation of derivative usage amongst companies and the highly publicized problems that have resulted in a few cases. Fair value accounting for all financial instruments is now the ultimate goal of the Accounting Boards.

The International Accounting Standards Board has given a direction to the Joint Working Group responsible for harmonizing accounting standards to 'study further the use of full fair value accounting for all financial assets and liabilities'. (IAS39, Background).

The IAS 39 standard is consistent with this goal as it significantly increases the use of fair values in accounting for financial instruments. The introduction to the US Accounting Standard FAS 133 states, similarly, that derivative instruments should be reported in financial statements and fair value is the only relevant measure for such instruments.

System Implications:

Due to valuations appearing in the balance sheet and possibly profit and loss statement, recording valuations (and changes in those valuations) for each asset and liability will be necessary.

What must be fair valued under IAS 39?

Almost everything is the short answer to this question! The Standard (IAS39.69) lists:

- nearly all derivative assets and liabilities
- debt securities
- equity securities
- other financial assets

It also lists many derivatives that are embedded in non-derivative instruments.

The three classes of financial assets that remain carried at-cost are loans and receivables originated by the enterprise, other fixed-maturity instruments that the enterprise intends and is able to hold to maturity and unquoted equity instruments whose fair value cannot be reliably measured. In a recent IASB meeting, purchased loans were also added to this list.

In practice, however, care must be taken when designating financial instruments as held-to-maturity, as a sale of such an instrument will 'taint' the entire held-to-maturity portfolio meaning this classification is not allowed for the enterprise for the next 2 financial years.(IAS39.83)

On the other side of the balance sheet, financial liabilities that are held-for-trading and derivatives that are liabilities should be measured at fair value.

System Implications:

Classification of assets and liabilities will need to be recorded and the held-to-maturity portfolio will need to be monitored separately.

Embedded derivatives may have to be recorded and managed separately to their host contracts.

What are the implications for the profit and loss account?

There are 2 separate cases:

- For derivatives and held-for-trading assets and liabilities, gains and losses should be included in the net profit or loss for the period.
- For available-for-sale assets (defined as everything else that is carried at fair value), the entity can either include all the gains and losses in profit or loss or in equity based on a one-off decision on accounting policy.

This leads us to the need for hedge accounting. For companies that hedge using derivatives, the regular revaluation of their hedges could lead to unsatisfactory movements in the profit and loss account. An obvious problem is that when hedges are entered into, accounting profit will become more volatile at the same time as projected cashflow becomes less volatile due to 'smoothing' effects of the hedging.

As a result IAS 39 contains provisions for hedge accounting. Under certain conditions, hedge accounting will allow a company to recognize symmetrically the offsetting effects on net profit and loss of changes in the fair values of the hedging instrument (almost always a derivative) and the related item (exposure) being hedged.

System Implications:

At the inception of the hedge relationship, all details must be fully documented. The hedges and exposures will need to be tagged. Valuations will need to be recorded regularly for both the hedges and (usually) the exposures.

Next Issue

Our next article will discuss the different types of Hedge Accounting. If you would like to discuss any issues relating to IAS 39 and Hedge Accounting in more details, please contact us.