Evolution of the Fair Value Concept under International Financial Reporting Standards IAS 32 and IAS 39[#]

Jiří Strouhal[*]

Historical cost has long now proved its deficiency in reflecting the true and fair view of companies' financial performance and position. The increasing use of derivatives and new types of financial instruments has opened the road to the development of international financial reporting standards IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement) by the International Accounting Standards Board (IASB, 2005). Recently, European listed firms launched the implementation of those two standards, along with the rest set of IFRS/IAS.

Introduction

Much of the current debate over fair value accounting (FVA) and historical cost accounting (HCA) has taken place on the grounds of reciting and comparing each method's benefits and drawbacks. Until now, academic research has generated a great deal of knowledge which contributed to this issue, and future research is expected to provide even further knowledge. It is apparent that researchers and academics are divided into those who support HCA and those advocating in favour of FVA. Those who try to adopt a moderate and objective view on the matter are few. Most of them who work on the specific issue offer results – strong enough in some cases or weaker in others – of a specific point of view and of a certain methodology, which in most cases tend to support one of the aforementioned accounting methods. Thus, in each scientific paper concerning FVA's and HCA's rivalry the reader can discern whether the

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[*] Ing. Jiří Strouhal, Ph.D. – senior lecturer; Department of Financial Accounting, Faculty of Finance and Accounting, University of Economics, Prague, W. Churchill Sq. 4, 130 67 Prague, Czech Republic; <strouhal@vse.cz>.

author supports or supplants one or the other method. Additionally, due to the large number of literature in the field, it is possible to confuse the average reader as to which accounting method is the most appropriate. One of the major concerns of this study is to review most of the extant literature and to delineate the aspects that surround one of current accounting's greatest challenges.

The International Accounting Standards Board (IASB) spent a lot of time and effort in evolving, issuing and amending standards IAS 32 and IAS 39, a procedure which has yet to finish. So far all existing international standards have been endorsed by the European Commission except the two on financial instruments IAS 32 and IAS 39 (and their related interpretations) which are currently undergoing a major overhaul. Evidently, in an effort to support and verify our statements, we are going to use much literature that does not concern IAS, but instead it concerns its US equivalents: statements of financial accounting standards (SFAS). Specifically, the Financial Accounting Standards Board (FASB) has issued a series of standards which resemble largely with IAS 32 and 39; the most representative of these standards are SFAS 107, 115 and 133.

Although IAS 32 and 39 included plentiful and profound changes in the traditional accounting framework, their provisions were limited. In IAS 39 many financial liabilities and financial assets are left at historic cost; hedge accounting is left in place; and as an outcome of these and other decisions, many blurred lines and implementation problems result. The Basel Committee on Bank Supervision expressed opposition to the use of fair-value accounting in IAS 39. The debate continues with numerous studies that act in favour or against FVA; the most important of these studies are cited in the following sections.

Historical background

Financial instruments where first developed by the International Accounting Standards Committee (IASC) in 1988. During the next eight years, two exposure drafts were published dealing with the issue of IAS 32. However, IASC decided that its initial proposals on recognition and measurements should not be progressed to a standard due to the critical response they had attracted, the evolving practices in financial instruments and finally due to the development of thought from national standard setters. During this period IASC concluded that the recognition and measurement of financial instruments should be dealt by a standard. This decision was taken because, apart from U.S., few countries were using any recognition and measurement standards, although financial instruments were widely held. Meanwhile IASC had agreed with the International Organization of Securities Commission (IOSCO) to develop a set of core international accounting standards, which IOSCO could endorse for the purposes of cross border capital raising and listing in the global markets. In these core standards, only one was included that concerned the recognition and measurement of financial instruments.

In March of 1997, IASC along with the Canadian Institute of Chartered Accountants (CICA) published a discussion paper and invited comments on its proposal. Many consultative meetings were held to discuss these matters. The analysis of the comment letters has shown that IASC was facing controversies and complexities in seeking a way forward. Although the view expressed in the discussion paper, followed some acceptance, some industries faced implications during the application of the measurement of all financial assets and inabilities at fair value. The main problems arose from reliability, volatility and the presentation of the effects of changes in values. These matters still exist today. Another issue, which concerned the difficulties in the widespread unease, was also evident regarding the prospect of including unrealized gains in income, especially on long term debt, as it was proposed by the discussion paper. In addition, despite the fact that several national standard-setters had undertaken projects to develop national standards on many aspects of recognition and measurement of financial instruments, in no country the proposed standards were even similar to those of the discussion paper. It was clear that the completion of an international accounting standard on financial instrument was not feasible before 1998.

Despite the difficulties, the ability to use international accounting standards for investments, credit decisions, security offering and listings was a very urgent matter for the investors and business enterprises. In 1997, IASC decided it was urgent to join with nine national setters in order to form the Joint Working Group of Standard Setters (JWG), aiming to develop the proposals from the 1997 discussion paper. The main objective was to develop an integrated and harmonized standard on financial instruments, which would reflect the best research and thinking on the subject worldwide. Although IASC stated that this standard would take many years to develop, the JWG made the first step by deciding to form a draft standard published in 2000. It was also decided, at the same time, to develop an international accounting standard on the recognition and measurement of financial instrument that would serve until the completion of an integrated comprehensive standard. It was concluded that the content of this standard would be based on US GAAP, the only major GAAP with comprehensive requirement for financial instrument. The result from this attempt was *IAS 39 – Financial Instruments: Recognition and Measurement*, issued in 1999, after a period during which it was under exposure and commendation.

In August 2001, the IASB (former IASC), announced that a project would be undertaken so as to improve IAS 32, IAS 39 and ease their application and implementation. Moreover IASB invented the IAS 39 Implementation Guidance Committee (IGC), to function as an advisory committee in identifying and reviewing issues that should be addressed. The IGC was formed from senior existents in financial instruments with background as accounting standard-setters, auditors and bankers, preparers from a range of countries as well as observers from the Basel Committee on banking supervision, the IOSCO and the European Commission.

In June 2002 an exposure draft of proposed improvements to IAS 32 and IAS 39 was published from IASB. IASB received over 170 comment letters in response. Viewing the large number of responses, IASB decided to expand the consultation by conducting a serial of public round-table discussions. During these discussions IASB decided to allow a free and open exchange of views, between the IASB and the respondents. The main aim was to determine whether there were better alternative applications of the principles underlying IAS 32, 39 or whether these existing applications could be simplified. In March of 2003 the IASB initiated its deliberation in open board meetings of the issues raised on exposure draft, by keeping in view the insights obtained from the consultation process. There was one issue that had emerged from the consultation progress, which the board decided that warranted further debate. Many constituents, particularly in the banking industry, expressed concern relating to the portfolio hedging strategies; they regarded that effective dates would not be qualified for fair value accounting under IAS 39.

Taking these matters into account, IASB decided upon launching intensive discussions with the banking industry, which was represented from the European Banking Federation (FBE). IASB attempted to investigate a way of the principles of IAS 39 to accommodate macro-hedging.

In August 2003, the IASB resulted in the publication of a second exposure draft fair value “Hedge Accounting for portfolio, Hedge of interest rate risk” proposing an important advance by permitting macro hedging. With the aim to help the companies under preparation to adopt the revised IAS 32 and IAS 39 in 2005, IASB did not delay the finalization of the rest of those standards. In December 2003, the amended IAS’s were ready. In March 2004 the IASB finalized the proposal so as to permit macro hedging and issued the amendment.

In April 2004 IASB published an exposure draft of the proposed limited amendment to IAS 39, titled “The fair value option”. This proposal was a direct response to concerns which were expressed by prudential supervisors of banks, security companies and insurers that the fair value option might be used inappropriately. This exposure draft proposed the limitation of the financial assets and financial liabilities to which the option may be applied while preserving the key benefits of the option. Currently, the IASB is considering the comment on this proposal.

The proposed amendments to IAS 39 financial instruments recognition and measurement: The Fair Value option was issued for comment on 21 April 2004. On the 15th of June 2005 the IASB issued its final amendment to IAS 39 Financial Instruments: Recognition and Measurement to restrict the use of the option to designate any financial asset or any financial liability to be measured at fair value through profit and loss (the “fair value option”). The IASB developed this amendment after commentators, particularly prudential supervisors of banks, securities companies, and insurers, raised concerns that the fair value option contained in the 2003 revisions of IAS 39 might be used inappropriately. The new revisions limit the use of the option to those financial instruments that meet certain conditions. Those conditions address that the fair value option designation eliminates or significantly reduces an accounting mismatch, or a group of financial assets, financial liabilities, or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

The proposed amendments to IAS 39 (financial guarantee contracts and credit insurance.), transition and initial recognition of financial assets and financial liabilities and cash flow hedge accounting of forecast intragroup transactions were issued for comment on the 8th of July 2004. The

Exposure Draft Financial Guarantee Contracts and Credit Insurance proposed that the issuer of a financial guarantee contract should measure the contract initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received. The Exposure Draft also addresses the subsequent measurement of those guarantees. The proposed requirements would apply even if the contract meets the definition of an insurance contract in IFRS 4 Insurance Contracts.

On August 18 2005, the IASB amended the scope of IAS 39 to include financial guarantee contracts issued. However, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 Insurance Contracts to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due. Under IAS 39 as amended, financial guarantee contracts are recognised initially at fair value. The Exposure Draft Transition and Initial Recognition of Financial Assets and Financial Liabilities issued an amendment that would apply when entities first adopt IAS 39. It would allow, but not require, entities to adopt an approach to transition that is easier to implement than that in the current version of IAS 39 and would enable entities to eliminate a difference between the IASB's Standards and US requirements and the Exposure Draft Cash Flow Hedge Accounting of Forecast Intragroup Transactions clarifies the treatment in consolidated financial statements of a foreign currency cash flow hedge of a highly probable forecast external transaction denominated in the functional currency of the group entity (e.g. a subsidiary) entering into the transaction. Thus, a group could designate that external transaction as the hedged item, provided that the transaction gives rise to an exposure that will have an effect on consolidated profit or loss.

Despite the conservatism, the globalization of markets has now led to a convergence on the needs of external investors, since, certainly for the large and medium-sized companies around the world, it is external investors who will for the future be the providers of capital. And if the external providers of capital are provided with the information to make judgements about their investments, it is also likely to be the case that the accounts will reflect economic reality and be suitable for internal management purposes also.

Recognition versus disclosure

According to IAS 39 all financial assets and liabilities are recognized on the balance sheet. IAS 32 states that, at acquisition, an enterprise should classify a financial asset into one of four categories: held-for-trading (HFT), held-to-maturity (HTM), loans and receivables (L&R) originated by the enterprise or available-for-sale (AFS). The standards also demand that all financial assets are measured at fair value except originated loans and receivables, unquoted equity securities whose fair value cannot be measured reliably and fixed-maturity investments that a firm has the ability and intent to hold to maturity. If a firm holds unquoted equity instruments at amortized cost, derivatives that are linked to and must be settled by delivery of those securities are also measured at amortized cost. All financial liabilities are measured at their original recorded amount less principal repayments and amortization except for derivative liabilities and liabilities held for trading, which are measured at fair value. In this section we will discuss on the renowned debate between disclosure and recognition.

Disclosure issues are mainly covered in IAS 32; but previous to this standard's final shape, the issue of disclosing financial instruments had been thoroughly studied and discussed. Academic literature on the disclosure of financial instruments' fair values is rich and provides useful feedback especially in terms of value relevance, which is defined in terms of the association of supplementary fair value disclosures with share prices.

Under IAS 39, at the date of initial recognition all financial assets and financial liabilities should be measured at cost, which is the fair value of the consideration given or received to acquire the financial asset or liability. Later on, for each subsequent measurement, fair values need to be used. SFAS 133 has a lot of similarities with IAS 39 and requires that:

- an entity recognize all derivatives as either assets or liabilities in the financial statements;
- derivative financial instruments are measured at fair value;

- accounting for changes in the fair value of a derivative be dealt with through the earnings statement; and
- special rules exist for hedge accounting.

Fair value measurements and recognition of financial instruments' values in the financial statements, along with adequate disclosures, will be able to provide necessary information to evaluate properly an enterprise's exposures to financial risks, as well as rewards. In deep and liquid markets recognition vs. disclosure does not make a big difference in some cases, but recognition vs. disclosure can produce distinctly different results when recognized numbers are used in contracting.

Conclusion

IAS 39 does not provide a reliable solution when it comes to non-marketable instruments. When valuing non-marketable assets using a present value calculation, there is going to be less agreement on the discount rate which should be used. Existing standards on recognition and measurement of financial instruments, such as IAS 39, are not going to be replaced overnight. However, it seems important that rigorous testing of a comprehensive fair value model should commence soon, so that standard setters will have fuller evidence available to assist them in deciding whether to embark on further changes. Accounting and reporting based on fair value principles require more extensive and detailed analysis of the methods and assumptions used to determine values recognized in the financial statements. This, in turn, will require market participants to redesign the current financial reporting model and to educate themselves in the application of these new principles.

References

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ABSTRACT

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