PRICEWATERHOUSECOOPERS

IAS 39: Financial Instruments: Recognition and Measurement

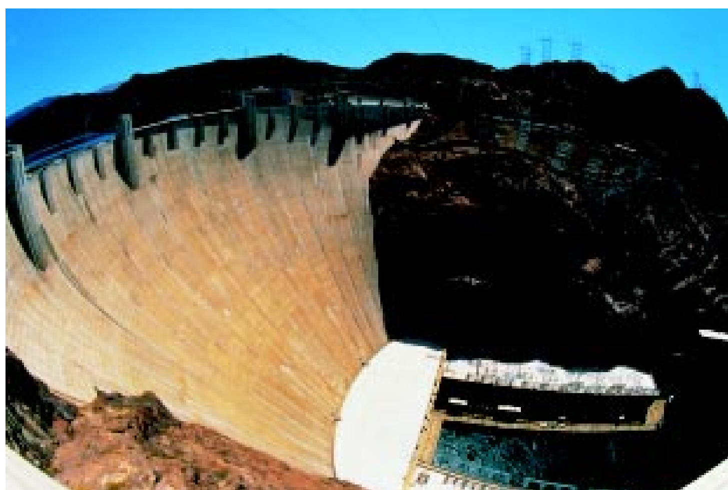
What is IAS 39?

Who does IAS 39 affect?

What are the key impacts of IAS 39 and why should I be worrying about it?

IAS 39, the new standard on financial instruments, is revolutionary. For companies that are significant investors, borrowers or users of derivatives, the standard raises wider issues than any previous standard in any area of accounting.

IAS 39 sets out, for the first time, requirements and rules for recognition, derecognition (removal) and measurement of all monetary assets and liabilities, derivatives and equity investments.



What is IAS 39?

The key features of the standard include:

- All derivatives must be recognised on balance sheet. The use of deferral hedge accounting will be subject to strict criteria. In particular, the use of macro, portfolio and internal hedges will be severely restricted;
- Significant changes may be required to internal risk management policies, systems, processes and procedures if financial statements are to reflect management's view of the economics of hedging activities. These must be in place by 1 January 2001;
- The rules are not applied retrospectively and the accounting for transactions in previous periods is not reopened. Nevertheless, transition rules highlight a number of accounting issues that may need to be addressed in the run-up to the adoption date;
- New securitisation and other transactions intended to remove assets or liabilities from the accounts may be 'on balance sheet' once the standard is applied.

Companies need to address these issues early in 2000 to ensure that appropriate action is taken to minimise these impacts. In addition:

- Classification of assets will need careful consideration. Investments will generally be carried at fair value unless designated as "held-to-maturity." Sale of an asset designated as held-to-maturity may have severe accounting consequences for several years including a prohibition from utilising the held-to-maturity category resulting in the mandatory measurement of such investments at fair value;
- You will need to review all existing financial assets and liabilities and may need to separate and mark-to-market derivatives that are currently contained within other instruments;
- Extensive quantitative and qualitative disclosure is required. System changes will likely be necessary to collect the required information.

Who does IAS 39 affect?

- All companies reporting under IAS, not only those using derivatives and not only to financial institutions;
- Subsidiaries and branch operations of companies reporting under IAS;
- Its greatest impact will be on companies that have significant investment or trading activities and those with treasury functions actively managing market risk.

Understanding the new standard is crucial for companies where risk management is fundamental to operations and for companies reconciling to US GAAP. SFAS 133, the US standard on derivatives and hedging, follows similar principles and has a similar implementation date. Companies reconciling to US GAAP should, with careful planning, be able to implement both standards concurrently, avoiding system duplications and minimizing new reconciling items.

What are the key impacts of IAS 39?

The impacts of IAS 39 are varied and include:

New, extensive definition of "financial instruments." The standard covers a wide range of instruments, including all derivatives, investments in debt and equity securities, financial assets and liabilities held for trading and a company's own debt. All financial assets and liabilities (including derivatives) must be recorded on balance sheet. You should consider the potential of the standard to have a wider than expected impact on your business.

Many financial assets and all derivatives must be measured at fair value. All derivative instruments must be accounted for at fair value. In contrast with current practice, most investments in equity and debt instruments will also be measured at fair value. Estimating fair values for unlisted securities or thinly traded derivatives may be difficult, particularly given that the standard does not prescribe a standardised fair value methodology.

Income Volatility versus Equity Volatility. Gains and losses arising from changes in fair values of derivatives will be recorded in the income statement, except when strict hedge effectiveness criteria are satisfied. Your Group will have a once-off choice of accounting policy as to whether fair value gains and losses on certain securities are recognized immediately in income or deferred in equity until disposal. Each entity must evaluate its appetite for volatility in an absolute sense and its relative appetite for income volatility versus equity volatility.

New rules for derecognition of assets and liabilities. The removal of assets and liabilities from the balance sheet is subject to strict requirements ensuring that control of assets is lost and primary responsibility for liabilities is extinguished. The ability to conduct activities through special purpose entities will require advance planning and an understanding of the standard's requirements.

Changes to the content of the income statement and balance sheet. The balance sheet must be grossed up to show the fair values of derivatives and securities "available-for sale". This may impact on bank loan covenants and on the way analysts evaluate your balance sheet. The additional income and equity volatility produced by the standard may affect the way shareholders, analysts and others look at your business.

New demands on your business systems. IAS 39 presents significant challenges for your treasury systems. If your business has a diversified investment portfolio or uses derivatives to hedge risk, it is likely that your systems will no longer be up to the task. New challenges include the requirement to calculate fair values for derivatives, and the rules and the new tests for assessing hedge effectiveness.

Special rules make deferral of hedging gains and losses much more difficult. IAS 39 will force many businesses to rethink the way they manage their risks. Many old hedging strategies, such as the use of macro hedging (pooling a range of risk items and then hedging the overall risk) or netting (offsetting equal but opposing risks of subsidiaries using a treasury center) will not qualify for hedge accounting. However the standard opens up new hedging opportunities, such as the opportunity to hedge forecasted transactions.

PricewaterhouseCoopers experience

PricewaterhouseCoopers is working with many corporates and banks at varying stages of preparedness for IAS 39. Examples of some recent projects to assist major banks and multinational companies in Europe are:

- A high level review of the impact of IAS 39 on the business' financial statements and systems strategy;
- Analysis and identification of risk management strategies consistent with the business' corporate risk objectives;
- Project management of the overall implementation of IAS 39 including the initial impact assessment and development of new risk management strategies;
- The implementation of new accounting processes, operations and systems.

Over the years, our team has established an extensive knowledge base of the treasury standards of the leading corporations and, by combining this knowledge with the multidisciplinary skills of the teams, we provide creative and practical solutions to meet the requirements of our clients.

Contact Details

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