



Wind of change blowing through financial instrument reporting

Accounting standards as we know them have undergone rapid change. However, after the *Memorandum of Understanding* was signed between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in September 2002 and updated in 2008, changes have become more frequent. The aim of the *Memorandum* is to align International Financial Reporting Standards (IFRS) with US GAAP, thus creating a worldwide standard for accounting, and improving the comparability of financial statements, which is essential in a global economy.

Following the 2008 world financial crises, the IASB has published a timeline that suggests changes to various accounting standards are to become more frequent and severe. The Group of Twenty leaders (G-20) meeting in 2008 called for "significant progress towards a single set of high quality global accounting standards". In addition, the G-20's plan to strengthen transparency and accountability recommended that global accounting standard setting bodies enhance guidance for the valuation of securities, especially complex, illiquid products, particularly in times of stress. This will result in changes to IAS 39 (AC 133) *Financial Instruments: Recognition and Measurement*, dealing with classification and measurement of financial instruments. Further, they recommended enhanced disclosures of complex financial instruments by companies to market participants, so as to understand better these instruments and the risks they pose. This will result in changes to IFRS 7 (AC 144) *Financial Instruments: Disclosures*.

There are many different types of financial instruments that entities can hold in today's complex financial markets, and this variety is becoming ever more extensive. Upon acquisition, these instruments must be designated into a category that IAS 39 (AC 133) currently prescribes, either: *at fair value through profit or loss*, *held-to-maturity*, *loans and receivables* or *available-for-sale*. Upon initial recognition, all financial instruments are measured on a similar basis. Subsequently, the four categories are measured either at cost, amortised cost or fair value. This facilitates different measurements being permitted for similar instruments, purely based on classification differences. Furthermore, fair value is determined using many different methods giving rise to further discrepancies. The current fair value measures are deemed by many to be inadequate and especially lack guidance in respect of illiquid markets. The IASB has thus also undertaken a project to develop a new IFRS on fair value measurements. The exposure draft (ED) issued on fair value measurements aims *inter alia* to establish a single source of guidance for all fair value measurements contained in IFRSs, to reduce complexity and improve consistency in their application.

In the current market, many instruments have had to be impaired. This issue is important, as the impairment rules amongst the four categories differ and result in a skewed picture of the value of these instruments. Despite these differences, a similarity between them is that, IAS 39 (AC 133), follows an 'incurred loss' approach. This results in impairments only being recognised once the loss has occurred. Many believe that this approach results in impairments being recognised too late, and the fair value of such instruments being inaccurately reflected. The FASB follows a different approach in which impairments are recognised based on expected future losses. Many believe this is a far better approach and more truly reflects the fair value of such instruments. The IASB has thus chosen to work towards a new single impairment rule for all instruments, following the 'expected loss' approach.



IMAGE: ISTOCK PHOTO

In response to the current credit crunch and calls from nations to improve standards and to prevent such a crisis from happening again, these projects have been accelerated by the IASB.

Progress thus far has been an amendment of the reclassification rules. Previously, reclassification in or out of the *at fair value through profit or loss* category after initial recognition was prohibited. The amendment now permits reclassification of non-derivative financial assets out of this category under certain circumstances, thus converging IFRS and US GAAP. Further, an ED on classification and measurement of financial instruments was issued by the IASB in July 2009. EDs on derecognition, impairments and hedging will follow in the near future.

Entities that hold a material amount of financial instruments need to consider the rapid changes that are taking place to IAS 39 (AC 133) as well as the EDs being released, when preparing their financial statements. Although the changes to be brought about will be onerous for preparers of financial statements, they should contribute much to bringing about a "single set of high quality global accounting standards" as desired by the G-20, and they will further align IFRS and US GAAP.

For references, log onto www.accountancysa.org.za. asa

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