EXPLANATORY MEMORANDUM

OF THE COMMISSION SERVICES

ON THE PROPOSAL FOR A REGULATION ADOPTING IAS 39

(only in EN)

24 September 2004

Formatted: English (U.K.)

1. Objective of the Draft Regulation

The EU will soon reach the final stage of implementing the financial reporting strategy which was unanimously agreed under the Lisbon Agenda in June 2000: As from 1 January 2005, more than 7000 listed European companies will have to prepare their consolidated accounts according to the International Accounting Standards (IAS), as endorsed by the Commission. Most IAS have already been adopted by the Commission. It is the Commission's firm intention to adopt all remaining IAS (including the new International Financial Reporting Standards (IFRS)) on time for their application in 2005.

Implementing this strategy without adopting any rules on the recognition and measurement of financial instruments before 1 January 2005 would be a major drawback. But the relevant standard, IAS 39, remains problematic. The International Accounting Standards Board (IASB) has officially recognised that an improvement of this standard is urgently needed. As far as the EU is concerned, two issues need to be resolved as a matter of urgency:

- **the full fair value option** for all financial assets and liabilities. In the light of observations from the European Central Bank and prudential supervisors represented in the Basel Committee, the IASB issued an Exposure Draft in April 2004 in order to limit the scope of this option; discussions are now taking place between the IASB, the ECB and prudential supervisors in order to find a solution for this issue. The Commission hopes that a solution will emerge no later than December 2004.

- **the hedge accounting provisions**, which, according to many European banks, pose a problem for operating their risk management. 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, make it impossible for them to hedge their core deposits on a portfolio basis. The IASB has now agreed to discuss with the European Banking Federation their proposals on a new hedging method, i.e. interest rate marging hedge. The Commission hopes that a solution will be found no later than September 2005.

Both issues have been the subject of in-depth discussions at several meetings of the Accounting Regulatory Committee. The Commission and Member States share the view that adoption in full of IAS 39 is the ultimate goal. It is clear however that this is not possible at present without finding an appropriate solution for these two outstanding issues. Faced with this problem, the Commission has presented three options to the Accounting Regulatory Committee: a partial endorsement of IAS-39; the exclusion of banks from the scope of application; and a deferral of the adoption of the standard.

After much debate in the Accounting Regulatory Committee, the Commission considers that a limited carve out of certain provisions in the standard is the best way forward. This is as close as possible to the objective of a full application of IAS from 1 January 2005 onwards. Only those provisions, which allow companies to apply the full fair value option and which prevent portfolio hedging of core deposits, are excluded from mandatory application. The exclusion of banks from the scope of application of the standard would be a far more extensive exclusion and is only supported by a few Member States; the deferral of the adoption of IAS 39 would be a major setback, would cause market confusion and would not be in line with the overall policy objectives set out in Lisbon. It would provide no impetus to rapidly solving the two

pending issues and it would provide a way out for those companies which have been late in preparing themselves for the application of IAS in 2005.

Given the exceptional scenario of a partial adoption of an international accounting standard, there are legitimate questions as to the general legal situation (see section 2) and concerns whether the carve out can actually work (see section 3).

2. Legal questions concerning the exclusion of certain provisions of IAS 39 from mandatory application

2.1. Is it legally possible to carve out certain provisions under the IAS Regulation?

The IAS-Regulation provides that the Commission can make mandatory either the application of standards elaborated by the IASB (which have been defined in Article 2 of the Regulation) under the conditions set out under Article 3 (2) or can decide not to apply such standards in accordance with Article 3 (1). The Commission has large discretion in this respect to take a decision with one exception: it is prevented from adopting a standard where the conditions under Article 3 (2) are not complied with. Moreover, the Commission has to inform the Accounting Regulatory Committee in accordance with Article 7 (2) in case where it did not have the intention to propose the adoption of a standard. The system is therefore designed to conclude that adoption or non adoption of standards by the Commission within the framework of its large discretion should take place as a whole.

Nevertheless, a standard may in reality cover two or more accounting subjects which are entirely autonomous, distinct and separable. This is for instance the case where a standard has a very wide scope and effectively covers several accounting subjects which are brought together, but remain autonomous. If the Commission were to adopt such a norm “as a whole”, the Commission would be unduly bound by the scope chosen by the IASB.

The Commission can therefore decide on the partial application of a standard where such standard covers several accounting areas which are distinct and separable. On the contrary, if a standard became meaningless without the provisions carved out and would accordingly become no longer operational, partial adoption could not be envisaged.

In the case of the full fair value option, this element is clearly separable and distinct for two reasons. First, historically this option did not exist with the earlier IAS 39 and was only added in December 2003. Second, an option is by nature separable from the mandatory part of an accounting standard.

On portfolio hedge of core deposits, the intended carve out pursues the objective of making it possible for banks to apply hedge accounting to their core deposits on a portfolio basis. It is limited to what is strictly necessary and does not make other provisions of IAS 39 meaningless.

2.2. Can Member States require listed companies to respect IAS 39 in full?

Although some limited provisions of IAS 39 are carved out, a Member State can still require or recommend full application of IAS 39, to the extent that this is allowed under Community

law. In this respect, the situation differs between the full fair value option and portfolio hedging of core deposits. Because the full fair value option is contrary to Article 42a of the Fourth Company Law Directive, a Member State cannot impose or allow its full use. The situation is different for the provisions on hedge accounting, because they are not the subject of specific provisions in the Accounting Directives.

- The full fair value option

Article 42a which was introduced into the Fourth Company Law Directive by the Fair Value Directive (Directive 2001/65/EC) restricts the type of liabilities which may be subject to valuation at fair value. It does not allow a fair valuation of all liabilities of a company. The main category of liabilities excluded from fair valuation is that of own debt; this category can represent a major part of a company's balance sheet. Therefore, Member States cannot allow or require companies to fair value liabilities beyond what is specifically allowed under Article 42a or under other provisions in the EU Accounting Directives, such as Article 31 of the Insurance Accounts Directive (Directive 1991/674/EEC), which 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[1].

Neither can a Member State under the IAS Regulation "override" Article 42a by invoking the "true and fair view" concept. This concept is referred to in Article 3 (2) of the IAS Regulation as one of the conditions which must be satisfied before the Commission can adopt a standard. The Commission can endorse a standard even though every provision of the standard is not entirely in conformity with the EU Accounting Directives. However, the Commission has decided not to endorse the full fair value option because it is still the subject of a continuing, important debate between the IASB the European Central Bank, the Basel Group and prudential supervisors, who all have a specific responsibility for financial stability and who have expressed concerns which the Commission considers as important and requiring further examination.

This interpretation is also in agreement with the comments issued by the Commission in November 2003[2]. These comments do not relate to the specific case where a standard has been only partially adopted. They deal with the relationship between the IAS Regulation and the EU Accounting Directives[3] as well as with the case where neither the IAS Regulation, nor the EU Accounting Directives contain any specific rules[4].

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[1] 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 91/674/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.

[2] *Comments by the Commission 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 – November 2003*

[3] Such as the requirement to draw up an annual report (Article 46 of the Fourth Accounting Directive); the publication of accounts (Article 47 of the Directive) and audit matters (Article 48 and 51 of the Directive)

[4] In such a case, the management should use its judgment to determine the most appropriate accounting treatment under IAS 1, paragraph 22 adopted under the Commission Regulation No 1725/2003. This right should not be restricted by a Member State.

- Portfolio hedging of core deposits

The EU Accounting Directives do not contain detailed provisions on hedge accounting. Member States may therefore require companies to fully comply with the hedge accounting provisions of IAS 39, including those which have been carved out. However, in doing so, Member States should take account of the reasons of this carve out, i.e. to provide a solution particularly for those banks which are operating in a fixed interest environment. Member States' competence however ceases to apply once the Commission adopts a revised standard covering these issues as well, or rejects its adoption on the basis of the criteria in Article 3 (2) of the IAS Regulation. As the carve out is made on procedural grounds awaiting an amendment of IAS 39 in due course, a Member State remains free to impose those provisions under national law for the time being.

2.3. Can a company – if it wants to do so – apply IAS 39 in full?

A company can fair value its financial assets and liabilities to the extent allowed under Article 42a of the Fourth Company Law Directive. It can apply the provisions of IAS 39 on hedge accounting which have been carved out.

3. Technical questions

3.1. Portfolio hedging of core deposits

The carve outs have been limited to the minimum strictly necessary. This is the reason why paragraph 49 of IAS 39 has not been carved out. It is understood that the requirement in this paragraph that the fair value of a financial liability with a demand feature (eg a demand deposit) may not be less than the amount payable on demand does not deal with a portfolio of demand deposits. As stated in recital 5, due to internal interactions and the law of large numbers, a portfolio hedge is necessarily different from the hedge of a single asset or a single liability.

3.2. "First time adopters"

IFRS 1, which was adopted under Commission Regulation No 707/2004, requires in principle companies to comply with each IAS/IFRS at the reporting date for its first IFRS financial statements, but grants limited exemptions in specified areas This standard is therefore of major importance for the great majority of listed European companies which do not yet report according to IAS/IFRS before 2005. Those companies which apply IAS 39 – as endorsed with the two carve outs under the present Regulation – can still make use of the exemptions under IFRS 1 because the reasoning is exactly the same: IFRS 1 should help "first time adopters" since the costs for complying with full IAS/IFRS will outweigh the benefits for the users of financial statements of such companies. As the two carve outs under IAS 39 are as limited as possible in substance and in time and the issues are likely to be resolved during 2005, it would be disproportionate in terms of costs for companies to take away the advantages granted under IFRS 1 whilst not offering any advantages to users of financial statements. Recital 12 expressly confirms this.

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