Commission Regulation (EC) No 2086/2004 of 19 November 2004 amending Regulation (EC) No 1725/2003 on the adoption of certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards the insertion of IAS 39 (Text with EEA relevance)

COMMISSION REGULATION (EC) No 2086/2004

of 19 November 2004

amending Regulation (EC) No 1725/2003 on the adoption of certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards the insertion of IAS 39

(Text with EEA relevance)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards[(1)], and in particular Article 3(1) thereof,

Whereas:

(1) By Commission Regulation (EC) No 1725/2003[(2)] certain international standards and interpretations that were extant at 1 September 2002 were adopted.

(2) On 17 December 2003 the International Accounting Standard Board (IASB) published revised International Accounting Standard (IAS) 39 Financial Instruments: recognition and measurement as part of the IASB's initiative to improve 15 standards in time for them to be used by companies adopting IAS for the first time in 2005. The purpose of the revision was the further improvement of the quality and consistency of the body of existing IAS.

(3) On 31 March 2004, the IASB issued an amendment to IAS 39 Financial Instruments: recognition and measurement on fair value hedge accounting for a portfolio hedge of interest rate risk. The general objective of the amendment is to simplify the implementation of IAS 39 by enabling fair value hedge accounting for a portfolio hedge of interest rate risk.

(4) Pursuant to Regulation (EC) No 1606/2002, it is the objective of the Commission to have a stable platform of international accounting standards in place as from 1 January 2005. However, certain important provisions in IAS 39 are still the subject of unfinished discussions between the IASB, the European Central Bank, prudential supervisors and the banking industry. These provisions relate to the option to fair value all financial assets and liabilities and to hedge accounting. Each of these provisions concern areas which are completely autonomous, distinct and separate from the rest of the standard.

Changes to legislation: *There are currently no known outstanding effects for the Commission Regulation (EC) No 2086/2004. (See end of Document for details)*

In order to respect the date of 1 January 2005, it is necessary to introduce IAS 39 with the exception of these provisions.

(5) IAS 39 introduces an option to fair value all financial assets and liabilities without any restrictions. However, the IASB has recently published an Exposure Draft (a consultative paper) which proposes an amendment to IAS 39 in order to restrict the fair value option contained in the standard. The proposed amendment is a direct response to concerns expressed by the European Central Bank, by prudential supervisors represented in the Basel Committee as well as by securities regulators of the Member States who are concerned that the fair value option could be used inappropriately, in particular in the case of a company's own liabilities. The Commission considers these questions as important and requiring further examination. The IASB has received many comments on this proposed amendment and is expected to take a final decision on this issue by the end of 2004. The Regulation permits the fair value option to be applied to financial assets. However, in the case of financial assets that are not traded in active and liquid markets, companies should take care to apply the fair value option to financial assets in a way that leads to reliable measurement.

(6) The full fair value option should not apply until the IASB has developed a solution to this issue and until the Commission is able to recognise that an appropriate solution for this issue has been found. Since the full fair value option is only an option, the provisions relating to this option are clearly distinct and separable from the other parts of the standard.

(7) On hedge accounting, there is discussion whether IAS 39 sufficiently takes into account the way in which many European banks operate their asset/liability management particularly in a fixed interest rate environment. The controversy is about the limitation of hedge accounting to either cash flow hedges or fair value hedges and the strict requirements concerning the effectiveness of those hedges.

(8) Many European banks argue that IAS 39 does not allow them to apply hedge accounting to their core deposits on a portfolio basis and would force them to carry out disproportionate and costly changes both to their asset/liability management and to their accounting systems. As a portfolio hedge, due to internal interactions and the law of large numbers, is different from the hedge of a single asset or a single liability, it is also argued that enabling portfolio hedge accounting of core deposits on a fair value measurement basis is consistent with the principle in IAS 39 that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand.

(9) The question whether and how the accounting treatment of portfolio hedging can be designed in such a way that it better reflects the particularities of banks operating in a fixed interest rate environment has been recognised as a significant issue by the IASB. The latter has created as a matter of priority a working group which is examining proposals made by European banks for the introduction into IAS 39 of a new hedge accounting method (interest margin hedge) which would reflect more closely the way in which these banks conduct their asset/liability management.

(10) The provisions of IAS 39, which are directly related to the accounting treatment of portfolio hedging should therefore not be adopted for mandatory use at this stage because they cannot be considered as final and may be changed in the near future. The relevant provisions that are excluded from mandatory application are clearly distinct and separable from the rest of the standard. They concern those provisions that do not reflect a portfolio approach and therefore prevent the application of hedge accounting to a portfolio of core deposits and those provisions that assimilate a prepayment risk to an interest rate risk and therefore prevent the continuation of risk management techniques recognised as acceptable by banking supervisors. However, companies do have the option to apply these provisions and can therefore apply all hedge accounting provisions in IAS 39.

(11) The existence in Community law of an accounting standard on the treatment of financial instruments is an essential element of the core set of standards to be applied by companies in 2005. It is therefore the objective to arrive as soon as possible, and if at all possible no later than around the end of 2005, at a situation whereby an amended IAS 39 can be adopted in full by the Commission. Accordingly, the Commission will review the applicability of IAS 39 once the provisions relating to the fair value option and the hedge accounting have been amended by the IASB and at the latest by 31 December 2005. A solution is being worked at between the IASB, the European Central Bank and banking supervisors for the full fair value option. Accordingly, the Commission will closely follow this ongoing work and will regularly review the applicability of the standard. Similarly, the adoption of appropriate provisions on hedge accounting in the near future is closely linked to the progress made by the working group set up by the IASB.

(12) Companies that prepare for the first time their financial statements in accordance with international financial reporting standards (IFRS) and apply IAS 39 in the version annexed to this Regulation should be considered as ‘first time adopters’ within the meaning of IFRS 1, as adopted by Regulation (EC) No 707/2004 and the present Regulation. The purpose of IFRS 1 is that costs for the transition towards full IAS/IFRS should not outweigh the benefits for the users of financial statements. This reasoning continues to apply in the case of moving towards full application of endorsed IAS. Accordingly, references in IFRS 1 to IAS/IFRS, which was adopted by Regulation (EC) No 707/2004, should be construed as references to IAS/IFRS as adopted on the basis of Regulation (EC) No 1606/2002.

(13) The adoption of IAS 39 implies, by way of consequence, amendments to IAS 12, 18, 19, 30, 36 and 37, and SIC 27, which were adopted by Regulation (EC) No 1725/2003, in order to ensure consistency between the accounting standards concerned.

(14) The Commission therefore has concluded that IAS 39 as set out in the Annex to this Regulation meets the criteria for adoption set out in Article 3 of Regulation (EC) No 1606/2002.

(15) Regulation (EC) No 1725/2003 should therefore be amended accordingly.

Changes to legislation: *There are currently no known outstanding effects for the Commission Regulation (EC) No 2086/2004. (See end of Document for details)*

(16) The measures provided for in this Regulation are in accordance with the opinion of the Accounting Regulatory Committee,

HAS ADOPTED THIS REGULATION:

Article 1

1 International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement*, with the exception of certain of its provisions on the use of the fair value option and certain of its provisions relating to hedge accounting, is inserted in the Annex to Regulation (EC) No 1725/2003.

The text for insertion, as referred to in the first subparagraph, is set out in the Annex to this Regulation.

2 Companies shall be regarded as 'first time adopters' in accordance with paragraph 1. References in IFRS 1 to IAS/IFRS shall be construed as references to IAS/IFRS as adopted by the Commission on the basis of Regulation (EC) No 1606/2002.

3 IAS 12, 18, 19, 30, 36 and 37 and SIC-27 as well as International Financial Reporting Standard No 1 are amended in accordance with Appendix B of IAS 39, as set out in the Annex to this Regulation.

Article 2

This Regulation shall enter into force on the 20th day following that of its publication in the *Official Journal of the European Union*.

It shall apply from 1 January 2005 at the latest.

Done at Brussels, 19 November 2004.

For the Commission

Frederik BOLKESTEIN

Member of the Commission

***Changes to legislation:** There are currently no known outstanding effects for the Commission Regulation (EC) No 2086/2004. (See end of Document for details)*

ANNEX

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INTERNATIONAL ACCOUNTING STANDARD 39

Financial Instruments: Recognition and Measurement

This revised Standard supersedes IAS 39 (revised 2000) *Financial Instruments: Recognition and Measurement* and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted.

OBJECTIVE

1. The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting and disclosing information about financial instruments are set out in IAS 32 *Financial Instruments: Disclosure and Presentation*.

SCOPE

2. ***This Standard shall be applied by all entities to all types of financial instruments except:***

   (a) ***those interests in subsidiaries, associates and joint ventures that are accounted for under IAS 27*** **Consolidated and Separate Financial Statements,** ***IAS 28*** **Investments in Associates** ***or IAS 31*** **Interests in Joint Ventures.** ***However, entities shall apply this Standard to an interest in a subsidiary, associate or joint venture that according to IAS 27, IAS 28 or IAS 31 is accounted for under this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in IAS 32.***

   (b) ***rights and obligations under leases to which IAS 17*** **Leases** ***applies. However:***

      (i) ***lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15-37, 58, 59, 63-65 and Appendix A paragraphs AG36-AG52 and AG84-AG93);***

      (ii) ***finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63);***

      and

      (iii) ***derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard***