6.25 FURTHER READINGS

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2. Maximilian J. Hale, 1993, *Banking Regulation and Supervision,* Edward Publishing Company.
3. Claude E. Barfield, 1996, *International Financial Markets : Harmonisation versus Competition,* AEI Press, Washington, D.C.
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UNIT 7 ACCOUNTING ISSUES IN INTERNATIONAL BANKING

objectives

After going through this unit, you should be able to:

- understand the fundamental accounting assumptions with regard to revaluation l translations.
- explain the accounting standards for the accounting and disclosure of foreign exchange and Internal rate instruments
- 'describe the BBA-SOW, FASB-133 practices.

Structure

7.1 Introduction

7.2 Fundamental Accounting Assumptions

7.3 Revaluations/Translations

7.4 Transaction Exposure and Translation Exposure

7.5 Accounting Objective

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7.7 BBA SORP

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7.9 International Accounting Principles : Convergence

7.10 Risk Disclosures

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7.1 INTRODUCTION

Shareholders' primary interests these days seem to be in understanding the profitability of business areas and sectors within banks and they are demanding full disclosure of management, account profitability, return on risk adjusted capital and better discussion and analysis of future business prospects. While risk and its successful management have been matters of concern, no real consensus exists on how this process does or should translate into share price. Some market participants hold that disclosure of this information is irrelevant; others find that the effect is negative as it exposes risks in a market that still has not achieved harmonization of accounting, reporting and disclosures; still others argue that it is a distinct competitive advantage that sets the well-managed firms apart from others. Analysts, in practice appear to put most of their emphasis on three factors - strategy, quality of management and volatility of earnings.

Arthur Levitt, Chairman of the US Securities and Exchange Commission once quoted British writer W. Somerset Maugham's witticism that "there. are three rules for writing a novel. Unfortunately, no one knows what they are". This is equally true of accounting, reporting and disclosure of the financial statements and the risk associated with them. Much of today's international accounting practice is built on historical cost conventions developed for manufacturers. These principles in many cases ignore derivatives altogether (e.g. the initial cost of a forward contract is' zero), Also reflecting historical developments, accounting principles differ from country to country and also among securities companies

and banks in some countries. With the myriad accounting standards for financial instruments in place around the world today and in some instances the complete lack thereof, even professional accountants cannot keep track of how to account for X financial instrument in Y country.

Through its own regulatory and/or professional accounting bodies, each country has established its own criteria for the presentation of financial statements and in particular, disclosure requirements. For example, the US has developed specific legal requirements in respect of the presentation and disclosure of the financial statemenh of US incorporated banks and bank holding companies. These are required to be prepared in accordance with the promulgations of the Financial Accounting Standards Board and regulations of the Securities and Exchange Commission. The UK does not have specific statutes relating to banks' financial reports. Within the UK, the financial statements and disclosure requirements of UK incorporated banks and other companies are governed by the companies Act and prepared and presented in accordance with the stateinents of Standard Accounting Practice (SSAPs) as promulgated by the Accounting Standards Committee.

7.2 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Notwithstanding the wide range of differing accounting practices throughout the world, there are four fundamental accounting concepts which are generally accepted everywhere. They are (i) going concern, (ii) consistency, (iii) accruals and (iv) prudence.

It is assumed that:

- the reporting institution is treated and viewed as a going concern.
- accounting policies remain consistent from one period to mother.
- revenues and costs are accrued as they are earned arid incurred and not when they are received or paid.
- it is also expected that "prudence", subslance over form and materiality should govern the selection and application of accounting policy i.e. "the prudence concept" prevails over the "accruals concept". This implies that.
- uncertainties which may apply to any transaction should be recognized by exercising prudence in preparing financial statements.
- transactions should be accounted and presented in accordance with their substance and financial reality and not merely with their legal form.
- financial statements should disclose a true and fair value.

7.3 REVALUATIONS/TRANSLATIONS

In considering asset value, the prudence concept requires that losses should be recognized as they occur but profits should only be accrued when they are realized. However, it also requires that substance over form and materiality should govern the selection and application of accounting policy.

A bank's asset structure is different from those of most other types of business. A hank's stock in trade comprises mainly monetary items or the exchange of one unit of measure for another. Therefore, in applying the four fundamental accounting concepts to a bank's assets and trading activities primary considerations are not related to placing a historic monetary value on any asset but in assessing fist the current market value of that monetary asset and secondly the purpose for which it is held. Also when reviewing a bank's dealing and trading activities, the issues to be considered are the profits and losses accruing and the impact of subsequent price movements thereon.

A bank's objective in maintaining portfolios of whatever nature is both to provide services and maximize profits from dealing opportunities. The results of these activities need to be frequently and carefully monitored and reported. It is now generally accepted that the only realistic basis of valuation and profit assessment is by a full comparison of all dealing portfolios with the, appropriate current market rates at which such positions

could he closed out. This procedure is commonly known as "Revaluation". A revaluation exercise is the process of valuing open positions at their current market price or prices.

Accounting policy for recording profits and losses resultant from a revaluation exercise continues to be a subject of considerable discussions and deliberation. Accounting and reporting policy for the revaluation of both current and contingents assets and liabilities is open to subjective judgements related to providing a true and fair view, prudence and accruals concepts together with accepted standards and practices with the banking industry in each country. It is now generally accepted accounting practice within the UK and many other countries that banks may either:

- value dealing assets at the lower of cost of market value thereof recognizing losses but deferring the recognition of profit until realization in accordance with the prudence concept and to provide a true and fair value.

Or

- value dealing assets at a full mark to market by recording all profits and losses resultant from a revaluation exercise immediately they are identified - in accordance with the accruals concept and the principle of providing a true and fair value.

For revaluation purposes the exchange dealing account in each currency will be revalued at current market rate and the resultant base currency equivalent compared with the base currency amount outstanding on the appropriate exchange dealing account within the base currency general ledger. As at profit reporting dates any surplus or shortfall between these two amounts will be credited. or debited, as the case may be to profit and loss account.

The revaluation of a bank's forward forex transaction is achieved by notionally closing out the net .overbought or oversold position for each value date in the future, by applying the appropriate - current market rates of exchange at which these positions could be closed out. Thereafter the net base currency contract amounts for each forward period of the revaluation at their contracted rates are compared to the revalued amounts. The net difference for each value date represent the notional profit or loss on that date.

Within the lower of cost or market value of accounting only realized profits and losses together with forward losses by currency would be recorded. Forward profits by currency are ignored. Under the mark - to market method of accounting all resultant profits and losses reflected by the revaluations will be applied to current income.

7.4 TRANSACTION EXPOSURE AND TRANSLATION EXPOSURE

International banks handling foreign exchange business incur transaction exposure and translation exposure.

Transaction exposure occurs when one currency must be exchanged for another and when a change in foreign exchange rate occurs between the time a transaction is executed and the time it is settled. Transaction gains or losses result from a change in the exchange rate.

Translation exposure has to do with how asset and liability values appear when translated into the domestic reporting currency for inclusion in financial accounts. Translation adjustment results from the process of translating financial statements into the domestic reporting currency. The effect of exchange rates which appears in financial statements is called accounting exposure.

An important objective in translating foreign currency is to preserve the financial results and relationships that are expressed in foreign currency. Perhaps the ultimate objective of translating foreign transactions and financial statements is to produce the same results that each individual underlying transaction would have produced on the date it occurred if it had been recorded in the reporting currency.

7.5 ACCOUNTING OBJECTIVE

The accountant's objective is to reflect the economic substance of past business transactions in the accounts. Typically the accountant will look first to published standards as primary reference for minimum standards of presentation and disclosure. From there the application of those guidelines in particular circumstances become a matter of professional judgement and best practice. The basic premise adopted is that the objective of any accounting principle is to ensure that the accounting reflects as closely as possible the economic effects and objectives of the transaction. Building on the accounting for commodity futures the principle of differentiating between speculative and hedging transactions has evolved. As the economic effects and objectives attributable to a speculative position may differ significantly from those relating to a hedge position the accounting should likewise he different, Furthermore the accounting for a hedge position should be consistent with the accounting followerl for the actual cash market transactions.

Hedging is the strategy of entering into transactions or financial positions whose primary purpose and effect is to protect an entity from potential losses by reducing its exposure to. interest rate, foreign exchange or commodity price risk. Hedging instrument is the instrument or security that counterbalances changes in the value of the hedge item. Hedge item(s) and hedging instrument(s) are collectively known as hedge components.

Hedge accounting is a special treatment that alters the normal accounting for hedge components in recognition of the principle that transactions designed as hedges are to be valued on an equivalent basis to the assetsfliabilities they are hedging and the resultant profit or loss is to be dealt with in accordance with the accounting treatment of the position hedged,

Current "best practices" and any related accounting standards stress continually the importance of defining whether a transaction constitutes a hedged or a speculative position.

7.6 ACCOUNTING STANDARDS

The various accounting standards may be summarized as follow:

a) ***United Kingdom***

Statement of Standards Accounting Practice (SSAP)

SSAP 18 - Accounting for Contingencies

SSAP 20 - Foreign Currency Translation

b) ***United States***

Statements of Financial Accounting Standards (SFAS)

SFAS 5 - Accounting for Ccontingencies

SFAS 52 - Foreign Currency Translation

SFAS 80 - Interest Rate Futures

SFAS 119 - (read with SFAS 105 & 107) - Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.

SFAS 133 - Accounting for Derivative Instruments and Hedging Activities.

c) **International**

International Accounting Standards (IAS).

IAS 10 - Contingencies for Events Occuring after the balance sheet date

IAS 21 - Accounting for the effect of changes in foreign exchange rates

IAS 32 - Financial Instruments

IAS E 62 (Proposed) - Financial Instruments - Recognition and Measurement.

d) **India**

Accounting for the effects of changes in Foreign Exchange Rates - Accounting Standard 11 (AS 11) Revised April 1, 1995,

FEDAI Guidelines for Revaluation of foreign currency positions and booking of exchange profits 1987.

With the exception of SFAS 52 covering forward foreign exchange contracts, SFAS 80 covering interest rate futures, and SFAS 133 covering accounting for Derivative Instruments and Hedging Activities, and IAS 32 covering disclosure standards these standards do not significantly refer to accounting and disclosure requirements for hedges and derivatives.

Many countries have not yet developed comprehensive accounting standards for the accounting and disclosure of foreign exchange and interest rate instruments. Accounting practices have not evolved to cover the constant evolutions of these markets. A broadly accepted statement which seeks to address this problem is the statemeni of Recommended Practices issued by the British Bankers' Association, formally titled "Off Balance Sheet Instruments and Other Commitments and Contingent Liabilities" or "BBA SORP

7.7 BBA SORP

Under the "SORP", derivatives are required to be placed under one of the two categories (i) trading transadtions (speculative transactions) and (ii) non-trading transactions (hedging transactions) which are essentially derivatives held for hedging purposes against assets, liabilities, cash flows which are themselves measured on accruals basis.

'Derivatives classified as "trading" should be measured at fair value while those classified as "non-trading" should be measured on an accruals basis equivalent to that used to the item being hedged. A dual approach to valuation or the so-called hedge accounting is needed because most of the traditional assets and liabilities such as loans are valued on an accruals basis. This approach is compatible with the core principles of matching and prudence. It has the following advantages:

a) It embraces the concept of accrual accounting, going concern and prudence.

b) It attempts to achieve a symmetry between the underlying asset, liability or contingency risk being hedged and the financial instrument being used.

c) It is an approach generally understood by accountants and is widely used for accounting for risk transfer instruments.

d) To a great degree existing control systems are based on this method of accounting.

The most important criteria which need to be satisfied before hedge accounting can be adopted are as follows:

- the derivative transaction should be intended to be a hedge and must in fact, provide a reasonable hedge.
- The hedging transaction must match or eliminate a substantial portion of the inarket risk inherent in the hedged position.

  Adequate evidence of such intention lo hedge should be established at the outset of the transaction.

Hedge Accounting Mechanism:

The following principles apply when hedge accounting is being followed in respect of a derivative transaction qualifying as a hedge.

- The hedge transaction should be valued on an equivalent basis to the item being hedged. It should be marked to market except where the item being hedged is being carried at original cost, in which case profit or losses should be spread or deferred in such a way as to match income with expenditure.
- Fees received at the outset of a hedging transaction, in substitution for a reduced income in future, should be spread over the life of the transaction.

- Fees or brokerage costs incurred on the transaction should be recognized in the same period as the income or expenditure of the underlying item being hedged.
- Income and expenses related to the hedging transaction should be included in the same category of the profit and loss account as the income or expenses of the underlying item being hedged.
- Where a transaction originally designated as a hedge is superseded by a more precise hedge the original hedge should be marked to market. Similarly a hedge which ceases to be effective should be marked to market. In both cases the profit or loss on revalution should be amortised over the remaining life of the item being hedged.
- Where aggregate net losses are expected on any discrete group of transactions inclusive of their hedges, these losses should be recognized in full immediately.

Disclosures:

The financial statements of the organization should contain a disclosure of the accounting policies followed for valuation and income recognition. A note should be given if derivative contracts are classified at the balance sheet date as having been made for hedging or trading (or both).

In addition to the notional principal amounts, the replacement cost and the credit risk weighted amount should also be disclosed in the financial statement as shown below:

	Notional Principal Amount	Replacement Equivalent Amount	Risk Weight	Risk Weighted Amount
Exchange Rate and Interest Rate Contracts	XXXX	XXXX	X-X%	XXX

7.8 FASB 133

In June 1998, the Finance Accounting Standards Board (FASB) issued Statement **133,** Accounting for Derivative Instruments and Hedging Activities. The four basic underlying premises of the new approach are:

- Derivatives represent rights or obligations that meet the definitions of assets (future cash inflows due from another party) or liabilities (future cash outflows owed to another party) and should be reported in the financial statements.
- Fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives, Derivatives should be measured at fair value and adjustments to the carrying amount hedged items should reflect changes in their fair value (that is, gains and losses) attributable to the risk being hedged arising while the hedge is in effect.
- Only items that are assets or liabilities should be reported as such in the financial statements (gains and losses from hedging activities are not assets or liabilities and, therefore, should not be deferred).
- Special accounting for items designated as being hedged should be provided only for qualifying transactions and one aspect of qualification should be an assessment of the expectation of the effectiveness of the hedge (i.e. offsetting changes in fair values or cash flows).

Statement 133 allows "special accounting" for the following three categories of hedge transactions:

- Hedges of changes in the fair value of assets, liabilities or firm commitments (fair value hedges).
- Hedges of variable cash flows of recognized assets or liabilities or of foiecasted transactions (cash flow hedges).

— Hedges of foreign currency exposures of net investments in foreign operations changes in the fair value of derivatives not meeting the criteria to use one of these three hedging categories must be recognized in income.

For those that meet the criteria Statement 133, provides the following approach to hedge accounting:

- To be considered as a hedge, in addition to other criteria a derivative instrument must be "highly effective" in offsetting exposure due to changes in fair values or cash flows of the hedged item.
- In a fair value hedge changes in the fair value of both the derivative and the hedged item attributable to the risk being hedged are recognized in earnings. Thus to the extent the hedge is perfectly effective the change in the fair value of the hedged item will be. offset in income with no net effect on earnings.
- In a cash flow hedge to the extent the hedge is effective, changes in the fair value of the derivatives are recognized as a component of other comprehensive income in stockholder's equity, until the hedged transaction affects earnings. The accounting for the hedged transaction is unaffected by the placement of the hedge.
- In a hedge of foreign currency exposures in a net investment in a foreign operation, to the extent the hedge is effective, the change in the fair value of the derivative is treated as a translation gain/loss and recognized in other comprehensive income offsetting other translation gains/losses arising in consolidatioii.
- If a derivative is 'highly effective" but not perfectly effective and does not exactly offset the changes in fair value or cash flows of the hedged item or transaction, the ineffective portion must be recognized in income at the same time the change in fair value of the derivative is recognized on the balance sheet.

Disclosures:

Statement 133 contains extensive disclosure requirements based on the type of hedge. The significant disclosures that are required by the new FASB Statement for all hedging activities are as follows:

— The. entity's objectives and strategies for holding or issuing derivatives,

— A description of the enlity's risk management policy for each type of hedge, including a description of the items or transactions for which risks are hedged.

— The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges ineffectiveness and (b) the component of the derivatives' gain or loss, if any, excluded from the assessment of hedge effectiveness and a description of where the net gain or loss is reported in the income statement or other statement of financial performance,

There are also some additional disclosures specific to fair value hedges, cash flow hedges and hedges of the net investment in a foreign operation respectively.

7.9 INTERNATIONAL ACCOUNTING PRINCIPLES : CONVERGENCE

International Accounting Standards - a body of rules that have been around since the early 1970s and revised in 1984, 1995 and 1998 (proposed) have not found wide acceptability. America so far has eschewed international standards despite the best efforts of the Lnternational Accounting Standards Committee (IASC), a private body supported by the worldwide accountancy profession. FASB has identified the'following three element as necessary for the IAS standards to gain acceptance in the US:

- The core standards must constitute a comprehensive, generally accepted basis of accounting.
- The standards must be of high quality.
- The standards must be rigorously interpreted and applied.

Four basic issues surround the debate on accounting for financial instruments:

1) From an accounting perspective, is fair value accounting the most representative of economic substance?

2) If so, where should gains and losses, be reported (income statement or shareholders' equity)?

3) What qualifies as a hedge and should the accounting treatment be consistent with the underlying item being hedged?

4) If fair value may not be appropriate in certain circumstances, to what extent should disclosure of fair value be required?

Harmonisation of standards is to everyone's benefit by creating a level playing field through which companies have access to capital markets around the world based purely upon competitiveness and liquidity.

7.10 RISK DISCLOSURES

Achieving more meaningful accounting and disclosure regarding the valuation of financial instruments used by firms in managing their risk profiles is a critical component of assessing an institution's earnings performance. Equally important is evaluating the level of risk that the institution takes to achieve those earnings.

The report of Public Disclosure of Market and Credit Risks by Financial Intermediaries (Fisher Report) issued by BIS in September 1994, recommended that all financial intermediaries provide the following:

- The market risks in the relevant portfolio or portfolios as well as firms' actual performance in managing market risk in these portfolios.
- The counterparty credit risks arising from their trading and risk management activities including current and potential credit exposure, as well as counterparties' creditworlhiness in a form that permits evaluation of firms' performances in managing credit risk.

The Basle Committee and IOSCO annually publish a survey of disclosure, covering a cross-section of the 79 biggest banks and securities companies in the G10 and Hongkong. The survey covers five broad areas of derivatives disclosures - qualitative information, gross position indicators, credit risk, market risk and earnings information. All of these areas have shown significant increases in the level of disclosures over the past few years, though much important information is still notably lacking.

In sum, accounting and reporting disclosure of derivatives has made significant progress over the past few years. Innovation, however, stiil outpaces the ability of stakeholders to keep up. Increasingly, levels of required disclosure as well as heightened expectations of voluntary information have been encouraged while regulatory and accounting bodies wade through the multitude of issues surrounding this area. Although national governing bodies have divergent national interests all insist on greater transparency if not uniformity of financial accounts.

While no amount of disclosure can prevent material losses from occurring, it is important that stakeholders understand managements philosophy and policies surrounding risk, how well risk has been historically managed and how future risks are being controlled. Current disclosures clearly do not meet these tests.

Activity 1

1. Points of distinction between Transaction exposure and Translation experience.

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2. Explain the terms 'Hedging instrument' and 'Hedging accounting'.

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7.11 SUMMARY

The effect of exchange rates which appear in financial statements is called accounting exposure. It is necessary to have rules for converting values of foreign assets, liabilities, payments and receipts into domestic currencies in order to include them in the consolidated statements in a firm's domestic reporting currencies. Different countries use different conversion rules and so it is difficult to provide uniform guidelines. Accounting policy for valuation of foreign exchange exposures continues to be a subject of considerable discussion and deliberation.

However, it is now generally accounting practice within the UK and many ether countries that banks may either. Value, dealing assets st the lower of cost or market value thereof recognizing losses but deferring the recognition of profits until realization in accordance with the prudence concept and to provide a true and fair value, or value dealing assets at a full mark to market by recording all profits and losses resultant from revaluation -exercise immediately they are identified in accordance with the accruals concepl and the principle of providing a true and fair value.

Special treatment is required for transactions designed as hedges which are to be valued on an equivalent basis to the assets/liabilities they are hedging and the resultant profit or loss is to be dealt with in accordance with the accounting treatment of the position hedged.

Current best practices e.g. EBA, SOW, FASB 133, continuously stress the importance of defining whether a transaction constitutes a hedged or a speculative position. These standards also lay down disclosure requirements in respect of accounting policies followed for valuation and income recognition, risk management policy for hedges, etc.

7.12 KEY WORDS

Derivatives Financial Instrument : A financial instrument whose value depends in some way on - is derived from - the value of another more basic instrument.

Foreign Currency Translation : The process of expressing in the domestic (reporting) currency of the firm those amounts that are denominated or measured in a different currency.

Hedge : A relationship between two or more otherwise separate positions wherein gains or losses on the hedge components are expected to be counter balanced in whole or in part.

Hedge Accounting : A special treatment that alters the. normal accounting for hedge components so that transactions designed as hedges are lo be valued on an equivalent basis to the assets/liabilities they are hedging.

Hedging : The strategy of entering into transactions or financial positions whose primary purpose and effect is to protect an entity from potential losses by reducing its exposure to interest rate, foreign exchange or commodity price risk.

Transaction Exposure : Occurs when one currency must be exchanged for another onk . when a change in foreign exchange rate occurs between (he time a transaction is executed and the time it is settled.

Ranslation Exposure : Has to do with how asset and liability values appear when translated into the domestic reporting currency for inclusion in financial accounts.

7.13 SELF ASSESSMENT QUESTIONS

1. What the generally accepted accounting concepts and practices for revaluation of foreign currency assets and liabilities?
2. Define hedge accounting and describe the hedge accounting mechanics in accordance with BBA SORP.
3. Discuss the treatment of derivatives, in FASB 133.
4. Write short notes on:-
   a. Transaction Exposure and Translation Exposure.
   b. Risk Disclosures
   c. Fundamentals of accounting assumptions.

'7.14 FURTHER READINGS

I. Richard Dale, 1985, The *Regulation of International Banking,* Prentice Hall, USA.

2. Maximilian J. Hale, 1993, *Banking Regulation and Supervision,* Edward Publishing Company.

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MS-424: INTERNATIONAL BANKING MANAGEMENT

Course Components

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