Master’s D-level Thesis

The Fair Value Option of IAS in the Context of Fair Value Accounting

The Practical Application in Financial Institutions

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Abstract

Research Question/ Purpose: Due to the increasing importance of international financial markets the significance of IAS 39 rises enormously. IAS39 deals with the measurement and recognition of financial instruments. One major aim is the valuation of the instrument at fair value. Therefore, the purpose of this paper is the examination of the major characteristics of the Fair Value Option (FVO) of IAS 39 and its affect on financial institutions.

Design/Methodology/Approach: An interpretative research philosophy is chosen in order to write the thesis. Therefore, the annual business reports of four major European banking institutions Dresdner Bank AG (Germany), Royal Bank of Scotland Group (Scotland), Nordea (Scandinavia), Crédit Mutuel (France) are examined. The gathered information does not have a statistical value, meaning that it cannot be used in order to develop a general conclusion.

Findings: The analysis of the empirical findings and the amended FVO exhibits that banks tends to implement the FVO and FVA instead of applying Historical Cost Accounting. In addition a coherency is drawn between the major results of the empirical study, namely the importance of Fair Value Accounting (FVA).

Conclusion: The conclusion can be drawn, that the FVO presents a milestone towards FVA but that the development is still in process. The FVO supports the reduction of accounting mismatches and facilitates the valuation of embedded derivatives. Furthermore, FVA increases the comparability and transparency of financial statements.

Research Limitations: Due to the limitation of time, only a small number of banking institutions can be analyzed. A second limitation is that the banks have to adapt IAS and IFRS as their accounting standards.

Originality /Value: The aim of this paper is not to generalize but to prove with the support of a small sample the effects of the FVO on the four selected financial institutions. On the basis of the literature review and the practical analysis the conclusion can be drawn, that in case of the analyzed institutions the FVO presents a step towards FVA.

Key Words: IAS 39, Fair Value Option, Fair Value Accounting
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<th>Description</th>
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<tbody>
<tr>
<td>EC</td>
<td>European Commission</td>
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<tr>
<td>EFRAG</td>
<td>European Financial Reporting Advisory Group</td>
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<td>EU</td>
<td>European Union</td>
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<td>FASB</td>
<td>Financial Accounting Standard Board</td>
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<td>FVA</td>
<td>Fair Value Accounting</td>
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<td>FVO</td>
<td>Fair Value Option</td>
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<tr>
<td>GAAP</td>
<td>General Accepted Accounting Principles</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standard Board</td>
</tr>
<tr>
<td>IDW</td>
<td>Institut der Wirtschaftsprüfer (institute of certified public accountants)</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
</tr>
<tr>
<td>LLP</td>
<td>Limited Liability Partnership</td>
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<td>PWC</td>
<td>PricewaterhouseCoopers</td>
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<td>RBS</td>
<td>Royal Bank of Scotland Group</td>
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<td>VaR</td>
<td>Value at Risk</td>
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1 Introduction

1.1 Introduction to the Topic

In the course of the last two decades global financial markets have experienced a significant expansion. The increasing share of international investments in combination with the reduction of capital control and the augmented diversification of world wide acting investors represent major reasons for this development. Therefore, the number and range of financial instruments have tremendously increased, resulting in an augmented importance of derivatives as well as of underlying financial instruments, such as shares or bonds (Sagmeister, (2006), p.1).

In order to meet the requirements of the new business environment concerning financial markets, adjusted principles and regulations are implemented to keep pace with the development of international financial markets. Those new regulations have to consider and be adaptive to the whole variety of existing financial instruments as well as for new financial instruments (Epstein et al, (2005), p. 88). The major intention of International Financial Reporting Standards (IFRS) is to provide external addressees with relevant information for decision-making. Furthermore, the aim is to augment the transparency and the comparability of consolidated accounts. Due to the continuous internationalization of capital markets a standard is necessary in order to guarantee the transmission of important and necessary information for the investors and addressees. International Accounting Standards (IAS) target to provide an overview and insight view concerning the financial positions, the changes in financial position as well as the performance of the entity (Selchert et al, (2003), p. 9).

1.2 Problem Statement of the Study

The International Accounting Standard 39 “Financial Instruments: Recognition and Measurement” is established as a principle in order to regulate the accounting treatment and to measure financial assets, financial liabilities and some agreements to purchase or sell non-financial items. Due to the introduction of this standard, the application of FVA
augments, possibly resulting in the rising volatility of published incomes. Since the implementation of the new class “at fair value through profit or loss” the leverage of FVA has further increased (Kurz, (2006), p. 13). The introduction of this valuation category allows enterprises to valuate financial instruments at fair value by capturing immediately changes in value in the current period statement (Bieg, et al, (2005), p. 219).

The reorganization leads to changes in the accounting procedure, due to the implementation of the fair value approach. One possible effect that may occur is that financial instruments, that were traded until the implementation of IAS 39 under most of the national General Accepted Accounting Principles (GAAP) as off-balance sheet entries have to be recorded at fair value on the balance sheet (Kurz, (2006), p. 13). The accounting of financial instruments according to IAS 39 is liable to a fast and dynamic development process. In the beginning of the literature review, the major objectives of IAS 39 as well as the scope of application are introduced. The International Accounting Standard Board (IASB) aims to implement a general obligation to valuate all financial instruments at fair value, also called FVA (Küting et a., (2006), p. 597). For the first time, the implementation of the FVO in IAS 39 provides enterprises and further financial institutions the opportunity to align the whole range of financial instruments optionally to the category “at fair value through profit or loss” and to valuate them at fair value. But the FVO can only be applied if enterprises or financial institutions fulfill the requirements announced in IAS 39. This possibility can be realized independently from the organization’s intention to trade those financial instruments or not (Kuhn et al (2006), pp. 4).

1.3 Research Objectives and Research Questions

Due to increasing criticism, especially through the European Union (EU) as well through major financial organizations, the FVO was modified several times. The ultimate version of the option was announced in June 2005 by the IASB. IAS 39 was also endorsed by the European Commission and therefore accredited as law of the
European Union. Reactive for the business year 2005, international companies using and acting in the capital market are allowed to apply the FVO for their consolidated financial accounting (Küting et al, (2006), p. 598).

The introduction of the new category “at fair value through profit and loss”, including the FVO coincides with a variety of changes and possible improvements for the valuation of financial instruments for enterprises and other financial institutions. Therefore, the two aspects that are investigated in the course of this paper are:

1. What are the main characteristics of the amended FVO?
2. How does the FVO affect financial institutions?

1.4 Delimitation

One major limitation in the course of this thesis concerns the choice of the banking institutions for the empirical study. In order to coincide with the literature review, the financial organizations have to valuate their financial statements according to IAS and IFRS and not according to US-GAAP. This circumstance aggravates the choice, because major international banks, such as “Deutsche Bank” publish their financial statements according to US-GAAP. Therefore, four banks are chosen that follow the rules of IAS and IFRS. But those entities differ in size as well as profit. Consequently, no generalized or harmonized results are deducted from the empirical findings and the analysis. Instead, the most interesting and meaningful information concerning the application of the FVO are figured out.

A second limitation deals with the limited amount of time. This circumstance minimizes the number of possible examinations of annual financial reports of banking institutions. In addition, due to the short time span, there is no possibility to receive all annual reports from 2007, because one bank, Crédit Mutuel has not published its financial report for 2007. For this reason, the business report from 2006 is analyzed.
1.5 Structure of the Thesis

The thesis is divided into seven chapters, as shown in Figure 1. The figure represents the complete and complex structure of the paper and aims to guide the reader through the study. In addition, an overview of each chapter’s content is provided.

**1. Introduction**
- Introduction to the Topic
- Problem Statement of the Study
- Research Objectives & Questions
- Delimitation
- Structure of the Thesis

**2. Research Methodology**
- Research Design
- Research Philosophy
- Case Study Research
- Time Horizon of the Empirical Study
- Data Collecting Model

**3. Literature Review**
- Overview of IAS 39
- Important Definitions of IAS 39 & IAS 32
- Fair Value Accounting according to IAS 39

**4. The Fair Value Option**
- Definition of the FVO
- Motives and Targets of the FVO
- Critics on the Initial FVO
- The Adapted FVO

**5. Empirical Findings**
- Presentation of the Banking Institutions
- Similarities in the Application of the FVO
- Differences in the Application of the FVO
- Particularities

**6. Analysis**
- Harmonization of the EU by Applying IAS & IFRS
- Historical Cost Accounting vs. Full FVA
- The Fair Value Option
- Particularities in the Risk Management
- Relevance of Information for the Addressees

**7. Conclusion**
- Conclusion

*Figure 1: Structure of the Thesis*
Chapter 1 provides an introduction to the research topic and forms the starting point of the thesis. The problem statement offers an explanation and insight view in order to specify the issue concerning the research topic. The research objectives in combination with the research questions present the aims of the analysis and what is targeted to be answered within this thesis. Additionally, the limitations of the research are introduced.

In the second chapter the research method is implemented. This comprises the description of the research design, the research philosophy, the exercised case study concept as well as the time horizon of the study. Finally, the data collection model is presented. The research methodology explains how the information for the study is gathered.

The literature review, presented in chapter 3, contributes to the introduction to the topic of the FVO. The major aspects of IAS 39 are introduced and summarized briefly to provide an overview of this standard. Especially FVA, defined in the standard, is explained. Significant definitions and theoretical approaches, concluding financial instruments, financial assets and financial liabilities are figured out as necessary to understand the concept of the FVO.

In the course of the practical analysis, comprising chapters 4, 5 and 6, the examination of the amended FVO presents the core part in the study. In the course of chapter 4 the main motives for the adaptations are discussed. What were the major points of criticism leading to the changes? The major aspects of the amendment are implemented and examined in detail. In addition, how the changes influence other IAS, that are linked to IAS 39 and the FVO, is investigated. The reduction of accounting mismatches or the limitation of volatility of published incomes forms the body of the discussion.

Chapter 5 illustrates the application of the FVO in the business environment. Empirical findings are extracted on the basis of annual published business reports of four banking organizations. It is analyzed how financial institutions deal with the FVO. Therefore, the four different banks are investigated in order to point out similarities and differences. Chapter 6 links the findings, deducted from the examination of the FVO
and the empirical findings in a final analysis. Therefore, the effects of the option and FVA are pointed out. The most interesting findings from the empirical study are analyzed. The main focus is the implementation of FVA and its effects on financial institutions in combination with the examination of the meaning of the FVO.

The thesis closes with chapter 7, a conclusion that summarizes the major aspects and cognitions from the theoretical and practical analysis. Furthermore, the reflection includes recommendations and a conclusion deducted from the above conducted analysis. This section contains the answers to the two research questions and the research objective is accomplished.

Each chapter of the thesis begins with an introduction into the subtopic. Therefore, the reader knows what the next section entails. In addition, to simplify the understanding of the final conclusion, each chapter of this thesis closes with a brief reflection paragraph. The main aspects discussed are summarized in this part, so that they can be easily beard in mind.
2 Research Methodology

This chapter investigates a variety of different approaches, that are applied in order to gather necessary information with the aim of conducting a successful research study that contributes to the development of a reflective and intense thesis. The variant steps, that have to be fulfilled in order to realize an efficient research process, are presented and shortly discussed. Section 2.1 introduces the research design, followed by the research philosophy in part 2.2 including the appropriate research method and the qualitative research. The case study research, one type of research strategies, is presented in 2.3. An explanation concerning the time horizon of the empirical study and the thesis illustrates the content of paragraph 2.4. The data collection procedure in section 2.5 forms the final point of the research methodology.

2.1 Research Design

In order to perform a successful research paper an explanatory research design is chosen with the aim to explain and clarify the driving forces influencing and causing the investigated phenomenon, the FVO. In addition, relationships, influencing this issue are examined by conducting documents’ analysis (Remenyi et al, (1998), p. 108). The core components of the study, comprising the theory, the FVO, the empirical findings as well as the analysis, are integrated in a consistent manner pursuing the target to answer the research question in an efficient manner.

2.2 Research Philosophy

The overall aim of this study is not to present a generalized or harmonized result in the end of the conclusion, but to package the most interest findings concerning the chosen topic. Therefore, the interpretive approach is chosen in order to reach this objective. A major difference to positivism is that an interpretative researcher provides an underlying explanation of the investigated phenomenon (Burrell et al, (2001), pp. 234). The main
characteristic of this concept is the subjectivity of the researcher, who is not regarding the situation from an objective perspective. In contrast, the researcher is deeply involved into the studied situation (Walliman, (2005), pp. 204). Therefore, the study is motivated by own interests. The task of the researcher is to identify the details beyond the phenomenon when he or she aims to comprehend the reality. (Locke, (2001), pp. 8) Each examination is subjective (Remenyi, (2000), p. 35). The thesis bases on a large number of sources and different concepts to collect and present information concerning and explaining the phenomenon. The objective of this approach is to provide the reader with a comprehensive and elaborated explanation and depiction of the analyzed situation. Thereby, generalization is less important (Blumberg et al, (2005), pp.19). Consequently, a smaller amount of samples is required (Davies, (2007), pp. 139).

The purpose of this paper is to investigate the changed FVO of IAS 39 and its effects on the banking institutions. According to the interpretative approach, no general results are presented in the conclusion, but the most interesting information or aspects, deducted from the empirical findings, are examined and reflected in the course of the analysis. It is attempted to provide interpretative explanations that are meaningful and important for the participants as well as for the addressees of this thesis. Knowledge is established and interpretations are deducted by observing and interpreting the phenomenon of the FVO.

In order to coincide with the selected research design and philosophy, a qualitative research method is chosen, in order gather the data needed to answer the research questions. In comparison to a quantitative research, a qualitative research is applied in form of an explanatory research design and in combination with the interpretative approach. (Alvesson et al, (2000), p.1). Qualitative data is mainly drawn from secondary sources of information. This kind of data is collected through a number of variant types of sources. Secondary data is also used when exhibiting the empirical findings in form of annual financial reports.
2.3 Case Study Research

A number of different research strategies can be identified, comprising experiment, survey, case study, grounded theory, ethnography and action research. A research strategy has to contribute to answer the particular research questions and should help to meet the objectives of the study (Saunders et al., 2003, p. 91).

In this thesis a case study provides the best alternative, due to the fact that this kind of research strategy comprehensively investigates the existing contemporary situation. Thereby, a thorough analysis of the elements of interest is conducted (Hair et al., 2006, p. 201). This means that case study researchers analyze the criteria of an individual unit (Blaxter et al., 2006, p. 71). To explain the application of the FVO, its exercise is examined at the example of variant banking institutions. Four different financial institutions, comprising the Dresdner Bank AG (Germany), the Royal Bank of Scotland Group (United Kingdom), Nordea Bank (Sweden), and the Crédit Mutuel (France) are selected with the aim to provide a sample in different countries. The small number of samples agrees with the interpretative approach.

One major motive for the choice of these four institutions is that all of them account their balance sheets according to IAS and IFRS. The fact that these banks differ in size and profits, contributes to the circumstance that an interpretative approach is chosen for this research. Therefore, no generalization of the findings is possible, but the financial institutions exhibit important and interesting facts concerning the application of the FVO and FVA. Due to the different sizes of the chosen entities, interesting information can be gathered for example whether the size of the bank influences the exercise and the effects of the FVO and FVA. The selected financial organizations enable a subjective interpretation of the FVO in order to figure out the consequences on their financial statements. In addition, all entities are settled within the European Union, indicating that all of them are confronted with the continuous harmonization process concerning the accounting procedures. Therefore, the chosen institutions contribute to the aim of the thesis to point out different meaningful aspects that coincide with the application of the FVO in the banking sector. On the basis of their annual published business reports, including their financial statements and in combination with further literature, for
example from the Basel Committee on Banking Supervision the relevance of the FVO in the real business environment is investigated. The gathered information supports the development of a comprehensive depiction of the items, resulting in answers to the research questions (Yin, 2003, p. 2). Furthermore, the examples confirm and extend the established theory (Ghauri et al., 2002, pp. 178).

2.4 Time Horizon of the Empirical Study

The research of this thesis takes place in a cross-sectional time span, due to the fact that a special phenomenon is analyzed at a particular time. Cross-sectional studies contribute to compare aspects or items in different organizations, such as banking institutions (Saunders et al., 2003, p. 96). In the course of this study, the application of the FVO in the fiscal year 2007 is analyzed and compared between the variant banking institutions. Due to the circumstance that the annual report of 2007 of Crédit Mutuel is not available, the one of 2006 is examined and compared to the other financial reports. Although, the business reports present figures from different fiscal years, a comparison of them is possible, because the aim of the study is to exhibit interesting and meaningful information concerning the topic, and not to draw a harmonized conclusion that is valid for banking organizations in general. Therefore, the overall result of the study is not influenced by the different annual reports.

2.5 Data Collecting Model

Secondary literature is used as the major source for data collecting. This data plays an important role in answering the two research questions. Different forms of secondary data can be applied for explanatory purposes when conducting a business research. The information can be exercised in order to analyze specific case studies. Secondary data can be examined for qualitative and quantitative research. This kind of information can be structured according to source, format and type. Normally, secondary data is gathered by third parties like single sources, syndicated sources or multiple sources. In
cases where data is gathered from within a company it is defined as an internal source. Otherwise, external sources provide information (Hair et al, (2006), p. 119).

The major reason for using secondary data is that this information confirms the findings made in the course of the analysis. In addition, the development or conduction of research in the context of a questionnaire is difficult with reference to the topic. Furthermore, the application of secondary data allows focusing on the analysis and interpretation of the collected information (Blaxter et al, (2006), p. 170).

In order to realize the purpose of providing a clear and comprehensive basis of the thesis, secondary data is collected and reviewed to establish a theoretical framework. The data enables a detailed and specific insight into the research topic and supports the comprehension of the research area (Cooper et al, (2003), pp. 152). The application of various sources guarantees a balanced as opposed to unilateral picture and knowledge about the research field. The most important and contributing definitions and theoretical approaches can be clarified with the support of a deeply rooted literature review.

Therefore, a large variety of different sources comprising literature, scientific papers and articles are accumulated, dealing with the topic of the FVO and FVA. The bibliography is gathered by using universities as well as online libraries, international accounting journals in combination with company reports, annual reports and reliable websites. Most important for the analysis of the changes of the FVO are the exposure drafts and amendments, dealing and defining the revised FVO, which are published by the IASB. It has to be remarked that, due to the topicality and the high degree of specification of this topic only a limited amount of literature in terms of books is available. The objective of this thesis is to base the theoretical as well as the practical approach on serious and reliable sources. The large amount of literature contributes to the interpretative approach, aiming to provide a comprehensive explanation of the examined phenomenon.

To deduct the case study, secondary literature in the form of annual reports is used. Therefore, the financial reports of 2007 of Dresdner Bank AG, Royal Bank of Scotland
Group and Nordea are examined. Due to the fact that the annual report of 2007 of Crédit Mutuel is not available, the one of 2006 is investigated.

2.6 Reflection of the Research Methodology

This chapter provides an insight into the research process of the thesis. A main aspect, that has to be emphasized, is that the interpretative approach as research philosophy is selected. This indicates that in the end of the thesis no generalized conclusion is presented, but that the most important and interesting information, gathered in the course of the empirical findings, is reflected. The purpose is to present an explanation, interpretation and understanding for the results of the empirical study and motivate the outcomes by linking them to the theory.

The selected research method can be described as reliable, transferable and valid. The information assembled from the analysis of the balance sheets, profit and loss statements and annual reports is compared to the secondary literature, derived from books, articles, international journals as well as electronic sources. Therefore, the findings from the empirical study can be explained with the support of the secondary literature. The outcome of the entire research supports the answering process of the research questions.
3 Literature Review

This chapter provides the theoretical background, necessary to follow the examination of the FVO. According to the overall topic of the thesis “The FVO of IAS in the Context of Full FVA” this part presents and examines the most important theoretical approaches that are linked to the FVO. Section 3.1 allegorizes an overview of IAS 39. The overall objectives as well as the scope of application are introduced. This enables a presentation of the picture of the current situation in combination with the integration of the FVO. Section 3.2 clarifies the most significant definitions and explanations that are related to the FVO. Finally, section 3.3 targets to describe FVA that is pursued by the IASB. The definitions of financial instruments and FVA form the body of the literature review. Within this theoretical approach, major targets and motives are analyzed. In addition, chapter four, that is already part of the practical analysis, deals with the examination of the FVO. It can be seen as the continuance of the literature review. But, due to the fact, that chapter four already examines and explains the driving forces and effects of the FVO it is integrated in the practical analysis. Therefore, in the beginning of this part, an explanation is given why the investigation of the FVO is settled at this point of the thesis.

3.1 Overview of International Accounting Standard 39
3.1.1 The Objectives

The setting of regulations and standards for valuating and recognizing financial liabilities, financial assets as well as agreements, dealing with the purchase, sale and holding of non-financial items in financial statements represent the major purpose of IAS 39 (International Accounting Standard Committee, (2000), p. 349). This indicates, that the principle also regulates the recognition, debit and measurement of derivatives and equity instruments (PWC, (2000), p. 7). In addition, this standard provides close and strict principles for the reporting procedure of hedge accounting (Ackermann, (2001), pp. 104).
In order to understand and to regulate the standards for presentation and disclosure of financial instruments, two additional standards have to be taken into consideration. IAS 32 contains rules for the presentation of financial instruments and itemizes the information that has to be published in the balance sheet. The standards, dealing with the presentation of financial instruments, refer to the designation of the financial instruments from the viewpoint of the issuers in financial assets, financial liabilities and equity instruments (Epstein et al, (2005), pp. 97).

IFRS 7, “Disclosures” contains a summary of IAS 32 “Disclosure and Presentation” and IAS 30 “Disclosures in the Financial Statements of Banks and Similar Financial Institutions”. The content of this standard is the formation of classes of financial instruments. The creation of these classes has to orientate on the manner and character of the financial instruments. Therefore, a transition to the appropriate positions in the balance sheet has to be possible. Those classes are created for publication purposes and therefore they have to be distinguished from the valuation categories formed in IAS 39 for financial assets and financial liabilities (Kuhn, (2006), p. 20).

![Figure 2: Overview of IAS 39; Excluded from “Overview of the Financial Instrument Standards”, (KPMG, (2006), p. 5)](image-url)

In order to capture all financial instruments, including derivatives in the balance sheet, they are assigned to different categories according to their attributes and intention to trade (Scharpf, (2001), pp.1). Three different denominations financial assets, financial liabilities and equity instruments can be distinguished. On the basis of this categorization the financial instruments are valuated. This approach aims to contribute
to a simplified understanding for the addressees, to comprehend the importance and
effects of financial instruments on the cash flows as well as on the financial results of

In summary, IAS 39 aspires the correct recognition and measurement of financial
instruments. Therefore a complete publication, comprising all information necessary to
reach a decision of the financial instruments has to be available. The underlying risks as
well as compliance with the IFRS-overriding principle have especially to be taken into

3.1.2 The Scope of Application

The standard is basically applied to all financial instruments that are assigned to the
scope of application of IAS 39 expect those that are excluded (KPMG, (2006), p.9). A
financial instrument can be defined as a contract that leads simultaneously to a financial
asset for one enterprise and to a financial liability or equity instrument for the other
contracting party (IAS 32.11). In the following, the financial assets and liabilities that
belong to the area of application are introduced.

Payment instruments and cash equivalents represent one group of financial instruments,
designated to the coverage as well as accounts receivable and trade payables. In
addition, derivative financial instruments, bond issues or repurchase agreements also
belong to the scope of IAS 39. Issued and purchased loans or financial guarantees are
financial assets and liabilities that are assigned to the scope of application as well as
financial guarantees. Credit approvals that are valuated at fair value as financial liability
and that are balanced in cash or other financial instruments (IAS 39.4) or agreements
concerning the sale or purchase of financial items enlarge the group of financial
instruments, covered by IAS 39. Contracts for the sale or purchase of non-financial
items, that are able to be balanced in cash or by another financial instrument, can also
be part of the standard, according to IAS 39.5. Finally, written options (short positions)
on the purchase or sale of a non-financial item that can be balanced in cash or by another financial instrument belong to the scope of application (PWC, (2000), p. 10).

Excluded from the scope of application, which are therefore regulated in other standards are interests in subsidiaries (IAS 27), associates (IAS 28) as well as interests in joint ventures (IAS 31). IAS 19 regulates the employer’s assets and liabilities under the employee benefits plans. The retirement benefit plans are ruled in IAS 29 and IAS 18 defines the revenue agreements. Furthermore, tax demands and liabilities are also excluded from IAS 39 as well as contracts on accounted return services in the context of mergers. In addition, rights and obligations under leases are regulated in IAS 17. Loan commitments are also barred from IAS 39 and structured in IAS 37, but this standard contains a number of exceptions. Loans that are designed “at fair value through profit and loss”, those that can be settled net in cash or those which involve a loan at a below-market interest rate are designated to IAS 39.

Finally, miscellaneous groups of contracts that are eliminated from IAS 39 include equity instruments, issued by the reporting entity as well as rights and obligations of insurance contracts. Defined contracts of guarantee and commodities futures for the own demand do not refer to the scope of application of IAS 39 (PWC (2000), p. 15).

Large parts of the balance sheet are influenced significantly by the implementation of IAS 39. Financial assets as well as financial liabilities including accounts receivable and payable as well as transactions in securities are affected by the standard. IAS 39 focuses to valuate financial instruments at fair value within the balance sheet.

3.2 Important Definitions of IAS 39 and IAS 32

3.2.1 Definition of Financial Instruments

A financial instrument represents a contract that simultaneously results in a financial asset for one contract party and in a financial liability or an equity instrument for the second participating partner (IAS 32.11). This comprises contractual regulated
requirements as well as obligations that centre on the direct or indirect exchange of payment instruments (Lopes, (2007), p. 234). A condition precedent to the existence of a financial instrument is that the rights and the obligations, agreed in the contract, have to deal with financial issues. This definition drops out all authorizations and obligations that do not dispose of an entitlement to the disposition of a financial asset (International Accounting Standard Committee, (2000), p. 350). In this context, an agreement describes an arrangement between two or more contracting parties that has clear economic consequences. Those ramifications are enforceable by law and therefore, they are preventable only in a limited manner (Walton et al, (1998), p. 43). Contracts and consequently financial instruments are able to adopt different forms and are not bounded to a written form (IAS 32.13).

The group of financial instruments comprises primary instruments, such as accounts receivable, liabilities to pay or equity instruments. Derivative financial instruments are additionally assigned to this group. Examples are options, standardized or other forward or future transactions, interest and currency swaps (IAS 32.AG15). Excluded are physical assets or those that are linked to the consignment of commodities or services (Ackermann, (2001), p. 51; IAS 32.AG8I).

Three types of financial instruments can be distinguished. Payment instruments as well as the right for the reception of cash equivalents are assigned to the first category, financial assets. Financial liabilities illustrate the obligation to deliver financial assets. Finally, equity instruments are represented by options, shares or interests in limited liability corporations (Walton et al, (1998), p. 43). The types of financial instruments are presented in the figure on the following page.
3.2.2 Explanations of Financial Assets

Referring to IAS 32.11, financial assets comprise cash payments as well as cash equivalents and equity instruments of other enterprises (Zingel, (2008), p. 161). In addition, the contractual right to receive cash payments or further financial assets from different companies or the possibility to exchange financial assets or liabilities with firms under beneficial conditions corresponds with the definition of a financial asset (Lopes, (2007), p. 234). Another alternative explanation is when the contract represents a derivative, that exchange can be settled on another way than by a fixed amount of cash or other financial assets for a predetermined amount of the entity’s own equity instruments (IAS Foundation Education, (2005) pp. 11).

3.2.3 Explanations of Financial Liabilities and Equity Instruments

The definition of financial liabilities accords to the one of financial assets. Financial liabilities comprise contractual obligations to transfer cash payments or other financial assets to another enterprise (Walton et al, (1998), p. 43). A further alternative that is described in the standard includes the possibility to exchange financial liabilities under
less advantageous conditions. Furthermore, a financial liability occurs, if a contract exists, that can be realized by the entity’s own equity instruments and if no derivate exists, that contains a contractual obligation engaging the equity to deliver a variable number of equity instruments (Lopes, (2007), p. 234).

In addition, a financial liability can be identified when a contract exists, that can be realized by the equity’s own equity instruments. In addition, a financial liability can be defined, if a derivate is present that can be realized on an alternative manner than by the exchange of a predetermined amount of cash payments or other financial liabilities against a fixed number of the enterprise’s own equity instruments (Scharpf, (2001), p. 43). Financial liabilities base on agreements for legal transactions and contracts that have financial items as their main context (Kuhn, (2006), p. 86). Financial liabilities represent commitments to deliver cash payments in the future (IAS 32 AG4). Liabilities that are linked to the transfer of commodities or services do not correspond to the definition of financial liabilities and are therefore excluded (International Accounting Standard Committee, (2000), pp. 351).

An equity instrument reflects a contract that certifies a residual interest in the net asset of an enterprise after the deduction of all liabilities (Wagenhofer, (2005), p. 227). This indicates that at no time a contractual obligation for the disposition of payment instruments or other financial assets may exist against another contract partner (Ackermann, (2001), p. 52). In contrast to financial assets and financial liabilities, ultimate criteria for the accounting of equity instruments are not available at the moment. Due to the fact, that equity instruments are seen and treated as a residue, the criteria for liabilities are equal important. This means that the assignment of equity instruments to bonded capital or equity capital represents an important role, due to the fact that the coherent interests, dividends as well as profits and losses are treated according to their designation (Ruhnke, (2005), pp. 513)

Shares and interests in limited liability corporations as well as special preference shares belong to the group of financial instruments in combination with issued options and subscription rights (Ernst & Young, LLP, (2005), Fn 943-944). But issued equity
instruments do not belong to the scope of application of IAS 39 for the reporting enterprise. Nevertheless, the holder of them is advised to adopt the standard (Scharpf, (2001), p. 51).

### 3.2.4 Designation of Financial Instruments

IAS 39 distinguishes financial assets into four separate classes that are treated in different manners concerning the measurement techniques as well as the handling of occurring profits and losses (Ernst & Young, LLP, (2005), Fn. 828). The category “held for trading” is defined in this context as a subcategory of the denomination “at fair value through profit and loss” (Zwirner, (2007), p. 351). The figure below shows the four different categories.

![Diagram](attachment:image.png)

**Figure 4:** Categories for Financial Assets (Schwarz, (2006), p. 126)

The designation of financial instruments to the different categories when recording the instruments at initial recognition determines how they have to be recognized and valuated (Zwirner, (2007), p. 351). This indicates that the denominations have to be clearly defined and specifiable. Therefore, the categories have to be delimited by clear targets as well as understandable characteristics in order to guarantee an equal handling within one category. The predefined criteria should be consistent with the entity’s organizational structure. Documentation is necessary to enable a comprehension and review of the categorization at the point of purchase.
In case of the designation of financial liabilities only two major categories are distinguished. The first group is identical to financial assets and comprises “at fair value through profit and loss” in combination with the subcategory “held for trading”. In contrast to financial assets, financial liabilities that cannot be categorized to this denomination are assigned to the group “other liabilities” (Schwarz, (2006), p. 151). The figure on the following page presents the designation of the two different categories.

![Figure 5: Categories of Financial Liabilities (Kuhn, (2006), p. 11)]

The first category “at fair value through profit and loss” contains financial assets and liabilities that are purchased with the purpose to realize profits on the basis of short-term volatility or price fluctuation, as well as those financial instruments that have been designated to this denomination at initial recognition (IAS 39.9). An entity disposes of the opportunity to decide for each single financial instrument to designate it to this class, as long as it is not an equity instrument that is not been quoted on an active market price and whose fair value cannot be determined appropriate (KPMG, (2006), p. 72). Financial assets and liabilities that are designated to this first group have to be valuated at fair value till their retirement. Changes in the fair value have to be recognized income statement-related in the profit and loss statement. Finally, all financial assets should be valuated at fair value, expect their fair value cannot be reliable measured. Then they are intended to be “held to maturity” or if they are defined as non-traded loans originated by the entity (Nobes et al, (2004), p. 118).
All financial assets have to be classified to the group “held to maturity” that exhibit the characteristics of fixed or determinable payment transactions in combination with a fixed maturity. Thereby, the ability and the intention to hold the investments are assumed with regard to the financial asset. This category only comprises items concerning accounts payable that are hold till maturity. After the initial valuation according to the initial value, financial instruments at this group are measured at amortized costs. Profits and losses of financial assets are recognized income statement-related in case of a debit, a diminution or an amortization. Vice versa, a write up has also to be recognized in the profit and loss statement (Schwarz, (2006), pp. 129).

The category “loans and receivables” includes original handed out and acquired loans and receivables with fixed or determinable payments that are not traded on an active market. A supplementary condition is that these financial assets should not be sold immediately. Then they have to be compulsory assigned to the first category “at fair value through profit and loss”. In addition, the class “loans and receivables” is not allowed to contain financial assets that are assigned to the first denomination on the basis of the choice of designation or that belong to the forth group “available for sale”. Similar to the second category, the financial assets of the third group are measured at amortized costs (Epstein et al, (2005), p. 90).

The fourth class “available for sale” represents a residual category. Financial assets are assigned to this category if they cannot be designated to one of the other three groups, especially equity instruments and investments that would not have been categorized to the first denomination. The financial assets at “available for sale” are measured at fair value. A valuation at amortized costs is only conducted if the fair value of a captured financial asset cannot be determined on a reliable basis. A change of the fair value of a financial asset has to be booked resulting in neither profit nor loss in the revaluation reserve. In case of an exclusion of the financial asset, the change of the fair value that has been recognized before neither in profit nor in loss is considered income statement-related. A decreasing value, due to changes in the solvency, has to be recognized immediately in the profit and loss statement. If the value augments, the distinction has to take place in order to determine whether a debt instrument or an equity security is
existent. In case of a debt instrument, the rise in value has to be published income statement-related in the profit and loss statement. If an equity instrument increases its value, this change has to be compulsory exhibited resulting in neither profit and loss in the revaluation reserve (Scharpf, (2001), pp. 36).

### 3.2.5 Definitions of Derivatives

A derivative is a financial instrument or a contract that is included in the scope of application of IAS 39 and fulfils the three following requirements (Zingel, (2008), p. 164).

1. The first criterion includes that the value of the derivative is defined from a specified interest rate, price of a financial instrument, commodity prices, currency exchange rates or other variables.
2. Furthermore, a derivative does not require any initial investment or the amount of the investment is lower than for different agreements that are estimated to react similar to changing market conditions.
3. Finally, the realization will take place in the future (European Commission; (2004), p. 1).

Major types of derivatives are forwards, swaps, futures as well as options (Schwarz, (2006), p. 17).

Derivatives are applied in order to reduce an enterprise’s risk exposure, especially in order to protect against changes in commodity prices, exchange rates or interest rates. Other reasons for using derivatives can be explained by speculation possibilities. Derivatives provide the opportunity to achieve high profit margins by investing only a small initial amount of money (Epstein et al, (2005), p. 278). A main target of the IASB has to be the publication, measurement and recognition of derivatives in the balance sheet in order to avoid misunderstandings and misinterpretations. This contributes to the
overall aim of the IFRS to provide a fair and objective view on the economic situation of an entity or an enterprise (Selchert et al, (2005), p.12).

3.2.6 Definitions of Embedded Derivatives and Hybrid Instruments

A hybrid combined instrument comprises an embedded derivative in combination with a non-derivative host contract (Bertsch, (2003), pp. 559, IAS 39 IN10). It is characteristic for hybrid instruments that parts of the cash flows, namely the embedded derivatives, are exposed to fluctuations as stand-alone derivatives (Wagenhofer, (2005), p. 226). An embedded derivative changes or adapts its cash flows in dependency from a specially defined interest rate, a price of a financial instrument or a commodity as well as changes in currency exchange rates or other variables as long as in case of a non-financial variable, the variable “is not specify to a party” (IAS 39.10). This definition indicates that IAS 39 should not only be applied for stand-alone derivatives, but also for embedded derivatives that are part of a hybrid instrument (Zwinger, (2008), p. 166).

An essential assumption for the existence of an embedded derivative is that the derivate has to be an integral part of the contract. Therefore this derivative is not separately negotiable or transferable on a third party (IAS 39.10). If the embedded derivative is closely related to the host contract, IAS 39 obligates the entity to valuate the contract as hybrid instrument. Thus the enterprise is not allowed to choose (Schwarz, (2006), p. 20).

3.3 Fair Value Accounting according to IAS 39

According to IAS 39, fair value is defined as “the amount for which an asset could be exchanged or a liability settled, between the knowledge, willing parties in an arm’s length transaction” (IAS 39.9). In IAS 40, paragraph 42 the term “knowledge” indicates that both, the eager seller and the willing buyer, dispose of reliable information concerning the planned investment. In addition, the willing buyer is not obligated but
motivated to purchase. Nevertheless, he is not bounded to a price (IAS 40.42). The same definition is valid for the willing seller. The seller is not compelled to retail at any price, but for the appropriate price according to the present market conditions (IAS 40.43). Arm’s length transaction implies that the participating parties act independently, meaning that they do not dispose of any relationship that may influence the market price of the transaction (IAS 40.44).

Information on the fair value is relevant and affects a variety of decisions that have to be taken into consideration by the investors. The fair value reflects the expectations of financial markets, respecting the present value of future cash flows, resulting from a special financial instrument. Furthermore, the fair value shall enable the comparison of different financial instruments (IAS 32.87). Consequently, it reflects the decision of purchasing, selling or holding financial assets. Simultaneously, it provides information with reference to borrowing, holding or amortizing financial liabilities. Thus, the fair value forms the basis for the valuation of the management’s performance from the viewpoint of the shareholders (IFRS 7.BC36). The definition of fair value bases on the approach of going concern. Concerning the valuation hierarchy (see Appendix 9.1), the fair value approach seems to be more reliable and meaningful as the valuation at acquisition costs (Sagmeister, (2006), p. 28). It mirrors the credit-worthiness of the respective financial instrument (IAS 39.AG69).

The best indicator to price financial instruments is the quoted market price on an active market. An active market is characterized by quoted prices that are readily and regularly available from exchanges, dealers or brokers. The quoted prices reflect current and regularly market transactions. Bid and ask prices represent proper market prices for assets and liabilities (KPMG, (2006), p. 76) In case that a published price quotation is available on an active market, it has to be applied (IAS 39.48A). A financial instrument is noted on an active market when the published market price is available under regular transaction conditions, such as a stock market, a broker, an industry group, a regulatory agency or a pricing service (IAS 39.AG 71). The fair value of a uniformed group of financial instruments is the sum of the individual quoted market prices of all units (Bieg et al, (2005), p. 209).
In case that an active market cannot be identified for a financial instrument, a valuation model has to be applied (IAS 39.AG 72). The target is to investigate the computed market or transaction price. This price aims to correspond with the market price that would arise on the measurement date in an arm’s length change, in case of regular market and business conditions (IASB, (2006), p. 14). Therefore, a valuation model has to consider all aspects that would be regarded by market participants in the course of the pricing process. In addition, the chosen method has to be consistent with accepted economical pricing models (IAS 39.AG.75f). Three most commonly used valuation techniques can be identified.

1. A first option is to compare the value of a financial instrument with a topical fair value of another in essence identical financial instrument.
2. Secondly, the analysis of discounted cash flow can provide a fair value.
3. A third alternative are option pricing models (IDW, (2006), RS HFA 9, Tz 90).

Due to the fact that the valuation techniques can be chosen partly, the methods and essential assumptions have to be published (IAS 32.92a).

In order to price financial instruments at fair value, IAS 39 includes a two stage hierarchical valuation system that has to be considered. This hierarchy distinguishes whether a quoted price on an active market is available for a financial instrument or whether the price has to be calculated with the help of valuation models (Schwarz, (2006), p. 125). Financial investments in equity instruments for which a quoted market price is not available cannot be assigned to the category “at fair value through profit and loss” (IAS 39.9).

To determine the fair values for equity instruments, the measurement bases on observations of market data concerning the market conditions in combination with further factors that may influence the fair values (Ernst & Young, (2004), Fn. 1023). As analyzed above, the applied valuation techniques have to be supervised on the basis of topical market prices and adapted if necessary. The review has to take place in periodic intervals (Bieg et al, (2005), p. 210).
The fair values of equity instruments that are not quoted on an active market can be defined as reliable, in case the fluctuation of the estimation of the fair values is not significant. In addition, the estimated values have to be reliable and adaptable in order to estimate the fair value (IAS 39.AG80).

But FVA is also associated with a variety of costs. One core item is whether the fair value of financial statements can be determined on a reliable basis, with special focus on those instruments for which no active market exists. Therefore, a cost/benefit trade-off between relevance and reliability is taken into consideration by the IASB. The aim is to identify the best measurement approach for special accounting amounts and to investigate whether the valuation is reliable for financial statement recognition. One critical point is that financial instruments recognized and published in the balance sheet are not measured on a reliable basis and do not support the assessment of the entity’s financial position. In case no active market for a financial instrument is available, the fair value has to be estimated, which may lead to a subjective valuation or even manipulation (Landsman, (2006), pp. 1).

Concerning the ascertainment of profits, the conclusion can be drawn that FVA focuses on an asset-liability approach that affects the balance sheet and consequently, the ascertainment of assets. In a world with perfect competition the admitted net assets at FVA would correspond to the company value. Consequently, the admitted profit has to be interpreted as an economic profit (Benston et al, (2006), p. 261). The information shown by the net assets cannot coincide with the company value, in case of a consequent application of FVA in the real business world. On the one hand, due to the market orientation enterprises’ individual synergies are not allowed to be considered. But when exercising the FVA a principal convergence towards the company value would be possible. Nevertheless, when determining the value, an expanded scope of discretion would occur (Bromwich, (2004), pp. 38). Especially the market orientation of the fair value shall ensure a high degree of objectivity, when measuring the company value. On the other hand, a company value cannot be measured by adding single financial assets and liabilities. Consequently, FVA can only minimize, but not close the gap between book value and fair value of equity capital (Benston et al, (2006), pp. 262).
Concerning the ascertainment of profits, significant criteria can be identified. Firstly, due to the asset-liability approach unrealized profits are arranged. Because of the market orientation of entities, fluctuations of the market affect the ascertainment of profits (Hitz, (2005), pp. 273). On the one side, the profit realized by FVA reflects all relevant developments for the valuation of the management just in time (Streim et al, (2003), pp. 475). On the other side, the performance measurement can be seen as a random game for the management due to the uncontrollable market fluctuations (Schildbach, (1999), p. 182).

A further aim of FVA is a neutral and objective presentation of the financial situation of the entity. The balance sheet functions in the international accounting only as a source for information, but it does not take over a function for the valuation of payments. Therefore, the fair value debate is not only a discussion about information shown, inclusion and valuation, but finally a discussion that concerns the principal tasks of accounting (Moitzi, (2007), p. 28).

In addition, an advantage of FVA is the increased relevance, whereas critics complain about the decrease in the reliability that occurs, due to a lack of observable market prices. The fair value approach represents the only concept that takes the estimation of future cash flows, the fair value of cash, and the price for the risk that coincides with the future cash flows as well as other factors into consideration (FASB (2000), SFAC 7.24). Simultaneously, the comparability of balance sheets should be increased, due to the market oriented current value. Furthermore, market fluctuations are recognized at the moment of their emergence, whereby conclusions can be drawn on the quality of the strategic risk management of an enterprise (Willis, (1998), p. 860).

The most critical aspect of FVA deals with the scope of discretion that occurs if market prices are not observable (Ballwiesinger et al, (2004), pp. 535). The question, concerning the relevant market and the purchasing conditions may lead to difficulties, resulting in variant fair values (Wagenhofer, (2006), p. 34). Different valuation techniques, e.g. the discounted cash flow or the Black-Scholes-Model require
compulsory the subjective estimation of a number of parameters, resulting in useable scopes of discretion (Schuetze, (2001), p. 10).

Finally, volatility represents a further disadvantage, coinciding with the reliability of fair values (European Central Bank, (2004), pp. 77). The effects of external factors, resulting in a blurred presentation of the company’s financial situation are out of the range of control of the entities. Otherwise, irrelevant possibilities could be published or addressees may misinterpret the information, so that negative consequences of the cost of capital are suspected (Hitz, (2005), p. 273).

3.4 Reflection of the Literature Review

Reviewing, all important theoretical items and definitions that are necessary to comprehend the research paper are examined. With reference to the general topic of the paper, the literature review covers and discusses all central and important subjects concerning and influencing the FVO. Additionally, the literature review is structured in a clear manner, providing the reader an overview over the theoretical framework. Reflecting, this chapter provides a lucid picture of the major characteristics of the definition and designation of financial instruments to the different groups of valuation categories and FVA.

The designation of financial instruments describes a major issue within the theoretical framework, because the categorization of the financial instruments influences the further treatment and valuation of them. In addition, the fair value approach represents an important item of the theoretical framework, due to the circumstance that the FVO is one possibility of FVA. Furthermore, this discussion already contributes to the answer of the first research question, concerning the major changes and the final version of the FVO.

The theoretical framework forms the starting point for the practical analysis. In the practical part, the theoretical results will be merged with the analysis of the FVO. As
proved in the literature review, variant approaches have to be taken into consideration, in order to form a profound basis for the practical analysis of the FVO.
Practical Analysis

The practical analysis represents the core examination of this paper. It aims to contribute to answer the two research questions. Therefore, the practical analysis is subdivided into three major chapters. In chapter 4, the limited FVO is investigated in order to exhibit its major changes and adaptations. The FVO represents a milestone towards the implementation of Full FVA, targeted by the IASB and therefore, has a great influence on the practical application of IAS and IFRS. Additionally, this approach is highly discussed by major international institutions, like the Basel Committee, the European Central Bank or the EU. Although, this chapter contains a number of theoretical aspects, it is implemented in the practical analysis, due to the fact that the literature is not only reviewed, but simultaneously an examination of the FVO is conducted aiming to identify the main driving forces. Therefore, this chapter presents the linkage between the literature review and the empirical study. The decision to integrate this topic in the practical analysis and not in the literature review bases on the fact, that the subject provides a high practical relevance. Because of its effects on and in the financial business environment and its importance in the practical exercise of IAS 39, the analysis of the FVO represents the first chapter of the practical analysis. Furthermore, the investigation provides the necessary comprehension in order to continue with the core examination in chapter 5, the empirical study of the FVO and FVA in the banking sector. Consequently, the two sections, the explanation of the FVO and the empirical findings, are linked and evaluated in a final analysis in the course of chapter 6.

4 The Fair Value Option

In order to answer the first research question, this chapter aims to analyze the changes and adaptations of the FVO. Therefore, the major items concerning the adapted FVO are separately figured out and investigated. Its motives, targets and effects present the focus of the practical examination. Due to the complexity of this subject, a subdivision into a variety of individual paragraphs is necessary, to simplify and improve the
comprehension of the topic. Point 4.1 comprises a definition of the FVO in order to provide the reader an introduction into the topic. Afterwards, in the course of the sections 4.2 and 4.3, the most significant targets and motives, as well as the occurred criticisms are discussed, resulting in the adaptation of the FVO. In 4.4 the three most important individual innovations are presented in a detailed manner to allegorize a lucid picture of the final amendments concerning the option. In addition the adoption and application of the FVO for entities are clarified.

4.1 Definition of the Fair Value Option

According to IAS 39, the FVO allows “an entity to designate specified financial assets or financial liabilities, on initial recognition, as ones to be measured at fair value, with changes in fair value recognized in profit and loss” (IAS 39 IN 16; IASB, Exposure Draft, (2004), p. 9). In order to ensure adherence and consistency, an enterprise is prohibited from reorganizing their financial assets and liabilities out of or into this class (IAS 39 IN 16; IASB, Exposure Draft (2004), p.9).

4.2 Motives and Targets of the Fair Value Option

The major objective of the FVO is to facilitate the application of IAS 39 in practice. The primary goal is to eliminate valuation asymmetries (Küting et al, (2005), p. 600), especially under those circumstances in which the absence of the option would result in an increased reported volatility on economically matched issues, due to the application of the mixed measurement model (IAS 39 BC5). Nevertheless, all financial instruments at initial recognition are valuated at fair value (IAS 39.43, IAS 16.6). In the course of the subsequent valuation, different valuation techniques can be optionally conducted e.g. at fair value or at amortized costs for special balance sheet items.

Amortized cost of financial assets or financial liabilities is defined as the amount at which the financial instrument is valuated at the point of initial recognition. Principal
repayments have to be deducted. In addition, cumulative amortization has to be added or subtracted of any difference between the initial amount and the maturity amount (International Accounting Standard Committee, (2000), p. 352). Consequently, a valuation with reference to amortized costs describes the task to recognize financial assets, according to their amortized costs and to continuously depreciate them until their sale on the sales market or their in-house usage. This guarantees that this process is resulting in neither profit nor loss. An influence on the profit and loss statement is related to concrete revenues, so that profits are realized by selling financial assets on the sales market (Leffson, (1987), pp. 252). In order to determine the amortization, the “effective interest method” is applied. This method discounts the predicted amount of future cash payments through maturity to the present net carrying amount of the financial asset or liability. The approach can also be defined as the level to yield to maturity and represents the internal rate of return of the financial asset or liability (International Accounting Standard Committee, (2000), p. 352).

As analyzed in chapter 3.3, the fair value is valued with reference to the hierarchical concept with the aim to use objective market data. In case of a fair value valuation, the changes are captured income statement-related in the present profit and loss statement, resulting from their designation. When valuating according to amortized costs, changes in the value of financial instruments are not recognized and captured in the balance sheet and therefore, they do influence neither the profit and loss statement nor the equity capital (IAS 39.55-56). This results in a mismatch of economically matched positions.

The fair value approach takes cash flows and future transactions into account, due to the fact that this method directly contacts to the information of the investors. But, in case that the fair value cannot be valued according to quoted market prices, its determination is linked to a large scope of discretion (Willis, (1998), p. 854). The supporter of the fair value approach states “that is more current as well as more relevant and useful” (Stanley, (1997), p. 81).

Until the implication of the FVO, those incongruities could only be managed by the application of hedge accounting, but this approach does not present a sufficient solution
for this kind of problem. In addition, not all financial instruments are covered by the definition of hedge accounting and are therefore, excluded from the range of application (Küting et al, (2005), p. 600). In addition, the FVO shall contribute to the simplification of hedge accounting (Schmidt, (2005), pp. 269). Therefore, the FVO presents an enhancement for minimizing incongruities, due to the fact that only a small amount of regulations have to be taken into consideration when exercising the option. In addition, no financial instrument is excluded from the scope of application of the FVO. Those arguments increase the attractiveness of this concept.

The characteristic of the FVO is that the asset and the liability side of the balance sheet are successfully valued at fair value. By assigning the concerned underlying transactions at the moment of purchase, an automatic synchronization with the hedging derivatives is possible, due to the fact that the financial instruments are considered in the profit and loss statement according to the regulations, valid for the valuation of derivatives. This procedure results in a voting right for the “Full Fair Value Accounting”, even beyond trading activities (Löw, et al, (2005), p. 1730).

A number of financial instruments are excluded from the scope of hedge accounting because of its strict definition. The FVO provides the opportunity to value financial instruments that are excluded until its introduction. This development contributes to a reduction of the distortion of an entity’s results and allocates a clear picture of the financial situation of an enterprise (Erchinger et al, (2007), pp. 543).

4.3 Critics on the Initial Fair Value Option

After the introduction of the initial FVO critics arose, pronounced by major financial institutions such as supervisors of banks, insurance companies, the European Central Bank as well as the EU. Those organizations doubted that the option would be applied in an appropriate manner (Jerzembek et al, (2005), pp. 224).
The first concern dealt with the issue that enterprises or financial institutions might apply the FVO to financial assets or financial liabilities although their values were not verifiable and therefore, not reliable. This indicates that, due to the subjectivity of the measurement of financial assets and financial liabilities the profit and loss statement would have been influenced in an unsuitable manner, leading to a distortion of the financial situation of the reporting entity (IASB, Exposure Draft, (2004), p. 18).

A second critical aspect that was highlighted by the European Central Bank examined the danger of increased volatility in the profit and loss statement. This situation could have been occurred in case of a complete reporting procedure for financial instruments at fair value that affects the profit and loss statements (Erchinger et al., (2007), p. 542). An augmented volatility also might have been arose, if an entity or a financial institution only applied the FVO not to all but only to a selected number of matched positions. Nevertheless, the target of the option is to minimize economical not justifiable income volatility. Due to the fact that the volatility offers relevant information, it should be recognized in the income statement. Furthermore, volatility could increase in case of short term fluctuations in financial market valuations or due to the inappropriate development of valuation techniques (European Central Bank, (2004), p. 7). In case of banking institutions, the danger existed that the introduction of the fair value approach would induce banks to forego their basic function, because this approach would not represent the lend and hold attitude. Therefore, banks would face an incentive to hedge or shift the risk to customers in order to reach a matched position. Furthermore, the application of the unlimited FVO would have been resulted in the production of more positive results if the assets prices are rising. This valuation of assets would have been visible in the profit and loss statement. Shareholder might increase the pressure for dividends, including unrealized gains on assets, remaining in the bank portfolio (European Central Bank, (2004), p. 7).

The IASB developed an exposure draft with special focus on the needs and requirements of banks and other financial institutions (Erchinger et a., (2007), p. 542). The reactions were explicit. From 115 comment letters, voted 76 per cent against the
amendments and only 15 per cent agreed with the limitations of the FVO (Löw et al, (2005), p. 1730).

Furthermore, the Exposure Draft, published in 2004 suggested limiting the scope of application of the FVO on the asset side of the balance sheet (IASB, Exposure Draft, (2004), p. 18). But this limitation did not correspond with the expectations of the European Union (Europa- Rapid – Press Releases, (2005), MEMO/05/246).

Critics occurred, because the accounting on the liability side of a balance sheet contravened with the EU Fair Value guidelines. According to European law, the FVO could only be applied for financial assets. This confinement reduced the simplification of illustrating hedge accounting as it is the major target of the option (Baetge et al, (2006), p. 134).

This situation described a great challenge for the IASB due to the fact that a significant majority demanded the FVO for reducing economically unjustifiable volatility in the profit and loss statement. But, this aspect did not belong to the fair value guidelines of the EU, due to the fact that derivatives were measured as pending transactions according to the law of the EU and therefore, they were not accounted. This disagreed with the concept of IAS 39, stating that derivatives should be accounted. From the viewpoint of the EU the rejection of the FVO was conform according to their guidelines (Jerzembek et al, (2006), p. 224).

The overall objective of the European Union is the creation of worldwide comparable financial statement. In May 2003, a directive was published by the European Council that aimed to eliminate any inconsistency between IAS and existing accounting directives of the EU (European Central Bank, (2004), p. 7). This development is desired by the participants in capital markets as well as by the reporting entities. In order to advance this development, the European Parliament and the European Council enacted in 2002 a degree that regulates the application of IAS. According to Article 4 and Article 2, entities oriented towards capital markets with registered office within the EU are obligated to create their consolidated accounts for fiscal years that start after the 31st
December 2004 in accordance with IAS (Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001; Nobes et al, (2004), p. 100). Therefore the EU Directives No. 4 and 7 have been modernized. This reconstruction enables FVA for specified financial instruments in individual financial statements as well as consolidated accounts of joint stock companies (Bieg et al, (2005), p. 87). Thereby, IAS served as reference norms in the course of the modernization process (http://www.standardsetter.de/drsc/docs/comments/eu_directives/4th/idw.html). The aim of the adaptation is an increase in the transparency of financial reporting, by publishing non-reported transactions as well as transactions with related persons or parties in the notes to the balance sheet. In addition, quoted entities in the EU have to hand in a corporate governance explanation (Der Betrieb, (2006), Heft 22). This can be seen as a disclosure of IAS 39.

A further target of the modernization of the EU Directives is not only the avoidance of the compulsory incompatibility, but also a total reconciliation of all IAS regulations with the EU Directives. A modernization of the basic structure of the valuation and accounting directives targets to establish an accounting framework, which corresponds to the modern accounting approaches and which is flexible enough to accommodate to future developments of IAS and IFRS (KOM, (2002), 259 final, p. 4). A limitation would result in competitive disadvantages of European entities towards companies, settled in those countries that are able to apply IAS without limitations. The modernization shall further minimize the risk that European firms have to set up two different financial statements, in case that foreign stock market supervision requires a financial statement that departs from the EU Directives (Simons, (2005), pp. 51).

Due to the disagreement and the critics, published by the European Central Bank and the Basel Committee of banking supervision, the European Commission decided to carve out the initial FVO. Although, the European Union decided to apply IAS, the commission agreed to leave out certain parts of IAS 39, like certain provisions on the use of Full FVO as well as certain provision, referring to the use of hedge accounting. They were considered as not suitable. The Commission does not take over the function as a standard setter. The exclusion of parts of IAS 39 was exceptional and only
temporary until the IASB published an adapted and improved version of the standard (Europa-Rapid-Press Releases, (2005), MEMO/05/246).

In order to overcome the obstacle, the IASB published a new and restructured draft. It considers the major arguments of the regulators. The European Financial Reporting Advisory Group (EFRAG) accepted the amendments and the FVO were affirmed by the European Commission on the 21st December 2005 (Commission Regulation (EC) No 2106/2005).

4.4 The Adapted Fair Value Option

4.4.1 The Category “At Fair Value through Profit and Loss”

The category “financial assets and financial liabilities at fair value through profit and loss” is subdivided into two groups. The first class comprises financial assets and liabilities that are designated to the denomination “held-for trading”. In the second category - the Fair Value Option - financial assets and liabilities can be designated at fair value, according to the regulations of IAS 39. Therefore, the category “at fair value through profit and loss” represents the FVO. The changes in value are recognized income statement-related (Erchinger et al, (2007), p. 543).

This category enables an appropriate accounting of hedging activities without fulfilling the strict hedge accounting regulations. In case that the assured underlying transaction is designated “at fair value through profit and loss”, it is valuated at fair value as well as the hedging instrument. Equilibrium in the profit and loss statement can be reached without the application of the “Fair Value-hedge” and the linked standards (Eckes et al, (2007), pp. 422). Nevertheless, other factors than the assured risk can influence the fair value of an underlying transaction. Even in case of a perfect hedging activities a 100 per cent match cannot be realized. This circumstance could be avoided by the application of rules of hedge accounting.
Financial assets do not correspond with the definition of loans and receivables. Those that include an embedded derivative or those that can be designated to the third category are allowed to be assigned to the class “at fair value through and loss”. Finally, financial assets or financial liabilities have to be valued optional or compulsory, according to IAS 39 or another standard at fair value (KPMG, (2006), p. 74).

The FVO should only be applied when the fair values of financial assets or financial liabilities are verifiable (Barock et al, (2004), p. 197). The term “verifiable” means that the differences between the estimated values for the fair value are low. The value is verifiable when the identification of the fair value bases on observable and present market transactions or whether a valuation technique is applied that reverts to parameters of financial markets. Those influencing values have to be controlled on a regularly basis and they have to be calibrated in the course of the “beck testing” process (IASB, Exposure Draft, (2004), p. 12; IAS 39 AG48B).

4.4.2 Modifications and Limitations

The amendment limits the FVO on its initial scope of applications, but simultaneously the IASB focuses to protect the major benefits and simplifications that are linked to the introduction of the option (IAS 39 BC10). The application of the FVO was modified on those situations when the designation of financial assets or financial liabilities at the valuation category “at fair value through profit and loss” results in “more relevant information” (IAS 39.9, IAS 39.AG4C-AG4K). Alternatively, the minimization of the complexity or the augmented reliability of the measurements represents further motives for justifying the relevance of the FVO (Ernst & Young, (2005), p. 5).

In order to concretize the limitations and after the final amendments of IAS 39, accepted by the Commission of the European Union, financial assets and liabilities can only be assigned to the category “at fair value through profit and loss” if one of the following three conditions is fulfilled (IAS 39.BC74).
1. The first criterion aims to avoid or significantly minimize an accounting mismatch “...it eliminates or significantly reduces a measurement or recognition inconsistency” (IAS 39(b)(i)). A mismatch may occur, due to variances in the valuation techniques of financial assets and liabilities or because of different capturing methods of the corresponding expenses and incomes (Erchinger et al, (2007), p. 543).

2. The management as well as the performance measurement of a portfolio comprising financial assets and liabilities represents the second alternative, in order to designate financial instruments at the category “at fair value through profit and loss”. The valuation is carried out on a fair value basis in compliance with a documented risk management or investment strategy. The involved information is provided for employees in key positions of an entity according to IAS 24, such as members of the management board or the supervisory board (PWC, (2006), p, 12).

3. In case a contract consists of a host contract and one or more embedded derivatives the whole hybrid instrument can be assigned as financial asset or liability to the category “at fair value through profit and loss”. Excluded are those contracts, whose embedded derivative results in a considerable modification of the cash flow of the contract (PWC, (2005), p. 1).

In addition, hybrid combined instruments should be designated to this category, when the contracts include embedded derivatives that are not able to be measured as stand-alone derivative (IAS 39.12). The FVO should be applied, in case that the fair value of a derivative is not definitely determinable. In addition, the option is used, if a derivative has to be valued separately as well as in case that the net realizable-value method is not applicable (IASB, Exposure Draft, (2004), p. 1).

Financial investments, for equity instruments for which an active quoted market price is not available and a reliable, fair value is not measurable or determinable are prohibited to be designated to the valuation category “at fair value through profit and loss”, according to the new and adapted regulations (IAS 39.9).
The decision to designate particular financial assets and financial liabilities at this category is comparable to an “accounting policy choice”, according to the IASB. In comparison to similar accounting transactions, the application of the FVO is not compulsory (IAS 39.AG4C). Furthermore, the exercise of the FVO for financial instruments is only integrative acceptable (IAS 39.BC86). A division of contracts into individual components for designation purposes can be eliminated (Ernst & Young, (2005), p. 6). In comparison to the regulated standards in the exposure draft, the limitations shifted from product or business based criteria to principle based criteria. Those standards and rules mainly refer to the scope of application of the FVO (Jerzembek et al, (2005), p. 227).

From my point of view, the modified and adapted FVO represents a major improvement in comparison to the initial FVO and its amendment in 2004. The major aspects of criticism that led to the adaptation of the option were the problem of a track record that proceeded reciprocal to the solvency, in combination with a lack of verifiability when calculating fair values. The effects on the financial statement on the basis of different accounting policies represented a further danger. Therefore, the adapted FVO may minimize or avoid recognition and measurement inconsistency and the coinciding, not justifiable volatility of equity capital. In addition hedge accounting is facilitated. Finally, the option contributes to a reduction of the separation of embedded derivatives (Küting et al (2006), p. 603). As already analyzed above, the adaptation still provides the benefits of the initial FVO, like the simplification of IAS 39 or the increased transparency for the investors. Simultaneously, it minimizes the possibility of manipulation or the inappropriate application of the FVO that have been a major point of concern, stated by the European Central Bank as well as by the Basel Committee on banking supervision.

4.4.3 Avoidance of Recognition and Measurement Inconsistency

A designation of financial assets or liabilities at the category “at fair value through profit and loss” is acceptable according to the first criterion, if with the designation
accounting mismatches can be avoided or reduced (IAS 39.BC75-BC75B). The designation to this denomination is irrecoverable and can only be exercised at initial recognition (Kurz, (2006), p. 44). The major reason for the existence of this kind of inconsistency in IAS 39 is the classification of financial instruments in the different categories “at fair value through profit and loss”, ”held for trading”, “held-to-maturity”, “loans and receivables”, “available for sale”, in combination with the strict and restrictive regulations for hedge accounting (Basel Committee, (2005), p. 4).

In case an entity disposes of liabilities, whose contractual cash flows are based on the performance of financial assets that would be in other respect classified as “available for sale”, effects on the profit and loss statement would be realized at different points of time. Examples are liabilities, containing a profit participation that rests upon realized or unrealized revenues from capital employed by a particular portfolio, including financial assets. In case the valuation pictures the current quoted market price, the application of the FVO for the financial assets would enable the entity to recognize the fair value changes of financial assets as well as liabilities income statement related in the same period (IAS 39.AG4E(a)). Consequently, variable recognitions of profits and losses could be eliminated (Löw et al, (2005), p. 1733), resulting in more relevant information. The same benefits can be reached in situations when a non-derivative financial asset is designated to the categories “held-to-maturity”, “loans and receivables” or “available-for-sale”. If this financial asset is hedged against a fair value risk by the application of a derivative this presents a financial liability. The relevance of information can be augmented, due to the fact that the illustration of hedging activities in the balance sheet is not written down, according to the restrictive regulations of hedge accounting in IAS 39 (Ernst & Young, (2005), p. 7).

In addition the FVO can be exercised, in case an entity has liabilities that are valuated according to IFRS 4.24. With reference to this approach, liabilities are newly priced in order to reflect the specialized interest rates of the financial market. Finally, the changes of the liabilities are recognized net income-related. In case the enterprise disposes of financial assets that are defined as corresponding and that are otherwise valuated according to the category “available-for-sale” or at amortized costs, incongruity, due to
the different valuation techniques can be reduced or eliminated by the valuation at fair value (IAS 39.AG4E (b)).

In the context of the practical application the question arises, which requirements and conditions coincide with the term “accounting mismatch”. From the viewpoint of the IASB, two major assumptions are in focus of the discussion (IAS 39.BC75). On the one hand, the accounting entity has to prove that it possesses financial assets and liabilities, whose valuation and designation result in the appearance of incongruity. On the other hand, the financial assets and liabilities have to be linked by an economic relationship (Eckes et al, (2007), pp. 418). With reference to the basis of conclusion, a perceived economic relationship exists when financial liabilities are exposed to the same risk as the financial asset. Therefore, the changes of the fair value are exhibited with the aim to offset the changes of financial assets and liabilities and the coinciding risk. The second purpose for defining an accounting mismatch occurs, when the entity holds the view that the financial asset is financed by a liability (IAS 39.BC75).

Recognition and measurement inconsistency can be caused by a variety of factors. The FVO simplifies the application of IAS 39, due to the fact that a number of anomalies, arising from variant valuation techniques and its consequences on single financial assets and liabilities, can be eliminated or minimized. The more relevant information can only be used if it contributes to the decision making process. This indicates that the gained data and statistics enable prognosis on the basis of former data or if they confirm previous assumptions or if necessary adjust them (IAS 39.BC75B).

From a practical point of view, all financial assets and liabilities, which may lead to the appearance of an accounting mismatch, do not have to be contracted “at exactly the same time” (PWC, (2005), pp. 3). If an enterprise or another financial institution possesses two or more financial assets that feature an economic relationship, but are characterized by different dates of maturity those financial assets and liabilities can also be valued by the FVO (Kurz, (2006), p. 45). An appropriate delay is accepted, if each transaction is designated “at fair value through profit and loss” at the point of purchase and if the “remaining transactions are expected to occur” (IAS 39.AG4F).
In contrast, the partly designation of only a selected number of financial assets and liabilities is prohibited, if a recognition and measurement inconsistency may occur at the category “at fair value through profit and loss”, in case this procedure does not reduce or eliminate an accounting mismatch. Consequently, this approach would not result in more relevant information. On the other hand, an only partly designation of financial assets or liabilities would be allowed if a recognition and measurement incongruity could be diminished significantly (Ernst & Young, (2005), p. 9).

If the FVO is applied, the total and complex financial instrument has to be valued at fair value and recognized in the profit and loss statement, including possible changes. It is forbidden to value only components of a financial instrument at fair value (IAS 39.AG4). For this reason, the application of the FVO does not present the same results as the use of fair value hedge accounting (Küting et al, (2006), p.605).

The FVO is applied in a practical context with the aim to protect fixed-interest items against fixed-interest risk. Volatility that arises, due to the compulsory income statement-related recognized changes of the fair values of derivatives in the profit and loss statement could be significantly minimized, without fulfilling the strict regulations of hedge accounting (Schmidt, (2005), p. 272).

The FVO cannot be exercised on a regular basis by industrial or commercial enterprises, pursuing the intention to ensure against exchange rate risk. The scope of application is limited on financial instruments. The option cannot be applied to hedge future revenues that are realized in foreign currencies. Future transactions that are not yet recognized in the balance sheet are not able to be valued at fair value. The FVO can only be exercised in order to hedge currency risks, if the underlying transactions are hedging instruments of the financial instrument (Kuhn, (2006), p. 111).

Nevertheless, the FVO cannot always avoid the existence of accounting mismatches. This is especially the case, when the underlying transaction cannot be identified as a financial asset. Nevertheless, this requirement has to be fulfilled, due to the fact that this
represents an imperative condition for the designation to the different valuation categories (Lōw et al, (2005), p. 1733).

4.4.4 Management on Fair Value Basis

A designation of financial assets or financial liabilities to the category “at fair value through profit and loss” is approvable with reference to the second criterion, if the categorized financial instruments are included in a portfolio. It enables entities to valuate all financial instruments that are concentrated in a portfolio as well as the implemented hedging instruments at fair value (Baetge et al, (2006), p. 130). In the course of the practical application, the restructured FVO can also be exercised as a compensation for a portfolio fair value hedge against changes of interest rates. A compulsory valuation at fair value coincides with the implementation of the option in this context (Basel Committee, (2005), p. 8).

Fair value management and performance measurement have to rely on fair value or total return basis with a documented risk management or investment strategy. The gathered information should be provided internally to employees in key positions (IAS 39.BC76). According to IAS 24.9, the term “entity's key management personnel“ comprises all employees that are directly or indirectly responsible for the planning, the leadership and the control of an entity’s performance and operation. Members of the supervisory board or the executive board are also included (Basel Committee, (2005), pp. 4)

Furthermore, a confirmation is necessary that the total portfolio is priced at fair value. An enterprise has to value each financial instrument of the portfolio on an individual basis at fair value. In case that a company does not apply the fair value approach for pricing the portfolio at fair value, but only for its risk management, the FVO is prohibited to be exercised (PWC, (2005), IFRS News Supplement). This condition indicates that all adequate financial assets and financial liabilities that are concentrated
and administrated in one portfolio should be valuated in common on a fair value basis (IAS 39.AG4J).

To apply the FVO, the documentation of the risk management or investment strategy has to be conducted in such a manner that external addressees of the balance sheet recognize that the exercise of the FVO coincides with the risk management of the entity (IAS 39.BC76A-BC76B). From the viewpoint of the IASB, this documentation does not have to be voluminous in the practical application. Furthermore, single items within a portfolio do not have to be documented individually, if the total portfolio is kept recorded (Kuhn, (2005), pp.1346).

4.4.5 Hybrid Instruments Containing Embedded Derivatives

In case that the embedded derivatives can be valuated separately from the host contract, they should be classified at “at fair value through profit and loss” (Erchinger et al, (2007), p. 546). The derivatives have to agree with a number of criteria.

1. Firstly, the traits of embedded derivatives and those of the host contract have to be economical independent, meaning that no close relationship exists.
2. A second criterion is that a single instrument with the same characteristics as the embedded derivatives would agree with the definition of a derivative.

The aim of this concept is to guarantee that entities do not avoid the application of FVA (PWC, (2005), p. 5). The standards of IAS 39 have to be applied, if the embedded derivatives have to be valuated separately from the host contract. In addition, the host contract has also to be measured according to the regulations, as long as it is a financial instrument.

Nevertheless, a complete hybrid instrument that includes one or more embedded derivatives can be designated as one whole financial instrument to the valuation category “at fair value through profit and loss”, if the embedded derivatives do not
contribute to a significant change of the cash flow of the whole hybrid instrument. This means that a hybrid combined instrument can be valuated as a whole financial instrument, if the embedded derivatives are closely related to the host contract (KPMG, (2004), p. 20). Consequently, the embedded derivatives would not have been valuated separately according to IAS 39.11 (IAS 39.11). In case the analysis of a similar structured hybrid instrument would clarify, that a separate accounting would be prohibited this instrument could not be categorized “at fair value through profit and loss” (IAS 39.9, IAS 39.BC77-BC78).

If a designation of all financial instruments would be feasible for all hybrid instruments, including embedded derivatives, this would question the remaining restrictions of the FVO, due to the fact that a large variety of financial instruments contain embedded derivatives. Otherwise this situation could be re-enacted by entities in order to profit from the application of the option (Baetge et al, (2006), p. 130). These conditions lead to the conclusion, that the existence of embedded derivatives, that have to be measured separately, allegorize an adequate assumption for the presence of a substantial embedded derivative. Therefore, the application of the FVO is allowed (IAS 39.BC78).

In case an entity concludes a contract on a hybrid instrument, that contains one or more embedded derivatives, the enterprise has to analyze whether the embedded derivative has to be measured and recognized separately from the host contract, according to the rules of IAS 39 (IAS 39.11). An obligation of a separate reporting procedure of embedded derivatives can result in the application of highly complex requirements. The valuation of the single components may be less reliable after the separation as if the entire hybrid instrument would be measured at fair value.

The analysis of hybrid instruments may lead to tremendous costs and expenses for entities that hold a variety of complex financial instruments, due to the implementation of IAS 39. Therefore, enterprises are allowed to categorize the whole hybrid instrument “at fair value through profit and loss”, if the entity is not able to measure the embedded derivatives individually, although the derivatives should be measured separately from the host contract (Eckes et al, (2006), pp. 419). A voluntary separation of embedded
derivatives from the host contract is not acceptable, according to the revised regulations (IAS 39.BC76B).

4.4.6 Amendments to IAS 32 Financial Instruments: Presentation

IAS 1 demands from enterprises to denounce all essential accounting and valuation methods, including the general expected principles, and the methods, that are applied at these events in the course of business. Due to the fact that the designation of financial assets and financial liabilities “at fair value through profit and loss” represents an accounting policy (IAS 39.AG4C), the exercise of the FVO is linked to the following analyzed disclosure requirements (IAS 32.66) concerning IAS 32.

The category “at fair value through profit and loss” comprises financial instruments, which belong to the group “held-for-trading” as well as those for which the FVO is applied. The designation of financial instruments to the group “at fair value through profit and loss” coincides with a variety of additional rules of publication of further data. Those new regulations indicate an adaptation of IAS 32 (Löw et al, (2005), p. 1736). In a next step, the rules for publications are integrated in the IFRS 7. This standard regulates the obligations for disclosure of financial instruments. Examples for the disclosure requirements are presented in the course of the empirical findings, in chapter 5.

IAS 1 obligates all entities to publish all essential reporting procedures and valuation methods. Therein, all assumed principles and the techniques that are applied to exercise those principles on transactions as well on other events and circumstances in the course of business of the entity should be included (IASB, (2005), p. 30). The decision to designate the special financial assets or financial liabilities at the category “at fair value through profit and loss” can be equated with the choice of the accounting policies, according to the IASB (IAS 39.AG4C). Therefore, the application of the FVO coincides with a variety of disclosures (IASB, (2005), p. 30, IAS 32.66).
The first standard for categorizing financial assets and financial liabilities “at fair value through profit and loss” states, that the entity should determine and publish the “criteria for designation” (IAS 32.66 (a)) in the context of the first implementation and initial recognition. The second rule, according to IAS 32 instructs to determine in which manner the enterprise fulfils the criteria for designation (IAS 39.9, IAS 39.11A). For financial instruments, that achieve the definition of IAS 39.9(b)(i) at initial recognition, meaning the designation of financial assets and liabilities at the category “at fair value through profit and loss”, the data has to contain a verbal description. This explanation should disclose an analysis how the designation of the financial asset and liabilities avoid the occurrence of measurement and recognition incongruity (IAS 32.66(d) (ii)).

For financial instruments, that also correspond to the criteria of IAS 39.9(b)(ii) and therefore, can be designated at this category “at fair value through profit and loss”, the specifications have to include an examination how the categorization can be in accord with the enterprise’s documented risk management or investment strategy (IAS 32.66(d)(ii)). Furthermore, the disclosure should determine the character of the financial assets and financial liabilities, that are grouped to the denomination “at fair value through profit and loss” (IAS 32.66 (d)(iii)).

In case an entity categorizes a financial instrument “at fair value through profit and loss”, the enterprise has to disclose the following data, intending separate carrying amounts for the subcategories “at fair value through profit and loss” and “held for trading” (Löw et al (2005), p. 1736). The company should figure out the carrying amounts for financial assets, that are classified as “held-for-trading” (IAS 32.94 (e)(i)). Collateral, the carrying amounts for the financial liabilities that are also classified at the category “held-for-trading” have to be included.

In addition, the carrying amounts of financial assets, that are classified “at fair value through profit and loss” at the point of initial recognition, have to be disclosed, meaning those financial assets that are not classified at “held-for-trading” (IAS 32.94(e)(iii)). In order to complete the overall picture, the amounts of the financial liabilities have also to be recognized upon the initial recognition that are assigned “at
"fair value through profit and loss" (IAS 32.94(e)(iv)). For financial instruments, that are categorized at this denomination an individual verification of net gains and net losses has to be established (IAS 32.94 (e)(iv)). The data can be either published in the balance sheet or in the notes.

For loans and receivables that are designated at this denomination, additional disclosures have to be accomplished considering changes in the financial risk (IAS 32.94(g)). The following components and aspects have to be disclosed by the reporting entity.

1. The maximum level of credit risk exposure of the loan or the receivable has to be determined at the reporting date (IAS 32.94(g)(i)).
2. The amount by which any linked credit derivative or comparable instrument minimizes the maximum of exposure to credit risk (IAS 32.94(g)(ii)) has to be examined.
3. An aspect, that should be disclosed, comprises the amount of changes that is referable to the current period as well as the cumulative change of the fair value of related credit derivatives or similar instruments (IAS 32.94(g)(iii)).

For financial liabilities, the changes of values that are dependent from the entity's solvency should also be announced. Therefore, the cumulative as well as the periodical amounts have to be investigated, that can be ascribed to changes of the exposure of credit risk of the liabilities (IAS 32.94(h)). For the determination two different methods are acceptable. An entity can apply a method which presents the amount of the fair value in a reliable manner. Alternatively, the enterprise has to calculate changes of the fair value that cannot be related to changes of market condition, such as prices or values from financial instruments offered by alternative entities (IAS 32.94(h)(i)). Finally, an entity has to publish all additional data for the methods, that have been applied in order to fulfill the requirement in IAS 32.94(g)(iii) and IAS 32.94(h)(i) (IAS 32.94,(i)).
4.4.7 Further Implications for Designating Financial Instruments

In case, that financial assets or liabilities that are designated to the category “at fair value through profit and loss” do not fulfill the requirements of the changed and innovated FVO, those financial instruments have to be designated and classified to another denomination. If a financial asset or a financial liability is valuated at amortized costs after the reclassification, this moment should be defined as the point of time of initial recognition. Financial instruments, that are already classified to another valuation category, are not allowed be designated at “fair value through profit and loss” (IAS 39.105B).

Equity instruments, whose fair value cannot be reliable measured and recognized according to the standards, due to the fact that a quoted market price cannot be determined in the active market are prohibited to be designated at the denomination “at fair value through profit and loss” (IAS 39.46(c), AG80-AG81, IAS 39.9).

4.4.8 Reclassification

In case, that a financial instrument is designated to the category “at fair value through profit and loss” this classification is irrecoverable and has to be exercised on an inception date. Due to this reason, a reclassification is not possible and prohibited (IAS 39.50). The principles and regulations for the designation of financial instruments are shown in the figure on the next page.

The figure exhibits that a reclassification of financial instruments is only allowed between the categories “held-to-maturity” and “available for sale”. Additionally, financial assets and liabilities can be shifted from “loans and receivables” to the denomination “available for sale”. This presentation illustrates the importance of the right denomination of financial instruments at initial recognition. In case of a wrong categorization, the entity is not able to benefit from the advantages, connected to the different categories.
4.5 Reflection of the Analysis of the Fair Value Option

Reviewing the first section of the practical analysis of the FVO, its major criteria and main aspects from the practical viewpoint are investigated. The first conclusion that can be drawn is, that the minimization of valuation asymmetries as well as the simplify exercise of hedge accounting represents the major targets of the FVO. Due to the increased number of critical voices, the major points of criticism and discussion are examined. Especially, the European Central Bank as well as the Basel Committee were concerned about an abuse of the unlimited FVO and the danger of increasing, instead of decreasing volatility.

Finally, the amended FVO is limited in its scope of application. The benefits of the application are analyzed in detailed in order to exhibit their influence on the financial statements. The reduction of accounting mismatches reflects one of the most attractive results of the application of the FVO. A second benefit that has to be taken into consideration is that the categorization of financial assets or liabilities to the denomination “at fair value through profit and loss” enables entities to measure financial instruments, that are accumulated in a portfolio or hedging instruments at fair value. Furthermore, hybrid instruments that contain one or more embedded derivatives
can be measured at fair value if the FVO is exercised and certain conditions are fulfilled. Consequently, entities are able to save costs and expenses and benefit from advantages of the FVO.
5 Empirical Findings

This section presents the findings of the empirical study. In order to provide a sample for the analysis of the application of the FVO in the financial sector, four different banking institutions, Dresdner Bank AG, Royal Bank of Scotland Group, Nordea and Crédit Mutuel, with home locations in different European countries are chosen. Those four banking institutions balance their financial statements according to IAS and IFRS, representing the harmonization pursuit by the European Union. Furthermore, all of them belong to the principal banks in their home locations, proving their importance for their home countries. Consequently, a number of different nations, covering a variety of European regions are presented in the empirical findings. In addition, the four banking organizations apply FVA and the FVO. All those aspects contribute to a successful analysis of those four banks. Paragraph 5.1 provides a short presentation and introduction of the four chosen financial organizations. The main business areas are figured out as well as the profit of the fiscal year 2007. Due to the fact that the annual report of 2007 is not available for Crédit Mutuel, the annual report and figures of 2006 are used. Chapter 5.2 investigates the similarities of the application of Full FVA and the FVO between the four banks. Part 5.3 examines the differences between the financial organizations when considering the FVO. Finally, 5.4, summarizes the most interesting aspects when considering the FVO in the practical application. The empirical findings represent interesting and meaningful aspects concerning the application the FVO and Full FVA. Nevertheless, due to the differences in size and profitability of the selected banks a general conclusion cannot be drawn.

5.1 Presentation of the Banking Institutions

Dresdner Bank AG: The Dresdner Bank AG, a part of the Allianz Group belongs to one of the five most important German banks (http://www.german-banks.org/html/10_news/List100-table-2006.asp). The Dresdner Bank AG functions as an integrated financial service provider, offering its customers single source banking in combination with insurance services. According to its business model, Dresdner Bank
AG serves financial requirements of private and business clients as well as multinational or institutional customers. Therefore, the banking institution offers services for private and corporate clients as well as investment banking under its roofs. The investment banking sector is subdivided into capital markets focusing on equities, bonds, interest rate, loans and global banking, providing classic corporate advisory services (Dresdner Bank AG, (2008), Fact Sheet). In 2007, Dresdner Bank AG realized a profit of € 410 million and the banking institutions accounted for total assets of € 500,209 million (Dresdner Bank AG, Annual Report 2007, p. 1).

**Royal Bank of Scotland Group:** The Royal Bank of Scotland Group (RBS) is an international acting major bank, located in Edinburgh. Concerning market capitalization, it is the biggest Scottish financial institution, the second largest in the United Kingdom, the third largest European bank and finally the eight biggest financial organization world wide (The Economist, (2006), Bank of America). The bank provides services for individuals, business and institutions. The RBS structures its services into five main operating divisions: global markets, regional markets, insurance, ABN AMRO and group manufacturing. In addition, the bank subdivides its business into personal finances, wealth management business and commercials as well as corporate and institutional services. This includes providing debt financing, risk management or investment services (http://www.rbs.com/about01.asp?id=ABOUT_US). In 2007, RBS generated a profit of £ 7,303 million (~ € 9,283 million, according to the exchange rate of 2008-05-06) and the total assets had a value of £ 1,909.519 million (~ € 2,415.8 million, according to the exchange rate of 2008-05-06) (Royal Bank of Scotland Group, (2007), Annual Report).

**Nordea:** Nordea is the leading financial services group in the Nordic and Baltic Sea areas. It arose from a merger of the Finnish Merit Bank, the Swedish Nordbanken, the Danish Unibank and the Norwegian Christiania Bank. The banking institution offers retail operations, corporate finance and insurances, in order to provide a complete range of financial services and products for a wide range of private individuals, companies, institutions as well as the public sector. The international operations offer payments, trade financing or custodial management (http://www.nordea.com/Corporate+)

**Crédit Mutuel:** Crédit Mutuel belongs to the biggest retailing banks in France. It plays a key role in financing the economy, by offering a complete variety of financial services to retail consumers, professionals and business of all sizes. Furthermore, the financial institution is the market leader in non-life insurances and the second largest retail bank in France in consumer credits as well as for associations. The international operations focus on financing, insurance and electronic payments. Crédit Mutuel aims to develop further within the European Market and the Euro zone. In 2006, the bank generated a profit of € 2,946 million and the total assets amounted to € 482,676 million (Crédit Mutuel, (2006), Annual Report).

5.2 **Similarities in the Application of the Fair Value Option**

5.2.1 **Measurement of the Fair Value**

In the course of the analysis a number of consensuses can be exhibited, referring to the application of the FVO by the chosen financial institutions. Due to the circumstance that the FVO represents a part of Full FVA, pursued by the IASB all four banking institutions follow the same concept when measuring the fair value of a financial instrument. The next section presents the definitions and explanations how the banks measure fair value.

**Dresdner Bank AG:** The Dresdner Bank AG recognizes its trading assets and liabilities as well as its financial instruments at fair value (Dresdner Bank AG, (2007), p. 169). Therefore, topical market prices are used, if an active market exists and if quoted market prices are available. If no active market exists, the prices are determined from the prices of comparable assets in combination with valuation models, especially the net present value or option pricing models. Yield and volatility curves are therefore applied. Thereby, consistent calculation and valuation adjustments have to be realized. Varieties
between the transaction price and the determined price, applying a valuation model that is not only based on observable market data do not directly influence the profit and loss statement (Dresdner Bank AG, (2007), pp. 76).

**Royal Bank of Scotland Group:** Fair values for financial instruments are determined according to current quoted market prices on an active market. If no active market for the financial instrument exits, reliable valuation techniques are applied that correspond with the requirements for pricing financial assets or financial liabilities. RBS applies a variety of valuation methods if a quoted market price or an active market does not exist. They include relative valuation methodologies, on the basis of observable prices for corresponding instruments or present value approaches, the Black-Scholes model, Monte Carlo simulation and binomial option pricing models. Major inputs are bond prices, credit spreads or interest rates (Royal Bank of Scotland Group, (2007), pp. 128).

Due to the continuous development of capital markets, the banking institution steadily adjusts its valuation techniques and methods. Furthermore, gains and losses that arise, due to the change of the fair value are captured in the income statement.

In case a trading portfolio consists of both financial assets and financial liabilities that are derivatives from the same underlying instrument, the fair value is measured by valuating the gross long and short positions at current bid market prices with an adjustment at portfolio level to the net open long or short positions on to amend the valuation to bid or offer as appropriate (Royal Bank of Scotland Group, (2007), p. 133).

**Nordea:** Nordea uses published priced quotation to determine the fair value. If quoted prices fail to represent actual and occurring prices fair values are established by applying appropriate valuation techniques. They range from simple discounted cash flows to complex option pricing models. The fair values for derivatives are calculated as the theoretical net present value of the individual contracts, based on independently based sourced market parameters. The calculations are supplemented by portfolio adjustments.
For financial instruments whose fair values are determined by valuation techniques it has to be examined whether the parameters used are fully based on data from observable markets. If those data does not seem to be reliable, the instruments cannot be valuated “at fair value through profit and loss”. Upfront gains are thereby deferred and amortized through the income statement over the contractual life of the contract (Nordea, (2007), p. 94).

**Crédit Mutuel:** Fair Values are determined by the quoted prices on an active market. Market data, such as yield curves are used. They are applied in order to calculate market price for derivative products. In case of a positive market value they are recognized as financial assets, in case of a negative fair value as a financial liability (Crédit Mutuel, (2006), p. 95)

The empirical findings figure out, that all four financial institutions apply similar valuation techniques for the measurement of fair values of financial instruments. All banks agree that quoted market prices from an active market represent the best alternative for the valuation at fair value. In addition, the examination exhibits that all financial institutions exercise appropriate valuation techniques, like net present value or discounted cash flows if no quoted market price from an active market is available. Therefore, all financial institutions act according to the fair value hierarchy (see Appendix 9.1). Furthermore, they base their calculation on a reliable basis, consisting of observable market data. Nevertheless, in the course of the investigation, the RBS presents the most elaborated measurement of the fair values of financial instruments. The group provides a large number of information for the investors how they calculate the fair values if market prices are not available. The bank is the only one that announces in a more detailed process which valuation techniques are exercised.
5.2.2 Financial Instruments Designated at Fair Value

Due to the large variety of financial instruments available and applied in capital markets, the most commonly financial instruments hold by the financial institutions are investigated in order to exhibit which are designated at fair value.

**Dresdner Bank AG:** The Dresdner Bank AG valuates their trading assets and liabilities, comprising debt as well as equity securities, derivatives and currency transactions at fair value. The same approach is applied for financial assets and financial liabilities. Financial assets, designated at fair value, comprise debt instruments, equities and other variable-rate securities as well as loans and advances to banks and customers (Dresdner Bank AG, (2007), p. 135). Financial liabilities, grouped at fair value, include liabilities to banks and customers, securitized liabilities as well as subordinated liabilities (Dresdner Bank AG, (2007), p. 143). In addition, derivatives and securities in held for trading portfolios also belong to financial instruments, measured at fair value (Dresdner Bank AG, (2007), p. 169).

**Royal Bank of Scotland Group:** Loans and advances, comprising reverse and repurchase agreements as well as syndicated loans present one type of financial instruments, valuated at fair value. Treasury and other eligible bills, like government treasury bills or banks bills as well as debt securities, issued by including government, municipal bodies, financial institutions or corporate bonds are measured at fair value. Listed or unlisted equity shares, deposits by banks or customers, short positions or debt securities in issue, such as medium term notes are additionally assigned to the application of the FVO. Derivatives, compromising swaps forwards, futures, options, traded on organized exchange or over the counter are also designated “at fair value through profit and loss” (Royal Bank of Scotland Group, (2007), p. 133).

**Nordea:** Nordea mainly designates treasury bills or other eligible bills at the category “net gains/losses on items at fair value”. As analyzed later, Nordea categorizes realized and unrealized gains and losses on financial instruments in this classification. Therefore, this category takes over the same task as the group “at fair value through profit and
loss”. Furthermore, interest-bearing securities, shares and derivatives represent further groups of financial assets and liabilities assigned at the FVO. Hybrid combined instruments as well as commodity instruments or derivatives also belong to this category. Finally, debt securities in issue, or so called issued mortgage bonds as well as mortgage loans or investment contracts reflect financial instruments, valuated at fair value (Nordea, (2007), p. 94).

**Crédit Mutuel**: This institution mainly applies the FVO on financial assets, such as securities, comprising government securities, bonds or other listed or unlisted fixed-income securities, as well as listed or unlisted shares and other variable yield securities. The second major group of financial assets is traded derivatives. Financial liabilities that coincide with the conditions of the FVO are debt securities, subordinated debts, due to credit institutions or due to customers (Crédit Mutuel, (2006), pp. 106).

The accounting principles, including the FVO, refer to assets and liabilities that also include inward and outward reinsurance as well as financial contracts that comprise a discretionary profit sharing clause. Therefore, financial assets that are reflecting technical provisions relating to contracts denominated in units of account are designated “at fair value through profit and loss” (Crédit Mutuel, (2006), p. 99).

This section shows that all financial institutions designate similar financial instruments, including mortgage loans, eligible bills or interest-bear securities, at fair value. Nevertheless, the annual reports of the banks do not always disclose the possibility to evaluate whether those financial instruments are also designated at the valuation category “at fair value through profit and loss”. Due to the fact, that each entity categorizes their financial instruments in a different manner, the empirical findings can only figure out which financial instruments are valuated at fair value. But this section emphasizes the importance of FVA in the banking sector. The four investigated banks pursue the intention to value as many financial instruments as possible at fair value. In addition this chapter also proves that this development is still in process, due to the fact that all banks apply the approach in different manners. Therefore, the findings confirm
the shift to FVA and the role of the FVO as accounting policies. This tendency will form the major point of discussion within the analysis conducted in section 6.

5.2.3 Reduction of Accounting Mismatches

As already analyzed in the first section of the practical analysis, the limited FVO shall contribute to the minimization of recognition and measurement inconsistency. The limitation of accounting mismatches represents one of three conditions that have to be fulfilled when applying the FVO.

**Dresdner Bank AG:** The Dresdner Bank AG applies the FVO in order to minimize accounting mismatches in the recognition and measurement of financial instruments. Structured transactions represent one example for such an inconsistency. Different valuation methods have to be applied if economic hedging instruments are recognized on the one side and further financial instrument on the other side of the balance sheet. In case of hybrid combined instruments the FVO enables a valuation of the total instruments. Therefore, this instrument does not have to be split up. Changes in the fair value are published in the net trading income. Traded related instruments affect the current interest income and expenses within the net trading income, whereas non-traded related instruments influence the net interest and the current income (Dresdner Bank AG, (2007), p. 115).

**Royal Bank of Scotland Group:** Policyholders, underpinning insurance and investment contracts issued by the Group’s life insurance are mostly designated “at fair value through profit and loss”. With reference to the overall aims of the FVO, this process contributes to a decrease of measurement inconsistency.

Major types of financial liabilities that reduce the accounting mismatches are structured liabilities that are published or issued by the entity. Furthermore, investment contracts issued by the RBS contribute to the minimization of the measurement inconsistency (Royal Bank of Scotland Group, (2007), pp. 128).
Only two of the four financial institutions fulfill this condition, meaning that they reduce their measurement inconsistency by exercising the FVO, namely the Dresdner Bank AG and the Royal Bank of Scotland Group. This section proves that the FVO is mainly used by large universal banks to avoid measurement and recognition inconsistency. Reasons for this situation may be that those large-scaled banks are more confronted with this phenomenon than smaller banks. Nevertheless, Nordea and Crédit Mutuel recognize the importance of FVA as shown in the previous section.

5.2.4 Hybrid Combined Instruments

**Dresdner Bank AG:** Combined or hybrid combined instruments are captured at the Dresdner Bank AG on the asset side as financial assets and are designated to the category “at fair value through profit and loss”.

Structured instruments on the liability side of the balance sheet are valuated as only one combined instrument, in case the economic criteria and the risk are closely related. If not, the host contract and the embedded derivative are measured separately, whereby the host contract is valuated according to amortized costs whereas the embedded derivative is categorized “at fair value through profit and loss” (Dresdner Bank AG, (2007), p. 120).

**Royal Bank of Scotland Group:** In case the embedded derivative is closely related with the host contract the whole instrument is recognized “at fair value through profit and loss”, if not the derivative is valuated at fair value. The changes in the fair value are recognized in the profit and loss statement, if the derivative is not a hedging instrument in a qualifying hedge (Royal Bank of Scotland Group, (2007), p. 130).

**Nordea:** Nordea treats hybrid combined instruments as only instrument as the embedded derivative is closely related to the host contract, as it is the case for index-linked bonds that are designated at fair value and whose changes are recognized in “net gains/losses on items at fair value” (Nordea, (2007), p. 95).
**Crédit Mutuel:** Certain composite financial instruments, whose separated measurement would not have been efficiently accurate, are valued as one individual instrument, without separating the host contract from the embedded derivative (Crédit Mutuel, (2006), p. 94). As analyzed, the FVO provides the opportunity to value this kind of financial instrument at fair value by designating the hybrid combined instrument “at fair value through profit and loss”.

All four banking institutions apply the FVO in order to value hybrid combined instruments as only one instrument. This indicates that all of them realize the third criterion that coincides with the application of this option. This emphasizes the importance and influence of the FVO on the valuation process of hybrid combined instruments, independent from the size of the banking institution. In addition, the empirical findings prove the results from the analysis of the FVO, due to the fact that in case that the embedded derivative has to be valued separately from the host contract, it has to be calculated at fair value by designating it “at fair value through profit and loss”. Furthermore, this section confirms again, the significance of FVA within the financial sector.

### 5.3 Differences in the Application of the Fair Value Option

#### 5.3.1 Information shown in the Financial Statements

Although all financial institutions do categorize financial assets and financial liabilities at the categorization “at fair value through profit and loss” and do apply the FVO, they publish the effects of the exercise in different ways in their financial statements.

**Dresdner Bank AG:** The Dresdner Bank AG is the only financial institution that gives voluntarily exact and detailed information about the gains or losses, realized by the application of the FVO. From the viewpoint of the IASB, the documentation of the application of the FVO does not have to be capacious. Simultaneously, single items do not have to be announced separately (Ernst & Young, (2005), p. 11). Therefore, the Dresdner Bank AG does it on a voluntarily basis. In order to provide the internal as well
as the external addressees a lucid picture of the net trading income this statement is subdivided. This breakdown also includes individual information that shows the gains or losses realized by the application of the FVO. Incidentally, the FVO is included in the balance sheet items “financial assets or financial liabilities designated at fair value” (Dresdner Bank AG, (2007), p. 127), (see Appendix 9.2).

**Royal Bank of Scotland Group:** Financial assets as well as financial liabilities, categorized “at fair value through profit and loss” are captured at fair value. The banking institution is the only financial organization that provides information on the calculation of fair values of financial instruments. The financial statement distinguishes between fair values determined according to quoted market prices or based on valuation techniques. This statement shows that in case of RBS the fair value of no financial asset is measured according to quoted market prices (see Appendix 9.3). The transaction costs are published in the profit and loss statement and subsequently valuated at fair value. Profits and losses on financial assets are captured in the profit and loss statement, according to the period they occur in the profit and loss statement (Royal Bank of Scotland Group, (2007), p. 128). In addition, gains on financial assets and liabilities categorized “at fair value through profit and loss” are included in the income statement, but they are not recognized in a single position (Royal Bank of Scotland Group, (2007), p. 146).

**Nordea:** Financial assets and liabilities classified “at fair value through profit and loss” as well as derivate instruments are recorded on the balance sheet with changes in fair value recognized in “net gains/losses on items at fair value”. Therefore all interest incomes and interest expenses, related to the financial instruments are presented on the same statement income line as revaluation effects from financial instruments at fair value “net gains/losses on items at fair value”, instead of being reported within “net interest income” (see Appendix 9.4). The application of the FVO mainly influences the balance sheet item “debt securities in issue” (Nordea, (2007), p. 92).

**Crédit Mutuel:** Financial instruments categorized “at fair value through profit and loss” are captured in the balance sheet at fair value. Changes in the fair value or
changes in the revenue realized or accrued on fixed-income securities, that are grouped “at fair value through profit and loss” are published as “net gains or losses on financial instruments at fair value through profit and loss” in the income statement. In the balance sheet, the item “at fair value through profit and loss” is applied and published. The separate presentation of the positions leads to an increased transparency of the financial statements (see Appendix 9.5). Purchases and sales have to be captured on the settlement date and the differences between the transaction and the settlement date influence profit and loss (Crédit Mutuel, (2006), p. 95).

This part figures out that all four financial institutions publish their information shown in the financial statement, concerning the application of the FVO and its effects in different ways. Whereas only one institution implements the category “at fair value through profit and loss”, the other banking organizations designate this denomination under one large balance sheet item, like Dresdner Bank AG “financial assets/liabilities designated at fair value”. This is possible, due to the fact that no regulations concerning the disclosure of the FVO exist. Therefore, the results and consequences of the exercise of the FVO are not recognizable on the first view, because they are published in different balance sheet items when comparing the financial institutions. But all four investigated banking organizations dispose of a single balance sheet item where they can publish changes in the fair value of their financial instruments.

5.3.2 Intention of the Application of the Fair Value Option

**Dresdner Bank AG:** The Dresdner Bank AG exercises the FVO in order to minimize the effects of IAS 39. This indicates that the most concerned items in the banking book are balanced by the appropriate changes in the fair value of hedging derivatives. Furthermore, the banking institutions target to reduce the complexity of its financial statement, facilitating the comprehension process for the addressees (Dresdner Bank AG, (2007), p. 115).
**Royal Bank of Scotland Group:** The major intention of the Royal Bank of Scotland Group is to reduce accounting mismatches and the measurement inconsistency when applying the FVO (Royal Bank of Scotland Group, (2007), p. 128).

**Nordea:** The application of the FVO is made to align the presentation of the operations of the financial instruments, exercised by the bank. In addition, transparency shall be further increased. Nevertheless, the effects on the group’s income statement are not material. The application does not change the presentation in the reported balance sheet (Nordea, (2007), p. 89).

**Crédit Mutuel:** The banking organization valuates certain liabilities at fair value, issued by the entity, which are not comprised in a trading portfolio. In addition, the FVO is exercised in order to facilitate the valuation of the insurance activities of the financial organization (Crédit Mutuel, (2006), p. 93)

The empirical findings exhibit, that next to the general aspects, like the reduction of accounting mismatches or the valuation of hybrid financial instruments each individual banking institutions pursues different targets with the application of the FVO. This underlines the wide scope of application of the FVO and its acceptance by the banking institutions.

### 5.4 Particularities - Documented Risk Management

As investigated in section 4.4.4 “Management on Fair Value Basis” the fair value measurement has to rely on a reliable risk management or an investment strategy. This kind of documentation has to be organized and published in such a manner that external addressees of the balance sheet recognize that the exercise of the FVO coincides with the risk management of the entity (IAS 39.BC76A-BC76B). In the following, the different approaches for an appropriate risk documentation and investment strategy are figured out.
Dresdner Bank AG: To deal with the great variety of different types of risk within the financial sector, Dresdner Bank AG acts, according to its risk management principles in order to identify risk early by applying effective tools. Therefore, the banking institution uses a risk management cycle, which identifies analyses and monitors the different types of risks. Regular analyses of the portfolios are conducted. The results as well as the recommended actions are directly communicated to the senior management in a full and comprehensive manner (Dresdner Bank AG, (2007), pp. 23). This process can be defined as the fulfillment of the second criterion of the FVO, the Management on the Fair Value Basis according to IAS 39BC76.

Royal Bank of Scotland Group: The RBS disposes of an appropriate risk management system with the aim to monitor changes in the fair values of trading and treasury portfolios. The banking organization applies a number of different valuation techniques, such as the Value at Risk (VaR) that calculates potential negative changes in the fair value of portfolio. Banking institutions are able to determine a quantitative measure in the trading book under normal market risks. Therefore, an estimation of potential future losses is conducted, which is not exceeded in the course of a predefined period and with a special confidence level. This approach enables to apply a constant and consistent measure for all trading activities and products (Schmidt, (2006), pp. 51). The results are proven by daily back testing in order to compare the results of the calculation and the current profit and loss realized in trading operations. These measurements are conducted by the group audit committee and the group executive management committee. These two committees are responsible for risk exposure. Risk management and capital adequacy are closely related. The determined outcomes are directly communicated to managers in key positions, such as the board of directors in order to provide them with a clear picture of the overall situation of the banking organization. This process can also been seen as management on a fair value basis (Royal Bank of Scotland Group, (2007), pp. 70).

Nordea: In order to guarantee a close control of its exposure to market risk, Nordea applies a strict reporting and control system. The overall target is to increase transparency in all elements of the risk management and documentation with the
intention to supervise the determination of the fair value of portfolios. Therefore, Nordea valuates its traded financial instruments by examining and documenting the instruments’ characteristics and risk factors, in combination with business intelligence IT systems to monitor possible changes and movements. Similar to the RBS, Nordea uses tools, like the VaR to measure market risk. The monitored data is reported on a regular basis to the group executive management as well as to the board of directors. The board of directors in each entity obtains a testimony that gives detailed information about market, credit or liquidity risk, including a variety of portfolio analysis (Nordea, (2007), pp.61).

**Crédit Mutuel:** The risk documentation and management is based on regular reporting to the different committees and to the board of directors to monitor market activities as well as main risk indicators. To provide a clear picture of the market risk and the changes of the fair value, the banking institution determines the capital adequacy requirements in combination with the analysis of the VaR. Finally, stress scenarios aim to calculate potential losses and gains. Therefore, Crédit Mutuel, communicates its risk documentation according to the FVO to its managers in key positions (Crédit Mutuel, (2006), p. 72).

Concerning the appropriate risk management systems all four financial institutions manage the challenge to establish those systems that enable a continuous and reliable presentation of the fair value of portfolios. In all cases, the collected data and information are transmitted and communicated to managers in key positions. Furthermore, similar measurement approaches, like the VaR are applied in order to measure the risk exposure. Therefore, all banks recognize the necessity of an efficient working risk management system in order to minimize the exposure to risk.

### 5.5 Reflection of the Empirical Findings

Reviewing the empirical findings, all four investigated banking organizations do apply the FVO in the context of FVA. A large number of agreements can be presented when
summarizing the findings, for example in case of the measurement of the fair value or the financial instruments designated at fair value. Major differences only occur in case of the presentation of the changes of the fair value, meaning that the changes are reported in different manners or in variant balance sheet items, by the variant financial institutions. A further interesting result is that only the two largest banks Dresdner Bank AG and the Royal Bank of Scotland Group make use from a reduction of accounting mismatches due to the application of the FVO.

All in all, the empirical findings prove the importance of the FVO and the FVA for the banking sector. Therefore, the analysis of the findings does not only concentrate on the FVO but also on Full FVA. The importance of this approach is emphasized when considering the current financial crisis. FVA is blamed to be one reason.
6 Analysis of the Empirical Findings and the Fair Value Option

This section aims to analyze the empirical findings and set them in a theoretical context. Therefore, the main results of the empirical findings are linked to the theory in order to investigate possible effects and outcomes of the application of Full FVA and the FVO. The FVO represents one important aspect on the way to Full FVA. In order to ensure a complete and overall picture of the situation not only the FVO forms the body of the analysis, but also FVA. The first section, 6.1 briefly analyzes the reasons for the harmonization of the European Union. Afterwards, the historical cost accounting is compared to Full FVA in 6.2. In the course of this paragraph the pros and cons of the two approaches are investigated. Special focus lies on the examination of the FVO and its effects on the banking sector, shown on the four banking institutions from the empirical findings in section 6.3. The particularities identified in 5.3 are settled in a theoretical framework in 6.4. Chapter 6.5 analyzes the benefits and the challenges, referring to the application of Full FVA and the FVO for external addressees.

6.1 Harmonization of the European Union by Applying IAS and IFRS

One conclusion that can be drawn from the empirical findings is that all chosen banking institutions account their balance sheets according to IAS and IFRS. In addition, all banks are settled within the European Union. Therefore, one interesting point is how the European Union and the newly implemented directives No. 4 and No. 7 influence the accounting procedures of Dresdner Bank AG, RSB, Nordea and Crédit Mutuel.

The European Union targets an augmented degree of harmonization resulting in an integrated single market. Since 2005 European listed enterprises are obligated to publish their financial statements, especially their consolidated accounts according to IAS and IFRS. Therefore, a consistent framework of financial reporting standards is required (Dewing et al., (2008), pp. 243). Major motives for this policy are the introduction of the Euro as well as the internationalization of financial markets, leading to an increased efficiency of global capital markets (McKeen-Edwards et al, (2004), p. 337). The
incorporation of the single or individual markets into one common market results in an improved and facilitated comparison between different institutions and organizations from variant European countries. An increased comparability can be confirmed by the empirical study. On the basis of the harmonized regulations the key figures are more easily to comprehend. In addition, the investment atmosphere of the analyzed banks is advanced, due to an increased reliability of the financial statements since the harmonization of the accounting regulations (Bittermann et al., (2004), p. 263). The application of individual GAAPs according to national law contributes to a lower degree of comparability. Investors are less willing to invest abroad, due to the fact that it is more complex and the exposure to risk is higher. Therefore, the conclusion can be drawn that the advantages of the implementation of IFRS prevail the critics. Dresdner Bank AG, RBS, Nordea as well as Crédit Mutuel are able to profit from the increased comparability by augmenting their competitiveness and by attracting more international investors.

6.2 Historical Cost Accounting vs. Full Fair Value Accounting

6.2.1 Historical Cost Accounting

A second interesting finding, resulted form the investigation of the financial statements confirms that the financial institutions exercise financial instruments, that belong to the banks’ core business or risk management strategies, comprising held-to-maturity securities, loans, deposits or other types of financial liabilities and different types of derivatives. According to historical cost accounting the present income-measurement of them does not include unrealized fair value gains or losses on those financial instruments (Hodder, (2006), p. 336). But they represent major items within the balance sheet of Dresdner Bank AG, RSB, Nordea and Crédit Mutuel. Consequently, their measurement, valuation and recognition can significantly influence the performance as well as the financial situation of the banking organizations. Therefore, the question arises whether historical cost accounting still presents an appropriate accounting procedure for the four financial organizations.
Historical cost accounting contributes to the distortion of the “economic reality” due to the possibility that managers are able to manipulate profits, by under-reporting assets, leading to a misinterpretation of resources (Ball, (2004), pp. 20). Variances in the accounting procedure of loans increase the difficulty to interpret and analyze banks’ financial accounts. Therefore, historical cost accounting can be defined as a “mechanical process” based on the knowledge of production costs and durations (Anagnostopoulos et al, (2005), pp. 111).

An advantage of historical cost accounting is the long-term orientation. This approach represents the economic basis of the bank transactions, considering the current cash flows as well as the earning processes (Ebling, (2001), p. 23).

Historical cost accounting indicates that gains, realized by financial instruments, are not reported in the period when they arise but in other periods. Furthermore, assets, basing on financial instruments, that are purchased at nil costs are not captured in the financial statements. Additionally, the accounts do not announce the risk management activities of the entities in an appropriate manner. Yet, a further disadvantage is, that losses are recognized before they occur, resulting in an asymmetry in the valuation of gains and losses. The complication of financial accounts, resulting in a decrease of transparency represents major outcomes of the application of historical cost accounting. The complexity of the financial statements can additionally be augmented by the exercise of special accounting techniques, like hedge accounting, exercised with the aim to limit the degree of asymmetry (Ebling, (2001), p.22).

This analysis shows that a large number of disadvantages are connected with the application of historical cost accounting. Due to this fact, the question has to be asked whether another approach exists that eliminates or minimizes the effects of historical cost accounting.
6.2.2 Full Fair Value Accounting

The most important outcome of the empirical study is that Dresdner Bank AG, RBS, Nordea and Crédit Mutuel are tending to shift from historical cost accounting towards Full FVA. Although, all four financial institutions follow the same approach, this aspect has to be further analyzed, due to the fact that Full FVA is a highly discussed approach in the current business environment. The discussion, concerning the benefits and risk of FVA, even has increased since the current financial crisis. The fact that major financial institutions, such as the “Deutsche Bank” or the chairman of the association of German banks blame FVA to be a major reason for the crisis in the banking sector even augments the importance of this topic. Therefore, the major advantages and disadvantages have to be taken into consideration, when investigating this topic and the effects on the banking institutions.

In 2005, the IASB published an amendment concerning the FVO of IAS 39. This approach provides entities the possibility to exercise Full FVA for financial instruments and liabilities (Anagnostopoulos et al, (2007), p. 361). The balance sheets of commercial banks and other financial institutions comprise mostly financial instruments (Hodder et al, (2006), p. 338). Especially, derivatives have experienced a significant augmentation, due to the development towards FVA (Gebhardt et al, (2004), p. 341). This is also shown in the financial statements of Dresdner Bank AG, RSB, Nordea and Crédit Mutuel. In the course of the last decade, banks’ financial accounts have shifted from historical cost accounting towards a mixed measurement model in combination with a market value approach. This process represents the development of the financial sector in the dynamic of economic cycles (Wall et al, (2000), pp.2). The FVA shall contribute to increase transparency or comparability between different banking institutions as well as to improve the consistency in financial accounts in order to fulfill the demands and requirements of the investors. This coincides with the first conclusion that can be drawn from the empirical findings, supporting the idea of harmonized accounting regulations. According, to the empirical findings, the main challenge, referring to the exercise and choice of the appropriate accounting policy for financial
institutions, deal with the topic of balancing, measuring and recognizing gains and losses of assets and liabilities (Anagnostopoulos et al, (2005), pp. 109).

Full FVA represents a future oriented approach, due to the fact that assets have to be revaluated (Anagnostopoulos et al, (2007), p. 371). But this approach does not differentiate between the different types of risk, e.g. interest rate risk, exchange rate risks, but they are included in the calculation of the fair value. Changes in interest rates or in risks influence the fair value of an asset (European Central Bank, (2006), p. 24).

In case all financial instruments would be valuated at fair value, no motive would exist to eliminate internal operations. The only effect in the presentation of the application of internal transactions would indicate that through the risk transfer between the banking and the trading book, result components would be shifted also between the results of those two books (Schmidt (2007), p. 269). The Full FVA model may enable the appropriate reflection of the economic situation of the banking operations. This is confirmed by the findings of the empirical study. FVA completely represents the results of the risk-management operations of a bank (Hodder et al, (2006), p. 336). The major innovation is that assets and liabilities in the trading and in the banking book should be valuated at fair value. Consequently, all changes in the fair value of all financial instruments directly effect and be captured in the financial income statement. This provides the opportunity to fully capture embedded losses or gains in the financial accounts (Anagnostopoulos et al, (2007), pp. 365). This leads again to an improved recognition and presentation of the financial situation of the investigated banks. The valuation of financial instruments at fair value represents the present value of expected cash flows realized in the future, discounted with reference to the present market rate of return. This procedure comprises the involvement as well as consideration of external risk factors (Anagnostopoulos et al, (2005), p. 117).

Nevertheless Full FVA represents one major disadvantage. As already analyzed, IAS 39 aims to valuate financial assets and liabilities at fair value with reference to the quoted market price in an active market. Due to the circumstance that market prices fluctuate, the values of assets and liabilities underlie also those fluctuations (Post et al, (2007), p.
This danger is also recognized by the Royal Bank of Scotland Group in their annual report 2007 as well as the Dresdner Bank AG. Those price fluctuations represent a major market risk (Dresdner Bank AG, (2007), p. 84), resulting in an increased profit volatility. This volatility may be further increased, due to the independency of interest rate and market prices. Because market prices as well as interest rates are facing fluctuations, these amounts will directly influence the volatility of the banks’ short-term profit. This can be seen as a source of instability. In addition, in case financial institutions valuate their assets and liabilities at fair value, the assessment of the fair value of mortgages seems to be more difficult, due to the fact that even though two mortgages are contractual equal, they exhibit total different economic features and interpretations. Consequently, the same fair value would be recognized for two totally different economic liabilities (Anagnostopoulos et al, (2005), p. 122).

All four investigated banks, Dresdner Bank AG, Royal Bank of Scotland Group, Nordea as well as Crédit Mutuel show mortgages as one item that influences their balance sheets. This supports the importance of this kind of financial instrument within the banking sector. Therefore, the theoretical approach that FVA leads to increased volatility is even from a greater concern, because all types of banking institutions are influenced and exposed to that risk. In addition, the volatility of equity may also increase, due to the fact that assets and liabilities are now directly influenced by market prices and the linked fluctuations. The difference in the duration from assets and liabilities results in equity volatility (Post et al, (2007), p. 251). Debt securities react sensitive to changes in market interest rate. This also contributes to an augmented volatility in earnings, due to the fact that the securities underlie fluctuation (Papiernik et al, (2005), p. 20). Assets, like mortgage loans or residual beneficial interest in loans, recognized in the trading book are highly sensitive to market developments and therefore tend to increase a company’s financial statement to income volatility (Kang Cheng, (2006), p. 39). The increased income volatility is also confirmed by a study conducted by Hodder, Hopkins and Wahlen, maintaining that a positive correlation can be drawn between the augmented volatility and market risk factors, in combination with disclosed measures of market risk (Hodder et al, (2006), p. 339).
The augmentation in volatility contributes and represents the current topic of the banking crisis under which all four investigated banking institution are suffering. Therefore, it has to be examined whether a connection exists between the crisis and FVA. This emphasizes the significance of the topic. According to Klaus Peter Müller, chairman of the association of German banks FVA is responsible for the crisis within the financial sector. The accounting procedure, according to IFRS seems to be pro-cyclical and intensify the overall situation. The continuous remeasurement of fair values represents the consequences of the current market developments. These processes have to be traced in the financial statements by banks such as the Dresdner Bank AG (Deutsche Börsen Zeitung, (2008); p. 4). Günther Ackermann, chairman of the largest German bank “Deutsche Bank”, also blames the newly introduced FVA for the financial crisis in the German banking sector. The regulation obligates financial institutions to balance financial assets at fair value, according to a predefined deadline in the course of the current quarter. Due to the fact, that chancy products are not currently treated because of a lack in demand, banks have to amortize them, although they do not mandatory result in losses (Wirtschaftswoche; (9th April 2008), Banken wollen Finanzkrise selber lösen). Additionally, Charly McCreevy, responsible for the European single market also opines that FVA may worsen the current financial crisis. In accordance with Klaus Peter Müller, McCreevy also makes the pro-cyclical dimension, within the balance sheet, responsible for the financial crisis (Frühauf, (2008), pp.1). In case of the application of FVA, funds have to be valuated at fair value that cannot be stated as beneficial with reference to the financial crisis. In order to overcome the crises he suggests implementing an analysis of existing regulation concerning balance sheet accounting and anomalies (http://www.finanzen.net/nachricht/McCreevy__Fair_Value_koennte_Finanzkrise_verschlimmert_haben_701401).

As a reaction on the crisis in the financial sector, the IASB plans to implement a disclosure, obligating the banking institutions to publish off-balance sheet interest in a more strict and detailed form. Furthermore, the IASB targets to compel financial organizations to announce detailed information concerning assets, that are not listed in the main financial statement, like mortgages or securitized assets. The IASB engages in the discussion, referring to the calculation of fair value of financial instruments, in case
of illiquid markets. Those approaches indicate that the IASB recognizes the necessity to adapt the current FVA approach (Hughes, (2008), p. 19).

A variety of critical aspects, as the increased volatility or the pro-cyclical presentation of the balance sheet, can be connected to the application of FVA in the banking sector. A further disadvantage is the short-term orientation. But in order to valuate the transactions in the banking book long-terms observations are necessary, in order provide a lucid picture of the financial situation. In addition, the financial instruments are exposed to the effects of changes in interest rates (Eberling, (2001), p. 24). A final problem that coincides with the application of the FVA is the determination of the fair value. As confirmed in the course of the empirical findings, quoted market prices from active markets represent the best fair value. But active markets are not always available for all kind of financial instruments. For example, the RBS figures out in its financial statements that none of the financial assets designated “at fair value through profit and loss” is measured according to quoted market prices (Royal Bank of Scotland Group, (2007), p. 128). Therefore, the question occurs how reliable fair values are, that are determined on the basis of market data with the support of valuation techniques. As the empirical findings figure out, all four financial institutions apply similar valuation techniques in order to determine the fair value of financial instruments when no active market price is available.

But, the advantages have to be considered, too. One of the major advantages is the increased transparency of the financial statements that coincides with the application of FVA and the FVO (Post et al, (2007), p. 254). Especially, the lucidity and visibility of derivative financial instruments augment significantly (Ahmed et al, (2006), p. 585). This phenomenon can be confirmed by the analysis of the financial statements of the, investigated financial institutions in the empirical findings. The statements can be more easily compared and examined.

In order to apply FVA a number of assessments are necessary to develop financial statements on the basis of fair values. This may indicate that the comparability of the results of the accounts may decline between different time periods or between different
enterprises or banking institutions (Perry et al, (2006), p. 565). The reduced comparability can also be exhibited by the circumstance, that all analyzed financial institutions show their information in their financial statements in different manners. As shown in the appendix, the FVO and the designation of financial instruments “at fair value through profit and loss” are recognized in different balance sheet items. This situation complicates the comparability of the financial accounts and may narrow the information for the addressees. Nevertheless, FVA provides increased decision relevance. A financial statement, consisting of assets and liabilities that are measured and recognized at fair value represent the equity capital as residual number at its fair value. The equity capital represents the company value, as a cash value of future cash flows (Ballwiesinger et al, (2004), pp. 61).

6.2.3 Critical Appraisal of FVA

The analysis of the two approaches and the implementation in a practical context exhibits the benefits and disadvantages of the different methods. The analysis contributes to the empirical findings, evaluating and investigating the benefits and risks of FVA. The examination confirms the results of the empirical study and emphasizes the importance and its potential for conflicts.

Nevertheless, the analysis also proves that Full FVA provides a variety of improvements and advancements that could not be offered by historical cost accounting, such as the augmented transparency of the financial statements and the augmented comparability or the increased scope of discretion for the banking institutions. But the disadvantages that coincide with FVA have to be taken into consideration, due to the fact that they can influence and effect the financial situation of banking institutions, as it happens in case of the financial crisis in the German banking sector. This example shows that the application of FVA may result in tremendous difficulties for financial institutions due to increased volatility and the pro-cyclical presentation within the balance sheet.
From my point of view, FVA represents a favorable approach within the IFRS. It aims to increase transparency within the financial statements of the banking institutions that may lead to a simplified understanding. Furthermore, this approach contributes to a clearer presentation of the financial situation of the banks, because changes in the fair value are captured directly in the income statement and not delayed. Nevertheless, the real business environment shows that the approach has to be further improved and shaped in order to avoid the occurrence of such financial crisis as described and analyzed above.

6.3 The Fair Value Option

A further outcome of the investigation of the financial annual reports is that the avoidance of measurement and recognition inconsistency represents one major motive for the application of the FVO. Nevertheless, the findings also exhibit that only the two largest banks Dresdner Bank AG as well as RSB confirm this aspect as a significant reason for the exercise of the option. Therefore, the analysis will discuss how those accounting mismatches can arise in case of Dresdner Bank AG and RSB and how they deal with this challenge. With reference to this phenomenon, the empirical findings also prove that Nordea and Crédit Mutuel do apply the FVO in order to reduce accounting mismatches only in a limited manner. Causes therefore are investigated as well. Another aspect, that has to be considered, is the functionality of the FVO in order to shape annual reports. All four banks aim to present predictable figures for their annual reports in order to plan future periods and investments. Therefore, the question has to be taken into consideration how far the FVO can be used as an instrument to shape the annual report. This aspect seems to be very interesting, due to the circumstance, that the fair values of financial instruments underlie a random walk like quoted market prices.

With reference to the empirical findings, one major aim of the FVO is to reduce and limit accounting mismatches (Royal Bank of Scotland Group, (2007), pp. 128; Dresdner Bank AG, (2007), p. 115). The major reason for the accounting mismatch is the circumstance, that no compensation concerning the financial instruments in the bank
book takes place. The mixed accounting approach supports the approach of banking institutions to use a whole book approach when supervising capital and market risk, instead of treating their banking books and trading books separately. Until now, instruments with trading purposes are recognized at fair value, whereas instruments held-to-maturity, like loans are valued at amortized costs, resulting in an augmented accounting mismatch (Jackson et al, (2000), pp. 108). The FVO provides banks the possibility to avoid the valuation at fair value on the one hand and amortized costs on the other hand.

These measurement inconsistencies occur, because derivatives and financial instrument should be valuated at fair value. Changes are immediately reported in the net income, whereas changes of derivative instruments exercised for hedging activities are captured in other comprehensive income. These accounting regulations contribute to accounting mismatches, due to the fact that bank book assets and liabilities as well as the linked derivative instruments are valuated and recognized according to different accounting approaches. The values of derivatives are calculated at fair value and changes directly influence income originated loans or non-trading liabilities. Consequently, the effect on interest rates is recognized in net income over time. The Royal Bank of Scotland Group, for example adjusts its interest income and expenses, in order to capture interest in financial assets and liabilities, categorized “at fair value through profit and loss”. Additionally, linked interest-earning assets and interest-bearing liabilities are also adapted (Royal Bank of Scotland Group, (2007), p. 39).

For inefficiencies in “natural hedges” in the banking book, concerning different balance sheet positions, measured at historical cost, banking book assets or liabilities are not shown in the earnings in the current period, but only in the remaining duration of the instrument (Gebhardt et al, (2004), pp. 359). In case of an application of the new standards, this mismatch can be avoided, because the market values of the financial instruments are recognized (Anagnostopoulos et al, (2005), p. 110). Furthermore, banks can avoid measurement inconsistency by matching fixed-rate financial assets with fixed-rate financial liabilities (Hirst et al, (2004), p. 454). This procedure can be also
recognized in the balance sheet of the Royal Bank of Scotland Group and Dresdner Bank AG.

As the empirical findings show, Nordea as well as Crédit Mutuel do not state the avoidance of accounting mismatches as major motive for the exercise of the FVO. This can be, due to circumstance that universal banks, like Dresdner Bank AG or RBS are more confronted with measurement and recognition incongruity, because they trade larger amount of derivatives and financial instrumented, valuated at fair value in comparison to smaller banks, such as Nordea or Crédit Mutuel. Due to the larger amount, the measurement and recognition incongruity increases. In addition, Crédit Mutuel focuses on the application of the FVO in order to simplify the valuation of insurance activities. Furthermore, large-scaled financial institutions are more involved in hedge accounting activities than national banking organizations. Yet another fact, that has to be taken into consideration, is that Nordea as well as Crédit Mutuel are less involved in hedging activities through derivative instruments. Therefore, they are less exposed to accounting mismatches due to the fact that those derivative instruments used for hedging purposes are recognized in different income statements than financial instruments designated at fair value.

The FVO enables banks to avoid problems, connected with hedge accounting by designating special financial instruments at fair value. All four investigated banks apply the FVO in order to benefit from Full FVA. Therefore, all of them fulfill one of three criteria that are linked to the application of the FVO. As figured out in the empirical findings all banks use the option, in case an embedded derivative can be identified or in order to reduce accounting mismatches. Furthermore, all banks provide risk documentations that agree with the second condition, settled in the FVO, meaning that important information, concerning the performance measurement of portfolios are communicated to managers in key positions. Simultaneously, this approach provides financial institutions with the possibility to shift fractionally from historical cost accounting to Full FVA. The FVO can be seen as a compromise, due to the fact that the option is no renunciation of the mixed model. Banks can decide on their own whether they designate certain financial instruments at fair value or not. The FVO shall be
exercised if financial instruments could not be adequately recognized in the financial statements due to their involvement in hedge accounting activities (Bieg et al, 2006, p. 409). But, in case that the FVO is exercised on an irregular basis, the financial statements of banking institutions cannot be compared.

Therefore, the FVO can be seen as an alternative for hedge accounting (Jerzembek et al, 2005, pp. 221). Nevertheless, the option cannot convince as a total alternative to hedge accounting, due to the fact that the practical application differs in major points. Indeed, when exercising the FVO for hedging activities, used derivatives are valuated at fair value. But in contrast to hedge accounting, the valuation that affects the net income cannot be limited on one risk in the context of hedging activities. Therefore, the additional risks may influence the intentions of the aimed “natural hedge”. In addition the exercise of the FVO in order to hedge a net position is a continuous process that cannot be stopped, leading to an ongoing expansion of the use of the FVO. A net position changes, according to its definition, if new credit transactions are agreed. Due to the fact that the application of the FVO is irrevocable, the banks are forced to emulate the option on a continuous basis. In time lapse an increasing numbers of transaction and operations of the portfolio, concerning underlying transactions, are valuated at fair value until the option is almost exercised for all performances within the portfolio (Schmidt, 2005, p. 272).

Concerning the annual reports, the FVO is only qualified in a limited manner. The irrevocably of the option indicates that changes in the fair value are obligatory captured. Outgoing from the assumption, that market prices of financial instrument or interest rates underlie a random walk (Ross et al, 2005, pp. 355), the FVO looses importance in order to shape annual reports. Therefore, the effects of the FVO for the representation of the financial situation are not assessable. But the purposeful application of a financial instrument in order to shape an annual report obligatory requires that the effects in the following periods can be estimated. This condition is not fulfilled in case of an application of the FVO (Schmidt, 2005, p. 272)
6.4 Particularities in the Risk Management

According to the empirical findings, the conclusion can be drawn that all analyzed institution disposes of an appropriate risk management and investment strategy. Furthermore, all of them apply the VaR approach as one opportunity to measure the changes of the fair value in a portfolio. Simultaneously, the banking organizations exercise further methods with the aim to support and test the results, determined by the VaR approach, such as intelligent IT software or risk management cycles. Therefore, the question is examined, which factors may influence the fair value of a portfolio and how the entities deal with these factors in order to ensure an appropriate risk management.

Dresdner Bank AG, RBS, Nordea and Crédit Mutuel aim to determine the fair value of portfolios and present the important information to managers in key positions. Several factors can influence the market value of a portfolio. The change in the market value of a portfolio is directly influenced by the interest rate structure. The interest rate risk increases, due to the changing market interest rate. Therefore, mortgage backed securities affect the life of the securities portfolio. In order to minimize the risk exposure of the portfolio, managers shift the maturity structure of the securities portfolio. In addition, managers target to reduce or transfer interest rate risk exposure. Simultaneously, managers and banks aim to increase financial flexibility (Papiernik et al, (2005), p. 21).

This examination proves the aim of the IASB that the FVO can be used in order to hedge against changes in the interest rates. Concerning the investment strategy of banks, managers of financial institutions reduce the securities investment portfolios (Papiernik et al, (2005), p. 22). As stated in IAS 39.BC76A-BC76B the documented risk and investment management has to be presented in such a manner, that the external addressees are able to recognize, that the FVO agrees with the risk management of the bank. All four financial institutions confirm this condition, due to the fact that all banks explain in their notes how they determine the fair values of their portfolios. In addition,
the net income valuation of a portfolio, basing on the application of the FVO and Full FVA supports an improvement of the relevance of information.

6.5 Relevance of Information for the Addressees

A further outcome of the empirical study concerns the relevance of the information for the addressees. The question arises whether the financial statements contribute to an improved understanding and an augmented comparability through the application of FVA. This aspect is important, due to the fact that an improved transparency and comparability represents a major aim of the IASB and the harmonized regulations and standards. In addition, increased importance is given to this topic, because the danger exists that FVA does not lead to an increased relevance but to a risen quantity of information, leading to a confusion of the addressees instead of increased transparency.

As analyzed in previous chapters and as shown in the annual reports of the investigated financial institutions, transparency will increase as well as the number of additional information, available for lower costs, resulting in an improved quality of the information (Post et al, (2007), p. 254). Therefore, on the one side investors can dispose of more detailed information on the financial situation of the financial institution and adapt their pricing strategy. The danger exists, that the investors may also feel overwhelmed by the abundance of information. In case of semi-strong market efficiency, a decline in the asymmetry of information between managers and investors is achieved, resulting in a lower cost of capital (Easley et al, (2004), pp. 1553). On the other side, transparency may be reduced due to the fact that the application of Full FVA is linked to a number of assumptions and assessment, made by the bank management. This would indicate instead of lower cost of capital, an increased cost of capital for the investors (Dickinson et al, (2004), pp. 540).

In addition, Full FVA and the FVO lead to a shift in the communication policy of financial institutions and other enterprises. Due to the fact that a risen number of explanations are necessary, the length of the annual reports increases (Post et al, (2007),
This can be also confirmed by the length of the annual reports of the investigated institutions, which nowadays comprises approximately 200 pages. Therefore, more complete and transparent reporting standards augment information acquisition and use. In addition, Full FVA contributes to a more complete measurement.

The information, gained from the application of the FVO, can influence the bank analysts’ judgment. External addressees can benefit from current information captured in the fair values of financial instruments that represent economic conditions in which they take place and from a better basis for analysis (Hirst et al., 2004, pp. 455). A further advantage of FVA approach is the fact, that the changes in the value of embedded derivatives and other financial instruments are directly recognized in the profit and loss statements. This indicates that the financial instruments have to be priced appropriately (Duverne et al., 2007, pp. 62). Furthermore, shareholders, who present one group of external addressees, are not depended on the interpretation of the managers’ interpretation of the economic reality. Additionally, the principle agent problem may be reduced with the help of Full FVA, because this approach shifts the power from the managers to markets. Under FVA the power of managers is reduced, due to the fact that financial analysts gain more power (Perry et al., 2006, p. 566).

Consequently, this development benefits external addressees and shareholders (Perry et al., 2007, p. 565).

The analysis shows that the quantity of the information augments in case of Full FVA. The aim is to simplify the comprehension process for financial statements. But it is questionable, whether the depth of information simplifies this process or worsens it. Furthermore, the risen level of transparency and reliability of the financial statements may lead to lower cost of capital, representing a further advantage of Full FVA.

6.6 Reflection of the Analysis

The second section of the practical analysis comprises the analysis of the most interesting findings, conducted from the empirical analysis. The conclusion can be deducted, that the harmonization of the accounting regulations within the European
Union contributes to an increased comparability as well as transparency. As a second result, the reflection exhibits that with regard to results of the investigations, historical cost accounting does not represent the optimal accounting procedure in order to present the economical financial situation of the banking institutions. FVA tends to replace historical cost accounting, although this is a highly discussed approach in the financial sector. The enhanced transparency or the recognition of changes of the fair value of financial instruments in the profit and loss statement and consequently in the balance sheet characterize major benefits of this development.

Increased income volatility, coinciding with the application FVA, presents one major risk. In the context of the current financial crisis it seems to be questionable, whether FVA is an appropriate alternative for historical cost accounting. In accordance with the findings of the empirical study, the difficulties in determining the fair values of financial instruments in absence of quoted market prices reflects a further challenge with reference to FVA. The FVO is especially applied by universal banks, indicating that those institutions are exposed to a large degree to accounting mismatches. The size of the banking institution seems to influence the scope of application of the FVO. In addition, the FVO can only be used on a limited level as an instrument for shaping annual reports. Therefore, the exercise of the option is limited and looses importance. Due to the fact, that the empirical study does not provide any information concerning the relevance of information for external addressees, this aspect has been analyzed. The outcome shows, that it is questionable, whether the relevance of information increases or only the quantity of information.
7 Conclusion

The aim of this thesis is to investigate the latest amendment of the FVO and how financial institutions, with special focus on banking organizations deal with the adapted FVO.

The first question is “What are the main characteristics of the amended FVO?” Outgoing from the practical analysis, the conclusion can be drawn that the amended FVO contributes to minimize valuation asymmetry and to provide a simplified alternative for hedge accounting activities. The main characteristic of the final version is the limited scope of application of the FVO. The major adaptation of the option concerns the conditions of designating financial instruments at the denomination “at fair value through profit and loss”. A categorization can only be carried out if it supports a minimization of measurement and recognition incongruity. Alternatively, the financial instruments have to be part of a portfolio, managed at fair value or the financial assets or liabilities are hybrid combined instruments. In case that one of the three conditions is fulfilled the FVO can be exercised. Therefore, the reasoning can be conducted that the option focuses on increasing the relevance of information and to augment the reliability of measurement and recognition of financial instruments by minimizing the possibility for an abuse of the option. This leads to the overall result that the changed FVO represents an accounting policy.

The second research question asks “How does the FVO affect financial institutions?” This question was analyzed at the example of Dresdner Bank AG, RBS, Nordea and Crédit Mutuel. The major conclusion that can be drawn is that the scope of application differs concerning the size of the financial institutions. Especially universal banks apply the FVO in order reduce accounting mismatches. A further result is that the FVO can only be exercised in a limited manner for shaping annual reports. The reflection of actual quoted market prices increases the income and equity volatility of the four banking institutions. This circumstance minimizes the importance of the FVO for financial institutions. The argumentation can be continued by concluding that the FVO represents one possibility for FVA. Cohesion is established to the current financial
crisis, proving that all four investigated banks are confronted by this phenomenon. Yet the analysis figures out that the FVO in combination with Full FVA provides a number of positive affects for banking institutions, like an increase of discretions or an augmented transparency of the financial statements. Simultaneously, the major risks, mainly the increased volatility have to be taken into consideration. This motivates the argument that FVA is still in a dynamic development and that the FVO presents a major step towards FVA. Therefore, the FVO does not illustrate a final solution but only packages an intermediate step in the continuous developing of IAS and IFRS. Nevertheless FVA offers an increased scope of discretion for the financial institution with reference to the valuation process of financial instruments, resulting in an augmented flexibility.

From my point of view the FVO and the FVA represents a first step towards a more transparent accounting policy, pursued by the IASB. The simplification of hedge accounting and the reduction of accounting mismatches improve the transparency of the financial statements of financial institutions. In addition, the valuation of financial instruments at fair value provides external addressees a better overview over the financial situation of the entity. Nevertheless, the disadvantages, analyzed in the course of the thesis have to be beard in mind. The absence of quoted market prices for financial instruments as well as the increased equity and income volatility represent major challenges that have to be solved in order to establish the FVO and FVA in an appropriate and sufficient manner in the banking sector.

The objective of the thesis is to answer the two research questions. This target is completed. The literature review and the practical analysis contribute to the answering process and the identification of the importance of Full FVA and the FVO on the example of four selected banking institutions. In addition, the empirical findings can be linked to the highly discussed topic of FVA due to the financial crisis. Major financial banking institutions claim the accounting policy, with special reference to FVA as one main cause for the banking crisis. The paper contributes to an improved understanding of the overall topic of the FVO and FVA and provides examples of the application of these approaches in the real business environment.
Retro perspective, I conclude by saying that the interpretative approach is an appropriate research philosophy for this thesis. It provides the possibility to deal with the delimitation of this thesis. Reflecting the circumstance, that only a small sample of banks was possible to be analyzed and that these differ in size, no harmonized conclusions, that are valid in general, can be deducted. Furthermore, this does not represent the intention of this thesis. The purpose is to investigate the current status and characteristic of the FVO and its effects on financial institutions. This paper aims to provide explanations and to figure out the major driving forces for the current development. Therefore, the explanatory research design in combination with an interpretative research philosophy is appropriate, due to the fact that both approaches offer the best possible basis for developing as well as establishing adequate explanations and analytical results.

It gives me, the author the possibility to analyze the collected secondary data with the support of a large variety of different literature to exhibit the most logical explanations. For this reason, this research philosophy simultaneously supports the fact, that IAS and IFRS underlie continuous adaptations, according to the development of the business environment. Outgoing from this aspect, researchers, who will investigate the same topic in future will not come up with the same explanations and results, due to the fact, that IAS and IFRS will change, because the requirements in the international business environment will have further developed.

Nevertheless, for future studies in this field, it may be interesting, not only to conduct an analysis on a small sample of banks, but to perform a large survey, concerning this topic. Then, alternatively, not an interpretative research philosophy can be chosen but a positive research philosophy may form the basis for the research process. Consequently, general results could be published and presented.
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9 Appendix

9.1 Fair Value Hierarchy

Is the fair value determinable as a quoted market price for financial assets and liabilities?

Yes → Fair Value = Quoted Market Price

No →

Is the fair value on the basis of quoted market prices from economical comparable financial assets and liabilities determinable?

Yes → Fair Value = Comparison Value

No →

Is the fair value determinable on the basis of approved valuation techniques?

Yes → Fair Value = Estimated Value

No →

Yes → Fair Value = Historical Costs

Source: Kümmel, J., (2002); p. 59
## 9.2 Dresdner Bank AG

### Balance Sheet

<table>
<thead>
<tr>
<th>€m</th>
<th>31.12.2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash funds</td>
<td>6.643</td>
</tr>
<tr>
<td>Trading assets</td>
<td>159.700</td>
</tr>
<tr>
<td><strong>Financial assets designated at fair value</strong></td>
<td>8.648</td>
</tr>
<tr>
<td>Loans and advance to banks</td>
<td>113.200</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>188.211</td>
</tr>
<tr>
<td>Loan impairment allowances</td>
<td>-762</td>
</tr>
<tr>
<td>Financial investments</td>
<td>13.718</td>
</tr>
<tr>
<td>Equity-accounted investments</td>
<td>565</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>1.265</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>445</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>1.912</td>
</tr>
<tr>
<td>Other assets</td>
<td>6.664</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>500.209</td>
</tr>
</tbody>
</table>

| **Liabilities and Equity** | |
| Trading liabilities | 119.026 |
| **Financial liabilities designated at fair value** | 2.309 |
| Liabilities to banks | 128.149 |
| Liabilities to customers | 185.372 |
| Securitized liabilities | 34.633 |
| Provision | 3.109 |
| Deferred tax liabilities | 107 |
| Other liabilities | 7.145 |
| Subordinated liabilities | 6.267 |
| Profit-participation certificates | 1.686 |
| **Equity** | |
| Equity attributable to shareholder of parent | 10.587 |
| Subscribed capital | 1.503 |
| Capital reserves | 6.383 |
| Retained earnings | 3.138 |
| Treasury reserve | -1.150 |
| Translation reserve | -622 |
| Cumulative remeasurement gains/losses on financial instruments | 1.335 |
| Distributable profit | 0 |
| Minority interests | 1.819 |
| **Total liabilities and equity** | 500.209 |

As analyzed in the empirical findings, Dresdner Bank AG shows its information, gained by the application of the Fair Value Option and Full FVA in the balance sheet in the item “financial assets/liabilities designated at fair value”.
Income Statement

<table>
<thead>
<tr>
<th>€m</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest and current income</td>
<td>3.061</td>
</tr>
<tr>
<td>Interest and current income</td>
<td>7.691</td>
</tr>
<tr>
<td>Current income from equity-accounted investments</td>
<td>245</td>
</tr>
<tr>
<td>Interest expense</td>
<td>4.875</td>
</tr>
<tr>
<td>Net fee and commission income</td>
<td>2.866</td>
</tr>
<tr>
<td>Fee and commission income</td>
<td>3.246</td>
</tr>
<tr>
<td>Fee and commission expense</td>
<td>380</td>
</tr>
<tr>
<td><strong>Net trading income</strong></td>
<td>-481</td>
</tr>
<tr>
<td>Other operating income</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total operating income</strong></td>
<td>5.446</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>4.849</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>4.868</td>
</tr>
<tr>
<td>Loan impairment losses</td>
<td>-132</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>710</td>
</tr>
<tr>
<td>Net income from financial investments</td>
<td>183</td>
</tr>
<tr>
<td>Restructuring charges</td>
<td>50</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>843</td>
</tr>
<tr>
<td>Tax expense</td>
<td>373</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>470</td>
</tr>
<tr>
<td>Profit attributable to minority interests</td>
<td>60</td>
</tr>
<tr>
<td><strong>Profit for the period</strong></td>
<td>410</td>
</tr>
</tbody>
</table>

Net Trading Income

<table>
<thead>
<tr>
<th>€m</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading in interest rate products</td>
<td>431</td>
</tr>
<tr>
<td>Trading in equities products</td>
<td>260</td>
</tr>
<tr>
<td>Foreign exchange and precious metals trading</td>
<td>256</td>
</tr>
<tr>
<td>Trading in credit products</td>
<td>-1,231</td>
</tr>
<tr>
<td>Other trading activities</td>
<td>26</td>
</tr>
<tr>
<td>Net effect of remeasurement under IAS 39</td>
<td>-223</td>
</tr>
<tr>
<td>Remeasurement gains/losses from the application of IAS 39</td>
<td>-279</td>
</tr>
<tr>
<td><strong>Remeasurment gains/losses from the application of the Fair Value Option</strong></td>
<td>56</td>
</tr>
<tr>
<td>Net trading income</td>
<td>-481</td>
</tr>
</tbody>
</table>

Those tables provide the external addressees information how the Fair Value Option influences the financial statement of Dresdner Bank AG. As examined, the option affects the income statement position “net trading income”. Dresdner Bank AG is the only bank that publishes the changes of the Fair Value Option separately. This announcement takes place on a voluntarily basis.
9.3 Royal Bank of Scotland Group

Financial Instruments measured at Fair Value

<table>
<thead>
<tr>
<th>€bn</th>
<th>Quoted prices in active markets</th>
<th>Valuation techniques based on observable market data</th>
<th>Valuation techniques incorporating information other than observable market data</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and advances to banks</td>
<td>119,7</td>
<td>16,6</td>
<td>136,3</td>
<td></td>
</tr>
<tr>
<td>Treasury and other eligible bills and debt securities</td>
<td>105,3</td>
<td>128,9</td>
<td>14,7</td>
<td>248,9</td>
</tr>
<tr>
<td>Equity shares</td>
<td>46,3</td>
<td>10,2</td>
<td>1</td>
<td>57,5</td>
</tr>
<tr>
<td>Derivatives</td>
<td>2,4</td>
<td>418,7</td>
<td>6,6</td>
<td>427,7</td>
</tr>
<tr>
<td><strong>Available for sale</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasury and other eligible bills and debt securities</td>
<td>40,7</td>
<td>79,1</td>
<td>1,3</td>
<td>121,1</td>
</tr>
<tr>
<td>Equity shares</td>
<td>7,3</td>
<td>1,3</td>
<td>1</td>
<td>9,6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>202</td>
<td>848,6</td>
<td>41,3</td>
<td>1091,9</td>
</tr>
</tbody>
</table>

| **Liabilities** |                                 |                                               |                                 |       |
| Deposits by banks and customer accounts | 167,2 | 1,9 | 169,1 |
| Debt securities in issue | 53,4 | 11,7 | 65,1 |
| Short positions | 80,6 | 12,5 | 93,1 |
| Derivatives | 2,7 | 412,7 | 5,6 | 421 |
| Other financial liabilities | 1,1 | 0,2 | 1,3 |
| **Total** | 83,3 | 646,9 | 19,4 | 749,6 |

The Royal Bank of Scotland Group does not publish the Fair Value Option in a single item in the financial statements. Therefore, the bank announces the fair values of financial assets at the valuation category “at fair value through profit and loss”. In addition, the table provides information how the fair value is determined, meaning whether quoted market prices are used or valuation techniques.
9.4 Nordea

Income Statement

<table>
<thead>
<tr>
<th>€m</th>
<th>Group 2007</th>
<th>Parent 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>12.909</td>
<td>2.741</td>
</tr>
<tr>
<td>Interest expense</td>
<td>-8.627</td>
<td>-2.381</td>
</tr>
<tr>
<td>Net interest income</td>
<td>4.282</td>
<td>360</td>
</tr>
<tr>
<td>Fee and commission income</td>
<td>2.734</td>
<td>618</td>
</tr>
<tr>
<td>Fee and commission expense</td>
<td>-594</td>
<td>-155</td>
</tr>
<tr>
<td>Net fee and commission income</td>
<td>2.140</td>
<td>463</td>
</tr>
<tr>
<td>Net gains/losses on items at fair value</td>
<td>1.187</td>
<td>192</td>
</tr>
<tr>
<td>Profit from companies accounted for under the equity method</td>
<td>41</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>22</td>
<td>1.325</td>
</tr>
<tr>
<td>Other operating income</td>
<td>214</td>
<td>127</td>
</tr>
<tr>
<td>Total operating income</td>
<td>7.886</td>
<td>2.467</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General administrative expenses:</td>
<td>-2.388</td>
<td>-596</td>
</tr>
<tr>
<td>Staff costs</td>
<td>-1.575</td>
<td>-514</td>
</tr>
<tr>
<td>Other expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation, amortization and impairment charges of tangible and intangible assets</td>
<td>-103</td>
<td>-101</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>-4.066</td>
<td>-1.211</td>
</tr>
<tr>
<td>Loan losses</td>
<td>60</td>
<td>25</td>
</tr>
<tr>
<td>Disposal of tangible and intangible assets</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Operating profit</td>
<td>3.883</td>
<td>1.281</td>
</tr>
<tr>
<td>Appropriations</td>
<td></td>
<td>-44</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>-753</td>
<td>-34</td>
</tr>
<tr>
<td>Net profit for the year</td>
<td>3.130</td>
<td>1.203</td>
</tr>
<tr>
<td>Attributable to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders of Nordea Bank (AB) publ.</td>
<td>3.121</td>
<td>1.203</td>
</tr>
<tr>
<td>Minority interests</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>3.130</td>
<td>1.203</td>
</tr>
</tbody>
</table>
Net Gains/Losses for Categories of Financial Instruments

<table>
<thead>
<tr>
<th>€m</th>
<th>Group 2007</th>
<th>Parent 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available for sale assets, realised</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Financial instruments designated at fair value through profit and loss</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Financial instruments held for trading</td>
<td>903</td>
<td>204</td>
</tr>
<tr>
<td>Financial instruments under hedge accounting</td>
<td>-11</td>
<td>-12</td>
</tr>
<tr>
<td>Of which net losses on hedging instruments</td>
<td>185</td>
<td>51</td>
</tr>
<tr>
<td>Of which net gains on hedged items</td>
<td>-196</td>
<td>-63</td>
</tr>
<tr>
<td>Other, not under IAS 39 or IFRS 4</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Financial risk income, net Life</td>
<td>245</td>
<td></td>
</tr>
<tr>
<td>Insurance risk income, net Life</td>
<td>41</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,187</strong></td>
<td><strong>192</strong></td>
</tr>
</tbody>
</table>

Although Nordea designates its financial instruments at the valuation category “at fair value through profit and loss” this denomination is not announced in their income statement or balance sheet. Instead this class is summarized in combination with further valuation categories, representing FVA under the balance and income statement item “net gains/losses on items at fair value”.
9.5 Crédit Mutuel

Balance Sheet

<table>
<thead>
<tr>
<th>€m</th>
<th>31.12.2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash in hand, balances with central banks and post office accounts</td>
<td>6.243</td>
</tr>
<tr>
<td>Financial assets at fair value through profit and loss</td>
<td>79.822</td>
</tr>
<tr>
<td>Derivative hedging instruments</td>
<td>1.506</td>
</tr>
<tr>
<td>Available for sale financial assets</td>
<td>83.446</td>
</tr>
<tr>
<td>Loans and advances to credit institutions</td>
<td>55.646</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>220.142</td>
</tr>
<tr>
<td>Remeasurement adjustment on portfolios hedged for interest rate risk</td>
<td>19</td>
</tr>
<tr>
<td>Financial assets held to maturity</td>
<td>9.874</td>
</tr>
<tr>
<td>Current tax assets</td>
<td>1.009</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>674</td>
</tr>
<tr>
<td>Prepayments, accrued income and other assets</td>
<td>18.641</td>
</tr>
<tr>
<td>Non-current assets intended for sale</td>
<td>0</td>
</tr>
<tr>
<td>Holdings in companies accounted for by the equity method</td>
<td>59</td>
</tr>
<tr>
<td>Investment property</td>
<td>1.421</td>
</tr>
<tr>
<td>Plant, property, and equipment</td>
<td>2.888</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>379</td>
</tr>
<tr>
<td>Goodwill</td>
<td>906</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>482.676</td>
</tr>
</tbody>
</table>

| **Liabilities and Equity** | | |
| Central banks, post office accounts-liability | 387 |
| Financial liabilities as fair value through profit and loss | 26.964 |
| Derivative hedging instruments | 1.561 |
| Amounts due to credit institutions | 67.854 |
| Amounts due to customers | 155.775 |
| Debt securities | 98.100 |
| Revaluation difference on portfolios hedged for interest rate risk | 137 |
| Current tax liabilities | 666 |
| Deferred tax liabilities | 807 |
| Accrued charges, deferred income and other liabilities | 18.349 |
| Debt relating to assets intended for sale | 0 |
| Technical provisions for insurance contracts | 79.959 |
| Provisions for contingencies and other liabilities | 1.192 |
| Subordinated debt | 6.604 |
Crédit Mutuel recognizes its financial instruments in the balance sheet “at fair value through profit and loss”. In order to show the connection between this balance sheet item and the income statement the bank publishes changes in this category under the position “net gains or losses on financial instruments at fair value through profit and loss”, leading to an increased transparency of the financial instatement than summarizing different position dealing with FVA under one balance or income statement item.
### Income Statement

<table>
<thead>
<tr>
<th></th>
<th>€m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and assimilated income</td>
<td>17.326</td>
</tr>
<tr>
<td>Interest and assimilated expense</td>
<td>-14.000</td>
</tr>
<tr>
<td>Fees and commissions (income)</td>
<td>3.578</td>
</tr>
<tr>
<td>Fees and commissions (charges)</td>
<td>-1.047</td>
</tr>
<tr>
<td><strong>Net gains (losses) on financial instruments at fair value through profit and loss</strong></td>
<td><strong>2.608</strong></td>
</tr>
<tr>
<td>Net gains (losses) on available for sale financial assets</td>
<td>295</td>
</tr>
<tr>
<td>Income from other activities</td>
<td>16.932</td>
</tr>
<tr>
<td>Expense on other activities</td>
<td>-14.855</td>
</tr>
<tr>
<td><strong>Net banking income</strong></td>
<td><strong>10.838</strong></td>
</tr>
<tr>
<td>General operating expenses</td>
<td>-5.909</td>
</tr>
<tr>
<td>Provisions, amortizations and depreciation</td>
<td>-434</td>
</tr>
<tr>
<td><strong>Gross operating profit</strong></td>
<td><strong>4.495</strong></td>
</tr>
<tr>
<td>Cost of risk</td>
<td>-239</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td><strong>4.256</strong></td>
</tr>
<tr>
<td>Share in net profit or loss of companies accounted for by the equity method</td>
<td>7</td>
</tr>
<tr>
<td>Net gains (losses) on other assets</td>
<td>18</td>
</tr>
<tr>
<td>Changes in goodwill</td>
<td>0</td>
</tr>
<tr>
<td><strong>Profit on ordinary activities before tax</strong></td>
<td><strong>4.281</strong></td>
</tr>
<tr>
<td>Corporation tax</td>
<td>-1.280</td>
</tr>
<tr>
<td><strong>Total consolidated profit</strong></td>
<td><strong>3.001</strong></td>
</tr>
<tr>
<td>Minority interests</td>
<td>55</td>
</tr>
<tr>
<td><strong>Net profit, group share</strong></td>
<td><strong>2.946</strong></td>
</tr>
</tbody>
</table>