THE ACCOUNTING REGULATION PROCESS IN THE FIELD OF FINANCIAL INSTRUMENTS

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Our paper develops an analysis on the accounting regulation process by considering the field of financial instruments as one of the most controversial areas of financial reporting. After a brief introduction, comprising aspects related to the accounting regulation process, we first stop upon the historical evolution of the two main accounting referential that currently collaborate through the convergence process. Our analysis focuses both on standards first issuance and on their amendment process. A special emphasize is given to the international accounting referential. The obtained results enhance the complexity of the approached field and indicate significant steps still needed to be taken.

Keywords: standard setting bodies, accounting regulations, financial instruments, regulation process

JEL Classification: M40, M41

Introduction

Approaching the accounting regulation process in the field of accounting can be done by using a large range of attitudes, starting with the vision of a free market and ending at the other extreme of excessive regulation that in our opinion can also be correlated with the typology of rule-based accounting systems. The fundamental assumption that lays at the basis of the "free market" approach when it comes to accounting regulations says that accounting information should be treated like any other economic goods. This implies that forces of demand and offer should be allowed to act towards that point that generates the optimal offer of information related to a certain entity (Deegan and Unerman, 2008, p. 57). In other words, those opinions militating for the reduction or even elimination of the regulatory process bring as an argument the fact that when someone wants to obtain a certain information regarding a certain entity he/she will also be prepared to pay for it, while the demand and offer would be the ones leading to the creation of the informational optimum. We will further develop a detailed analysis in the field of accounting for financial instruments as being one of the most controversial areas of financial reporting.

Research methodology

Our paper is based on analyzing accounting standards being issued by significant accounting standard setting bodies in the accounting arena. This involves on one hand closely considering the results of the accounting regulation process and on the other the development of the process itself. Once the particularities of the accounting regulation process were established, it also helped us organize our paper. Since the IASB work plan includes amending already existent standards, after presenting their first issuance, we needed to insist on corresponding amendments. This was not an issue for the American accounting referential issuing a new standard once an amendment is needed. The developed analysis allowed the identification of the most problematic areas in reporting for financial instruments.

Historical evolution of two great accounting referential

Developments taking place within financial markets that become more and more sophisticated from one day to another, allowing entities to trade innovative contracts that significantly transform their risk profile, represent maybe the only factor within the business cycle that brings significant problems when it comes to traditional financial reporting practices (Bonham *et al.*, 2008, p. 1131). All these aspects started to make their presence obvious from some time now, IASB (International Accounting Standards Board), former IASC (International Accounting Standards Committee) commenting since back in 1996 on such aspects and emphasizing that:

At the root of the necessity of changing the accounting for financial instruments, we must place fundamental changes that appeared within international financial markets. An entity can significantly and instantly change its profile from the financial risk's perspective, therefore imposing careful and continuous supervision. Meanwhile, an entity can use derivatives as speculative tools in order to multiply the effects of changes taking place in interests, exchange rates, commodities' prices of securities, therefore multiplying their earnings if prices move in an advantageous direction or, similarly, multiplying their losses at a contrary evolution. Accounting for financial instruments did not keep pace with these informational necessities of market participants. Existent practices are grounded based on some principles that were developed when accounting's main preoccupation were production entities that combined different forms of inputs (materials, labour, machinery, etc) and transformed them into outputs (goods or services) with the purpose of selling them. Accounting for these processes generating incomes was first preoccupied by achieving a certain connectivity of expenses with revenues. A key element of this process is represented by the moment of revenues obtaining, representing that point when a company may consider that it has transformed its inputs into cash or rights on cash. These traditional concepts of valuation being based on realization and costs are not suitable for recognizing and measuring financial instruments. By recognizing this aspect, many countries have made a significant step towards acceptance of fair value accounting in the case of certain financial instruments (IASC, 1996).

Recognizing these issues more than a decade ago was actually clearly delimiting the challenges that were going to fully solicit accounting standard setting bodies for some time. More precisely, it was necessary to accept new approaches to financial reporting if wanted to keep pace with particular features of financial instruments. Moreover, identifying to what extend would this new approach also generate implications in other areas of the activities being developed by entities, therefore being necessary to abandon traditional accounting methods. Direction for actions to be taken that were chosen by the IASC and afterwards IASB indicate the fact that these issues were closely considered, developments within the field of financial instruments also affecting other areas. A particular attention was also paid to creating some models that were to be used in measuring fair values for some balance sheet elements such as those in the field of insurance contracts, agriculture and even recognition of revenues (Bonham *et al.*, 2008, p. 1132).

If we are to make reference to that point in time when accounting regulations in the field of financial instruments were initiated, we must take into consideration the American accounting referential whose development in the considered area was actually imposed through the level and complexity of transactions taking place within the American capital market. At least after World Word II, USA occupied a leading position when it comes to financial innovation and corresponding regulation in this field (Veron, 2007, p. 22). The domination of American capital markets and unprecedented powers being concentrated in the Securities and Exchange Commissions' (SEC) hands represents a clear proof of the fact that the American financial environment exerts a significant influence on a global level, regardless if we make reference to SEC's representatives or American members of the accounting profession.

A turning point in the history of accounting regulation was created once with Enron's bankruptcy back in 2001 and other financial scandals manifesting in 2002, but also the unforgettable '90s bubble. Previous to these events, there was also a series occasional criticism towards certain standards within the American accounting referential, but in generally it was still considered to be, in America and other areas of the world, as being the best available set of accounting standards (Veron, 2007, p. 23). We also mustn't forget the fact that US was the first to issue accounting standards (in 1930) and also the first (once with the establishment of the Financial Accounting Standards Board – FASB in 1973) to be based on an accounting regulatory body that claimed independence towards the accounting profession and towards direct political pressures. Although FASB was the one to initiate a series of projects in different problematic areas from an accounting perspective, Enron's collapse shook to the grounds all perceptions on what quality of accounting standards meant, bringing to surface a series of shortcomings of the American accounting referential.

It was therefore reached a totally different context, recent endorsement of the international accounting referential by UE favoring its acceptance as an alternative to the American one, now being more doubted than ever. In February 2002, president of IASB David Tweedie was explicitly criticizing the rule-based approach that was predominant within US GAAPs. In contrast, he was presenting the principle-based vision that IASB had approached. Shortly afterwards, the possibility of introducing a principle based system (such as the International Financial Reporting Standards - IFRS) within USA was being analyzed, the Sarbanes-Oxley Act (SOX) asking SEC to consider this issue (SEC, 2003).

Since 2000, FASB and IASB started to work on eliminating existent differences between US GAAP and IFRS. They decided to entitle this process as convergence, bearing in our opinion a particular character if we are to consider just the involved parties. The principle being incorporated within the Norwalk agreement in September 2002 (also known as Memorandum of Understanding - MoU) and renewed in February 2006 sustains that both parties should make significant efforts towards reciprocal closeness of the two accounting referential.

Analysis focusing on accounting for financial instruments

Starting with the grounding of other studies approaching this issue of great accounting referential (Hail *et al.*, 2009, Veron, 2007) we will also approach a presentation that focuses on the international accounting referential, but while also making numerous references and parallels with other accounting referential where their content or the considered moment impose it. A parallel approach of all aspects in accounting for financial instruments through the perspective of great accounting referential would generate an unjustified dimension of the presentation. We therefore chosen to particularize the manner in which information will be presented based on authors' professional judgment.

Considering the fact that each accounting referential has its own rules regarding the way the regulation process takes place, it would be rather difficult to achieve a parallel, but yet unitary presentation, of all preoccupations in the field of financial instruments. Our objective is to follow the main moments in time that were marked through an accounting regulation being issued, while considering three accounting referential. Choosing the three accounting referential was done with the aim of enhancing global representativeness. We therefore obviously chose the international accounting referential being issued by IASB, the American accounting referential issued by FASB, and also the Australian accounting referential issued by AASB (***Australian Accounting Standards Board***), which often proved some significant particularities. We must mention the fact that within the international accounting referential we now[410] find three distinctive standards whose objective is directly represented by financial instruments. These are IAS 32 *Financial instruments: Presentation,* IAS 39 *Financial instruments: Recognition and Measurement* and

[410] We only considered the three standards currently being effective. Furthermore, within its project of replacing IAS 39, IASB has already issued in 2009 a new standard, IFRS 9 having January 1, 2013 as effective date.

IFRS 7 *Financial instruments: Disclosures.* According to IASB's work procedure, these standards have often been amended and for this reason, we will first stop at pointing those moments when standards have first been issued and afterwards come back for a detailed analysis.
The American accounting referential on the other hand issues a new standard each time it wishes to amend an already existent standard, and for this reason, it is necessary that we enumerate a significant number of distinctive standards (SFAS[411]). Still, we must keep in mind that there are some situations when more of the mentioned standards approach the same aspects. In accordance to our methodology of presenting those moments when financial instruments standards have been issued we must distinctively present all of them. As previously mentioned, the corresponding attention will also be granted to those moments that brought standards' amendment, also within the international accounting referential, even if it did not represent new standards, implications still being significant.
The Australian accounting referential involves a similar working procedure to that of IASB, therefore having some moments that involve distinctive standards being issued, while since January 1, 2005 the so-called Australian equivalent standards for IAS/IFRS became effective. The following figure 1 presents the manner in which the three considered accounting standard setting bodies acted in time in order to regulate the field of accounting for financial instruments. Figure 1 reflects each regulatory body's manner of working, but also its preoccupations in the field of financial instruments. A closer analysis on the significant moments in our figure demonstrates the fact that the American accounting referential seems to be taking the initiative most of the times, while representing a valuable source of inspiration for the international one. Creating accounting standards in this field is challenging for all regulatory bodies for some time now. As figure 1 proves it, a series of developments were initiated in US that also paid special attention to the requirements related to the use of fair value measurements of financial instruments. The purpose would be to better reflect both risks and rewards connected to those instruments. The Australian approach is also interesting, developing its own specific accounting standards that are tailored to suit their need, while also beneficiating from the evolutions within the international accounting referential that they keep pace with.
Despite the fact that based on their methodology of amending existent standards, our figure seems to reflect a clear and easy approach of IASB on accounting for financial instruments, a content analysis proves the contrary. Difficulties constantly raised from practice have often determined the international accounting referential to move away from the declared principle based approach towards rules that made the standards extremely complex, difficult to apply and also controversial. In order to catch the dynamic of the approached field and the complexity of the corresponding accounting regulations, we will further graphically represent those moments that imposed significant amendments of the international accounting referential in time. Figure 2 mirrors IASB's reaction in time during the difficult task of establishing financial reporting standards for financial instruments.

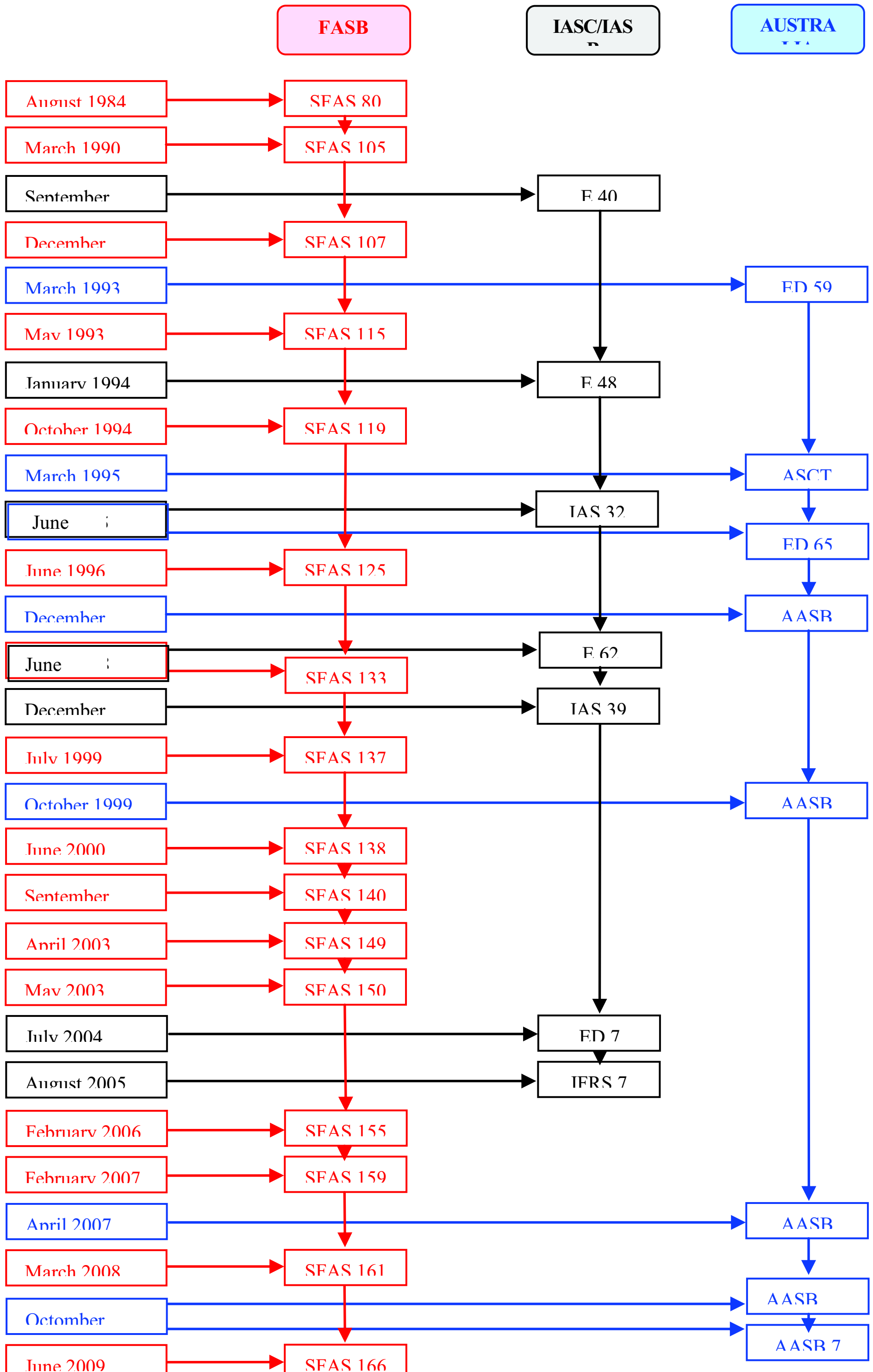
Conclusions and further developments

The below presented figures both reflect the complexity of the approached area and also the difficulty of developing the accounting regulation process in this field and reach the desired true and fair view. When closely analyzing the international accounting referential we notice that three standards were necessary and are still not sufficient. Figure 2 details their development in time, but also the correlations between them with regard to responsibilities each one should face. IASB's first efforts within the accounting regulation process in the field of financial instruments, or better said back then IASC, manifested staring September 1991 through Exposure Draft E 40 *Financial instruments*. This was afterwards modified in the shape of Exposure Draft E 48 *Financial instruments* that also

[411] We have chosen to use the old FASB codification because we considered the new codification, having only been introduced since last year, is not yet very popular. The correspondence between the old classification and the new one is provided by the FASB on its official website.

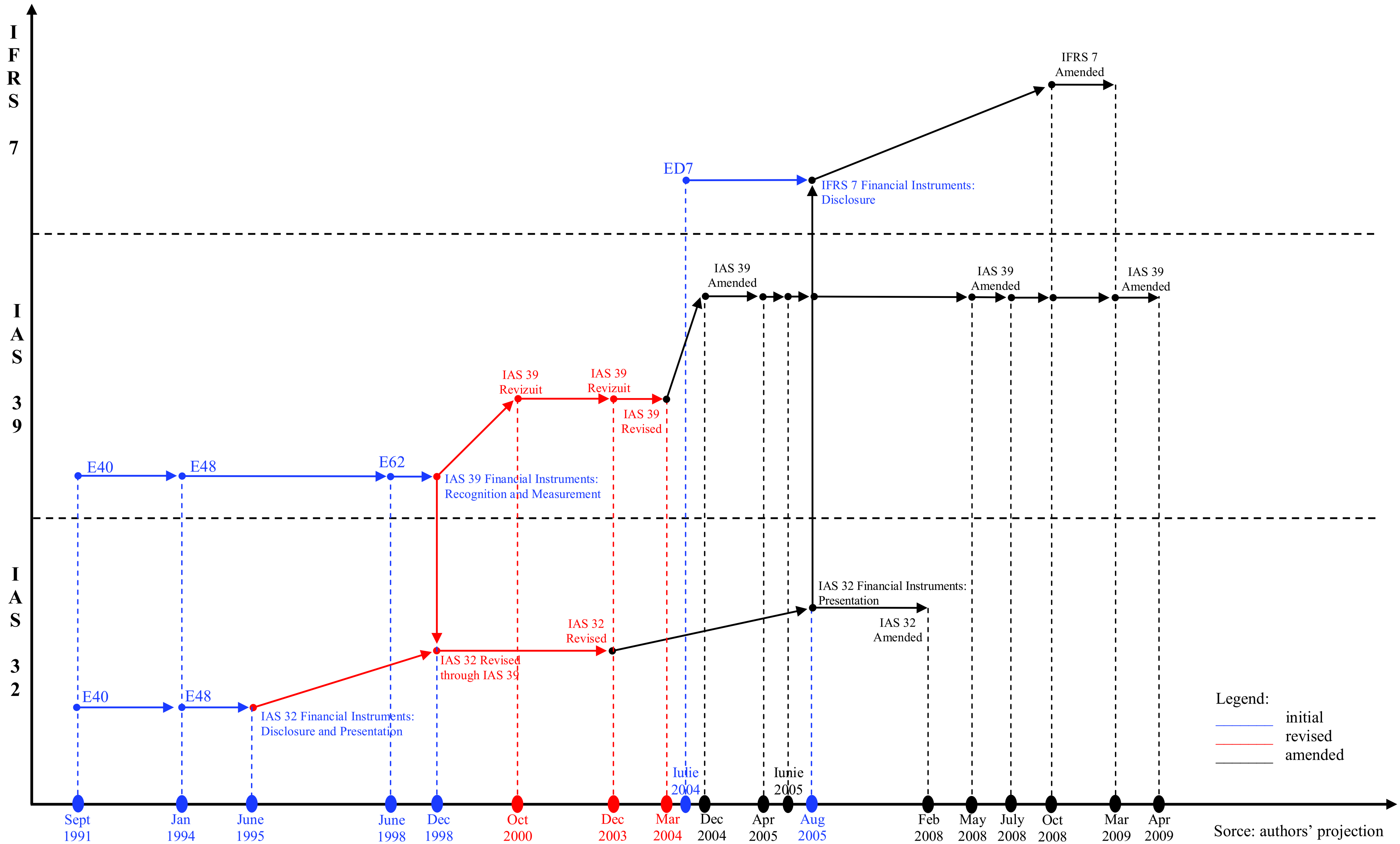
generated the first version of IAS 32 *Financial instruments: Disclosure and Presentation*. Meanwhile, analysis within the field of accounting for financial instruments continued to be developed with regard to recognition and measurement issues. These researches also soon took the shape of an Exposure Draft, namely E 62 in 1998, shortly becoming IAS 39 *Financial instruments: Recognition and Measurement*. IAS 32 was also revised with this occasion.

Figure 1. *Accounting regulations in the field of financial instruments*



Source: authors' projection

Figure 2. *Evolutions of the international accounting referential in the field of financial instruments*



Sorce: authors' projection

It is now more than obvious that IAS 39 represents the most revised and amended standard being issued by IASB. This does not come as a surprise considering the controversial aspects this standard deals with. Recognition and measurement have always represented a difficult aspect of financial reporting, but the current financial crisis enhanced its importance. Therefore, IAS 39 was amended with regard to the reclassification of financial assets. Significant pressures were made due to the fact that classifying a financial asset within a certain category also dictated its valuation at fair value or amortized cost. Considering the resulting inactive financial markets due to crisis circumstances, entities required for the right to reclassify arguing that current circumstances have also determined them to change their intentions upon their financial assets. But on the other hand, allowing them to reclassify also offers the opportunity of avoiding fair value measurement with manipulation purposes. This decision of amending IAS 39 was very much criticized ad brought damage to IASB's formal independence, especially since it was done very urgently and without respecting the complete due process. European banks were also among the first to put pressures on IASB. The problem of financial instrument's measurement remains open, the new IFRS 9 *Financial Instruments* seeking to replace IAS 39 and eliminate their classification determining the measurement attribute. The problem is even more difficult do to the context now surrounding fair value that took some of the finger pointing for the current financial crisis. While already being a sensitive topic, fair value measurement brought even more controversies due to the circumstances generated by the impact of the financial crisis on capital markets around the world.
We consider that the development in June 2004 of the exposure draft for a standard that was to be entirely dedicated to disclosure issues on financial instruments represented a clear proof of accepting a change in accounting paradigms. We refer here to the necessity of reorienting approaches when it comes to accounting for fictive capital. The emphasize now moves from recording data towards measurement, reporting and disclosing information, that is imperative for a good understanding of the implications of financial instruments being used by reporting entities. We conclude by saying that reporting for financial instruments represents a challenging area for all involved parties. Events surrounding European Union's endorsement of IFRS, with the well known carve out concerning IAS 39 and the fair value option, also represent a good example for the manner in which political forces can intervene within the standard setting process even when dealing with its international level. It is therefore an area imposing changes in accounting paradigms and continuous search for better solutions, while practice keeps facing us with a new riddle every day.

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