

Structured products and derivatives show volatility in financial statements.

Volatility as a downside of fairness

■ Prof. Dr. Peter Leibfried, MBA, CPA, Managing Director, and Dipl. Kfm. Marc Zimmermann, MBA, research associate, Institute for Accounting, Controlling and Auditing, University of St. Gallen

Accounting Standards increasingly require financial instruments such as stocks, derivatives and structured products to be measured at fair value. As fair values represent a financial instrument's market value, price fluctuations find their way into financial statements. Even though fair value measurement provides useful information about the current value of a corporation's assets, it also increases the volatility of earnings.

Accounting Standards such as the International Financial Reporting Standards (IFRS), the US Generally Accepted Accounting Principles (US-GAAP) and the Swiss GAAP «Fachempfehlungen zur Rechnungslegung» (Swiss GAAP FER) require some financial instruments to be measured at fair value. Depending on the instrument and its intended use, the change in fair value from one reporting period to another is either recognised in profit and loss or in a separate component of equity.

Fair value measurement considerations

The fair value of a financial instrument is defined as the amount for which an asset could be exchanged (or a liability settled) between knowledgeable, willing parties in an arm's length transaction. In practice, the determination of the fair value of a particular instrument depends on the market in which the instrument is traded. If current prices are publicly available, those prices provide the best estimate for fair values. Contrarily, if market prices are not publicly available, a company estimates fair values by means of valuation models, which are widely accepted within financial markets.

How fairness coincides with volatility

As the case study in the box on

page 35 illustrates, the book value on the firm's balance sheet under fair value accounting equals the current market value of the option at every reporting date. This information is particularly useful for investors seeking to value a company's assets and helps to evaluate the performance of the firm's trading activity.

Concealing the actual performance of the assets

Under historical cost accounting, the value on the balance sheet would be equal to the lower of cost or market meaning that the company would report an option book value of 100 000 Swiss francs at reporting date 0, 1 and 3. Only at reporting date 2, the company would report the true market value of 50 000 Swiss francs as it is below the cost of acquisition (100 000 Swiss francs). Although reporting at historical cost partly avoids volatility in earnings and balance sheet values, it conceals the actual performance of the firm's assets. In comparison, while reporting at fair market values provides insights into the firm's success in trading activities, it also increases the volatility in balance sheet and income statement. It is important to note that the increased volatility is not caused by the accounting technique itself but rather reflects fairly the current development in financial markets.

Earnings smoothing

Often firms enter into derivative contracts not in order to speculate on particular market expectations, but to eliminate certain risks that evolve from other financial instruments. In such cases, modern accounting standards such as IFRS, US-GAAP and Swiss GAAP FER allow for special treatment of the hedging relationship, which is referred to as hedge accounting. Hedge accounting on the one hand maintains reporting book values equal to market prices and thus still provides decision useful information to investors. On the other hand, hedge accounting eliminates earnings volatility by matching the risks from the derivative and the hedged security.

Accounting principles for structured products

Structured products often combine one or more derivative instruments with a non-derivative asset such as a share or a bond. The virtually indefinite number of possible combinations of derivative and non-derivative assets makes structured products extremely flexible. This allows investors to use only those instruments that exactly match their trading strategy, market expectation and risk profile.

In spite of their complex composition, structured products are generally accounted for in the same manner as other financial instruments. Depending on the intended use, they are often measured at fair value with changes in fair value recognised either in profit and loss or in a separate component of equity. In contrast to traditional financial assets such as bonds and shares, structured products often raise a special accounting issue which evolves from the combination of different derivatives with traditional asset classes. This special

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³ Quelle: JPMorgan Asset Management

Wichtige Hinweise

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issue concerns the question of whether or not the different components of a structured product have to be unbundled and separately accounted for. According to IFRS, derivatives, which are embedded in structured products, have to be separated and accounted for as a stand-alone derivative if the economic characteristics and risks of the derivative are not closely related to those of the non-derivative part of the structured product. In practice, this separation of an embedded derivative can increase the volatility of financial statements.

More transparency through fair value

Fair value accounting for derivatives and other financial instruments causes volatility in financial statements and affects both, the balance sheet and the income statement. Even though volatile financial statements are more difficult to interpret and might even cover up the operational performance of a firm, fair value measurement only reflects the volatile nature of financial markets.

Firms investing in volatile financial markets do properly report the volatility of their investments to existing and potential investors by means of fair value accounting. Under historical cost accounting, the volatility and the associated risk and return of such investments would not be as visible to investors. Thus, fair value accounting leads to more transparent reporting at the cost of more volatile earnings.

Case study: changes in fair value to be recognised in profit or loss

The No-Gambling Corporation enters into a call option contract written on an equity security in order to benefit from futures price increases. The option contract conveys the right, but not the obligation, to sell a specified quantity of the underlying equity security at a predefined strike price during a set time period before expiration. The price of the option at the time of acquisition is 100 000 Swiss francs. The fair values from time period 0 to 3 are depicted in the following table.

Time periode	0	1	2	3
Option Fair Value	CHF 100 000	CHF 400 000	CHF 50 000	CHF 120 000

At time 0 when the company enters into the option contract, the premium paid (100 000 Swiss francs) is recognised as an asset on the firm's balance sheet. The acquisition itself does not affect profit and loss.

At reporting date 1, the value of the option has increased to 400 000 Swiss francs. The company recognizes the change in fair value of 300 000 Swiss francs as a gain on derivative securities and adjusts the balance sheet item to 400 000 Swiss francs.

At reporting date 2, the option value has decreased to 50 000 Swiss francs. Accordingly, the company records a loss of 350 000 Swiss francs in its income statement. The book value is adjusted to 50 000 Swiss francs in order to reflect the current price development in the option market.

At the last reporting period, the value of the option has recovered to 120 000 Swiss francs. The company reports a gain of 70 000 Swiss francs (the change in fair value) and adjusts the book value to 120 000 Swiss francs.

The book value on the balance sheet and the impact on profit and loss (P&L) from period 0 to 3 are illustrated in the following table.

Time periode	0	1	2	3
Book Value	CHF 100 000	CHF 400 000	CHF 50 000	CHF 120 000
P&L Effect	0	CHF + 300 000	CHF -350 000	CHF +70 000