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FIRST-TIME ADOPTION OF IAS 39: IMPACT ON SELECTED PHILIPPINE UNIVERSAL BANKS

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The adoption of IAS 39 (Financial Instruments: Recognition and Measurement) in the Philippines for fiscal year ended 2005 was felt most strongly by the banking sector. As of December 31 of that year, Philippine banks reported aggregate financial assets and financial liabilities of P7.1 trillion that are subject to the provisions of IAS 39. Using a sample that included the biggest universal banks in the country, this study finds that adoption of IAS 39 resulted in three main adjustments to the banks' financial condition and results of operations: 1) recognition of previously unrecognized assets and liabilities, (mainly derivative instruments); 2) re-measurement of existing assets and liabilities; and 3) reclassifications *within asset accounts in the balance sheet. The net financial impact of these adjustments was a decrease of almost P15 billion in the sampled banks' reported assets, an increase of P650 million in their liabilities, and a decrease in their capital or equity of P15.33 billion. The decline in assets and capital arose principally from impairment losses recognized by the banks on their loans and receivables in compliance with IAS 39 measurement rules.*

I. INTRODUCTION

The evolution of International Accounting Standard (IAS) 39 started in 1988. In that year, the International Accounting Standards Committee (IASC) embarked on a project to develop an accounting standard for financial instruments[1]. The project was undertaken at a time when financial instruments were beginning to be widely held and used throughout the world. Initiatives such as cross-border capital raising and listings in global markets resulted in a need for a financial reporting standard that will generate information that reflected the economic substance of transactions was comparable across companies and countries. However, apart from the United States, very few countries had an established standard for the recognition, measurement and disclosure of financial instruments. The clamor of financial market participants for relevant, comparable and transparent information led to the issuance of IAS 39 Financial Instruments: Recognition and Measurement in 1998[2].

It is a common misconception that IAS 39 is mainly about the accounting for investments. IAS 39 established the standards for accounting for a whole range of financial instruments including simple accounts receivable, creative embedded derivatives, and complex pass-through securities. It also covered the life cycle of a financial instrument – from initial measurement, subsequent valuation, to eventual derecognition – in the accounting books. IAS 39 also prescribed the accounting treatments for financial instruments from the point of view of both the holder (investment assets) and the issuer (financial liabilities). Thus, the extent of the coverage of IAS 39 and the complexities of its provisions made it one of the most difficult and controversial of the IAS and International Financial Reporting Standards (IFRS) that were adopted in the Philippines in 2005.

Similar to the rest of the world, in the Philippines, the strongest impact of IAS 39 was on the banking sector. According to the Bangko Sentral ng Pilipinas (BSP), the Philippine banking system as of year-end 2005 held total assets valued at P4.3 trillion[3], P3.6 trillion or 83% of which were in some form of financial

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instrument. Financial liabilities as of the same period amounted to P3.5 trillion. In total, financial instruments with a book value of P7.1 trillion, held or issued by commercial banks, were subject to the provisions of IAS 39[4]. Due to this magnitude, the determination of the effects of this standard on the financial position and performance of banks is warranted. Bank regulators and the users of banks' financial statements need also to be informed of the degree of compliance by banks with the provisions of IAS 39.

II. OBJECTIVES AND METHODOLOGY OF THE STUDY

This paper documents the effects on the financial position and results of operations of banks of the first time adoption of IAS 39. Publicly issued financial statements of banks were analyzed to meet this objective.

IAS 39 became effective in the Philippines in 2005. The transition provision of the standard required the retroactive application of some of its provisions. Retroactive application means that comparative historical information presented with the 2005 financial statements should also be in accordance with IAS 39. Net adjustments from remeasurement of affected accounts are required to be charged to opening retained earnings.

The Philippine Securities and Exchange Commission (SEC), however, gave reporting entities under its jurisdiction a relief from the retrospective application of IAS 39[5]. Instead of a restatement of their 2004 figures, entities were required to present, in the notes to the financial statements, a reconciliation of the December 31, 2004 ending balances with the January 1, 2005 beginning balances of accounts affected by the adoption of IAS 39. The December 31, 2004 financial statements were prepared under the accounting principles superseded by IAS 39 (see Appendix B). The January 1, 2005 beginning balances were required to be measured based on IAS 39 provisions.

All banks covered in this study took advantage of the relief offered by the SEC. Their reconciliation disclosures were used to isolate and reconstruct the effects of IAS 39 on their total assets, liabilities and stockholder's equity at the time of their adoption of this standard.

This study also documents the degree of compliance by banks with the provisions of IAS 39. This required a review of the banks' financial statements[6], with particular attention to the following accounts[7]:

1. Loans and receivables
2. Trading accounts securities / financial assets and financial liabilities at fair value through profit or loss
3. Available for sale investments
4. Held to maturity investments
5. Derivatives

III. BANKS INCLUDED IN THE STUDY

Universal banks dominate the Philippine banking industry. As reported by the Bangko Sentral ng Pilipinas (BSP), universal banks had assets of P3.2 trillion[8] as of December 31, 2005. This is 74% of the P4.3 trillion assets of the entire banking system. Moreover, universal banks contributed P102.3 billion[9] (69%) of the P148.8 billion net interest income generated by the banking system in 2005.

The universal banking system of the Philippines in 2005 was composed of three government banks, three branches of foreign banks and eleven[10] private local banks. The 11 private local banks were initially targeted as the sample for the study. Due primarily to the insufficiency of information in the financial statements of five banks in order to accomplish the objective of the review, the sample was eventually reduced to the six banks presented in Table 1.

Table 1
List of Banks Covered in the Study with their Respective External Auditors

Name of Banks	Code	External Auditor	Opinion
Allied Banking Corporation	ABC	SGV & Co.	Unqualified with reliance on other auditors
Bank of the Philippine Islands	BPI	Isla Lipana & Co.	Unqualified
Equitable PCI Bank	EPCI	SGV & Co.	Unqualified
Metrobank and Trust Company	MBTC	SGV & Co.	Unqualified with reliance on other auditors
Philippine National Bank	PNB	SGV & Co.	Qualified
Union Bank of the Philippines	UBP	SGV & Co.	Unqualified

The banks in the sample controlled P1.7 trillion (53%) of the P3.2 trillion assets of the universal banking system (Table 2). Moreover, the six banks earned P50.1 billion (49%) of the P102.3 billion in net interest income generated by the universal banks in 2005.

Table 2
Total Assets of Sampled Banks

Name of Banks	Total Assets*	Industry Rank**
Allied Banking Corporation	121.11	10
Bank of the Philippine Islands	428.95	2
Equitable PCI Bank	303.62	3
Metrobank and Trust Company	492.69	1
Philippine National Bank	221.90	5
Union Bank of the Philippines	106.98	13
Total	**1,675.25**	

** As of December 31, 2005 (P in billions)*
*** Ranking is based on total assets as of December 31, 2005*

IV. REVIEW OF RELATED LITERATURE

In 1997, Cayanan and Valderrama reviewed the compliance of 132 companies' financial statements for the period 1991 to 1995 with generally accepted accounting principles (GAAP) and found at least one instance of non-compliance in all the financial statements in their study. All of the financial statements were given an unqualified opinion by the companies' external auditors. The study also observed two kinds of non-compliance: error of omission and error of commission. Error of omission refers to inadequate disclosures while error of commission refers to accounting treatments contrary to existing GAAP.

Agustin (2003) updated the 1997 compliance study by Cayanan and Valderrama and reviewed 239 financial statements for the period 2001 to 2002. She found that only 7% or 17 financial statements were in compliance with all the provisions of existing Statement of Financial Accounting Standards (SFAS). The remaining 93% or 222 financial statements were found to have had violated at least one provision of the SFAS. The most prevalent violation was lack of required disclosures. In spite of the low percentage of full compliance, the study found that SFAS compliance actually improved from 2001 to 2002. Cases of violations decreased from 510 in 2001 to 314 in 2002.

Echanis (2002) summarized problems in financial reporting in the Philippines into four: 1) weak monitoring by regulatory agencies; 2) active attempts by reporting firms to influence external auditors; 3) inconsistent application of GAAP by external auditors; and 4) lack of detail in SFAS issued by ASC.

Cayanan (2004) assessed the financial reporting practices of listed Philippine banks against existing financial reporting standards. His study found the following violations: 1) questionable accounting policies which led to overstatement of reported net income; 2) lack of adequate disclosures on guarantees and segment information; and 3) non-presentation of amounts expected to be received and due within a year in an unclassified balance sheet.

V. FINDINGS

The main findings of this study are presented in two sections. We first discuss the effects of the first time adoption of IAS 39 by the banks on their reported financial position and results of operations. The observed effects are grouped into three categories; namely, recognition of previously unrecognized assets and liabilities, remeasurement of existing assets and liabilities, and reclassifications within the financial statements.

The findings regarding the degree of compliance by banks with IAS 39 are presented in the second section.

Findings on Effect of IAS 39 Adoption on Banks' Financial Position and Results of Operations

The overall effect of the adoption of IAS 39 on the financial position of the sampled banks as of January 1, 2005 is shown in Table 3. As can be seen in the table, IAS adoption resulted in a decrease of almost P15 billion in the reported assets of the banks, an increase of P650 million in their liabilities, and a decrease in their equity of P15.33 billion. These consequences came mostly from the recognition and measurement requirements of the standard, which are explained in greater detail below.

Table 3
Effect of IAS 39 Adoption on
Sampled Banks' Financial Position as of Jan 1. 2005[11] (P in billions)

	Remeasurement	Recognition and Bifurcation of Embedded Derivatives	Total
Assets	(14.25)	(0.43)	(14.68)
Liabilities	(0.10)	0.75	0.65
Capital	(14.15)	(1.18)	(15.33)

Recognition of Previously Unrecognized Assets and Liabilities

Accounting for derivatives is unique to IAS 39. The standard covered the accounting for both stand-alone and embedded derivatives. Under specific criteria, embedded derivatives are bifurcated from the host contract and accounted for separately. Derivatives not designated as hedging instruments are required by the standard to be recognized as Financial Assets or Liabilities at Fair Value through Profit or Loss (FVTPL) on trade date or contract date. Compliance with this requirement resulted in the sampled banks recognizing liabilities from their embedded derivatives of P753 million. Also, marked to market valuation of derivatives resulted in a decline in assets of P430 million. Consequently, there was also a net downward adjustment to the banks' opening capital of P1.18 billion.

Remeasurement of Existing Assets and Liabilities

Remeasurement adjustments resulted in a net decrease in opening retained earnings of P15 billion. There are three kinds of remeasurement adjustments: mark to market valuation, effective interest amortization and impairment losses. Valuation on balance sheet date based on IAS 39 is dependent on the classification of the financial instruments. Financial Assets and Liabilities at FVTPL and Available for Sale (AFS) securities are recorded at fair market value. Held-to-maturity securities (HTM) and Loans and Receivables are valued at amortized cost.[12] Financial assets are also subject to impairment losses which are recognized when the recoverable value of the asset exceeds its carrying value in the entity's accounting records. Contrary to superseded GAAP, IAS 39 computed impairment using present value concepts.

The bulk of the remeasurement consequences arose from the impairment requirement of IAS 39. Impairment losses of P15 billion from various categories of financial instruments resulted in a decrease in the banks' January 1, 2005 opening retained earnings. Of this, P13.5 billion related to the impairment of the sampled banks' Loans and Receivables. Previous GAAP computed bad debt expense based on management's judgment of the uncollectibility of accounts and BSP rulings[13]. IAS 39, on the other hand, specifically provided that impairment should be computed based on the present value of estimated future cash flows from the financial instruments[14].

Mark to market adjustments resulted in an increase in total assets of roughly P617 million. AFS securities contributed P798 million to the increase in assets but this was reduced by P181 million due to the lower market valuation of financial assets at FVTPL .

P388 million positive adjustments to the opening balance of retained earnings resulted from the use of the effective interest method of premium and discount amortization. While the previous standard encouraged the use of the effective interest method of amortization, use of straight-line amortization was still permitted as long as the difference between the two methods is immaterial. The use of straight-line amortization is no longer permitted by IAS 39.

In summary, the application of the measurement principles of IAS 39 resulted in a decrease in the sampled banks' total assets of P14.25 billion, a decrease in their reported liabilities of P102 million, and a decrease in capital of approximately P14.15 billion.

Reclassification

Reclassification means a change in the specific accounting designation of an asset, liability or capital account. Reclassifications are normally made because revisions in circumstances or management intention regarding particular assets, liabilities, or capital accounts require a change in the latter's accounting status (e.g., from an investment intended to be sold to plant property that will now be used in operations). In the present study, these adjustments were undertaken mainly to comply with the classification principles of IAS 39[15]. These movements did not result in a net change in the banks' reported assets, liabilities and/or equity.

Except for BPI[16], banks in the sample made a two-step reclassification process. The first step was basically to rename some of the accounts used in its December 31, 2004 financial statements in order to comply with IAS 39 classifications. The results are presented in Table 4.

Table 4
Changes in Account Names to Comply with IAS 39

Renamed from	Renamed to
Receivable from customers	Loans and Receivable
Trading account securities	Financial assets at fair value through profit or loss
Available for sale securities	Available for sale investments
Investments in bonds and other debt instruments (IBODI)	Held to maturity investments

The second step of the reclassification process involved the transfer of financial assets from one account to another in order to comply with the definitions of each account classification under IAS. The summary of the second step of the reclassification process is presented in Table 5.

Table 5[17]
Results of Second-step Reclassification Process[18] **(P in billions)**

	Cash	IBLR	FAFVTPL*	AFS	HTM	Loans	Equity Investment	Other Resources	Sub-Debt**	Other Liabilities
Balance, after first-step reclassification	32.34	121.11	23.21	107.89	296.89	614.35	46.09	97.96	35.11	70.73
Transfers:										
Migration-out of HTM			5.96	95.98	(101.94)					
Unquoted securities			(0.08)	(0.28)	(43.04)	43.41				
Other Receivables, i.e. Interest Receivable, Accounts Receivable and Sales Contract Receivable						41.40		(41.40)		
Quoted securities		(8.46)	8.46							
Equity investments available for sale				5.23			(1.46)	(3.77)		
Foreign currency bills and deposits and other cash items	4.51							(4.51)		
Advances to affiliates and subsidiaries							0.86	(0.86)		
Others reclassifications due to changes in definition			0.16	(0.16)		(0.05)		(0.05)	(0.05)	(0.05)
Balance, before remeasurement	36.85	112.66	37.71	208.66	151.91	699.10	45.50	47.36	35.06	70.67

* *Includes Trading Account Securities of BPI*
***Subordinated Debt*

Apparent in Table 5 is the P102 billion HTM investments that were moved to AFS and Financial Assets at FVTPL. Considering that HTM investments under IAS 39 are of the same nature as IBODI in the superseded GAAP, this migration is likely a consequence of new rules introduced in IAS 39. Previous GAAP and IAS 39 are similar in that financial instruments may be classified as HTM / IBODI if management has positive intent and the financial ability to hold the instruments to their maturity. However, the significant difference between the two sets of rules is the tainting rule under IAS 39 that provides that sale or reclassification of HTM instruments will prohibit the entity from using the HTM classification for two years.[19]

IAS 39 provides that only financial instruments that are quoted in an active market can be classified as Financial Assets or Liabilities at FVTPL, AFS and HTM. Financial instruments without quoted market prices are classified as loans and receivables (see Appendix A). As a result of these definitions, P43.4 billion of unquoted instruments were moved into Loans and Receivables from HTM, AFS, and financial assets at FVTPL. On the other hand, P8.5 billion of quoted debt securities that were previously classified as Interbank Loan and Receivable were moved to Financial Assets at FVTPL.

Interest Receivable, Sales Contract Receivable, Accounts Receivable and Other Receivables were grouped as Other Resources under the old accounting standards. Provisions of IAS 39 allow these receivables to be classified as Loans and Receivables. As a consequence of this definition, P41.4 billion was moved to Loans and Receivables from Other Resources.

P4.5 billion was transferred into Cash from Other Resources. This represented foreign currency cash on hand, foreign currency deposit accounts, checks and other miscellaneous cash items previously classified as Other Resources.

Other Observations: Non-Application of Hedge Accounting

Hedge accounting allows an entity to manage fair value and cash flow risk by recognizing the offsetting effects on profit or loss of changes in fair values of the hedging instrument and hedged item (see Appendix A). Thorough documentation is required in order to qualify for hedge accounting. At the inception of the hedge, an entity should appropriately identify the hedging relationship, hedged item, hedging instrument, hedged risk, method of determining hedging effectiveness, and the entity's risk management objective and strategy.

All banks in the sample disclosed that they used derivatives for two reasons: 1) to support the needs of their clients; and 2) for risk-hedging operations as part of their risk management strategies. However, both stand-alone and bifurcated derivatives were classified as "held for trading". None of the banks opted to use hedge accounting for their 2005 financial statements. Given that hedging was explicitly identified as a reason for banks derivative transactions, it is surprising that none of them opted to use hedge accounting in their 2005 financial statements.

Findings on Compliance by Banks with IAS 39 Provisions

This study found the following cases of non-compliance with IAS 39:

1. Non-reporting of the tax effects of equity adjustments due to IAS 39 compliance. Surplus or retained earnings represent the accumulated and undistributed *after-tax* income of an entity. Any correction of prior-period net income for errors or changes in accounting policies should be adjusted to the beginning balance of retained earnings instead of to current income. Such adjustments to retained earnings should be net of tax. The tax effects of retained earnings adjustments, if any, should be recognized by the entity as additional income tax payables, deferred tax assets and/or deferred tax liabilities.

   Moreover, IAS 12 (Income Taxes) states that fair value adjustments on Available-for-Sale investments may give rise to a deferred tax liability or a deferred tax asset.

   Aside from BPI, it was observed that adjustments made by the remaining sample banks to the beginning balances of surplus were not net of tax effects. In their income tax disclosures, these banks noted that management opted not to recognize deferred tax assets on certain impairment losses because management deemed that the bank will not be able to use these tax benefits. However, surplus adjustments are not entirely composed of impairment losses. They also include mark to market gains and effective interest amortization that may give rise to a deferred tax liability or additional income taxes payable.

   Of the banks in the sample, only MBTC reported a mark to market gain on its adjustments to opening surplus as of January 1, 2005. The mark to market increase in Financial Assets at FVTPL of P92.8 million reported by MBTC was equally reflected as an adjustment to surplus. Hence, this adjustment to surplus was overstated by about P32 million[20] representing MBTC's deferred tax liability. While companies have the option not to recognize a deferred tax asset if management is of the opinion that the tax benefit will not be realized, such is not available for recognizing a deferred tax liability.

   Four of the six sampled banks also reported positive fair value adjustments in relation to their Available-for-Sale (AFS) investments. There were no corresponding adjustments made to deferred tax liability for the income tax effects of these adjustments. The four banks, MBTC, PNB, Union Bank and EPCI, reported an aggregate increase of P1.7 billion in their Net Unrealized Gain or Loss on AFS equity account. The non-recognition of the tax effects of these adjustments resulted in the overstatement of these banks' capital by roughly P600 million[21].

2. Lack of disclosure and inappropriate presentation of derivatives in the financial statements.

   It was observed that derivatives were presented differently by the sampled banks. PNB, BPI and EPCI reported positive fair value derivatives of P723.4 million[22] as part of miscellaneous items in Other Resources.

ABC and UB reported an aggregate of P920.7 million of positive fair value derivatives as Financial Assets at FVTPL. Based on Note 5 (Fair Value Measurement) in MBTC's Notes to Financial Statements, the Bank reported derivatives with positive fair value of P192.6 million. However, MBTC did not disclose in which of its balance sheet accounts the derivatives were included.

According to IAS 39, derivatives held for trading are classified as financial assets / financial liabilities at FVTPL. PNB and EPCI used the account name Financial Assets at FVTPL on its balance sheet. Therefore, it is misleading to users that derivative assets were not reported as part of this account in these banks' balance sheets. Derivative assets of PNB (P511.8 million) and EPCI (P138.6 million) should thus be reclassified from Other Resources to Financial Assets at FVTPL.

Except for MBTC, the five sample banks appropriately reported derivatives with negative fair values as part of Other Liabilities. MBTC did not disclose in which of its balance sheet accounts the negative fair value derivatives of the bank were included.

VI. AREA FOR FUTURE STUDY

A topic for future study concerns the derecognition of financial assets. IAS 39 prescribes that financial assets be derecognized when: 1) the contractual rights to the cash flows from the asset expire, or 2) the entity transfers substantially all the risk and rewards of ownership of the asset, or 3) the entity transfers the asset, while retaining some of the risks and rewards of ownership, but no longer has control of the asset. The transition provision, further states that, an entity shall apply the derecognition requirements of IAS 39 prospectively. Accordingly, if an entity derecognized financial assets under previous GAAP as a result of a transaction that occurred before 1 January 2004 and those assets would not have been derecognized under this Standard, it shall not recognize those assets[23].

Prior to January 1, 2005, some banks, pursuant to Republic Act No. 9182 and BSP Resolution No. 135, transferred non-performing loans (NPL) to special purpose entities (SPE). The NPLs were taken out of the books of the selling banks based on the GAAP existing then. However, some of these transfers may not have qualified for derecognition based on the risk-reward criteria of IAS 39. Instead of full derecognition, IAS 39 would have required the recognition of a continuing involvement liability for the transferred assets when, for example, buyers have recourse to the seller in the case of default. Under previous GAAP, a recourse provision would have merited only a disclosure of the contingent liability in the notes to the financial statements.

Further investigation of this issue is necessary in order to determine whether or not there are significant off-balance sheet liabilities of banks at present that would have been required to be explicitly recognized as liabilities in their financial statements had the transfer to an SPE happened under the IAS 39 regime.

VII. CONCLUSION

IAS 39 is a strict accounting standard that provides rules for the recognition, measurement, and valuation of financial assets as well as penalties for non-compliance. Nevertheless, the success with which IAS 39 improves on the reporting of financial instruments by banks rests on the reporting entities as well as on their auditors and regulators. The challenge with auditors and regulatory bodies is to ensure that banks abide by the provisions of IAS 39 in order to prevent manipulation of earnings and financial position through the use of opaque valuation methods and/or the deliberate misclassification of financial instruments.

Of concern in the application of IAS 39 is the fact that the Philippines does not have well-developed financial markets that can readily quote the fair values required by IAS 39 for many types of financial instruments. Such readily available quotes provide the transparency and objectivity needed by users of the financial statements. However, in the Philippine setting, banks rely more on their own valuation models in order to satisfy the measurement requirements of IAS 39, especially for derivatives.

Implementation of accounting standards does not end with the preparers of financial statements. As noted in Echanis (2002), weak monitoring by regulatory agencies contributes to the problems in financial reporting in the Philippines. Regulators and auditors should be equipped with the skills necessary to appropriately evaluate compliance with the provisions of the standards. Valuation is the most critical aspect of IAS 39. Regulators and auditors must be competent in the evaluation of the appropriateness of valuation models and the input variables used by banks in these models to value their financial instruments.

IAS 39 aims to capture and appropriately convey to readers of financial statements the true economic essence of transactions involving financial instruments. It is also meant to provide appropriate guidance to the preparers of financial statements so that similar transactions are subject to common accounting principles These laudable objectives, however, will not be met if IAS 39 is not appropriately implemented.

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APPENDIX A
Glossary of Terms[24]

Terminology	Definition
Amortized cost of a financial asset or financial liability	This is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.
Available-for-sale financial assets (AFS)	Non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
Derecognition	The removal of a previously recognized financial asset or financial liability from an entity's balance sheet.
Derivative	A financial instrument or other contract, within the scope of IAS 39, with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'); (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
Effective interest method	The method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

Glossary of Terms

Terminology	Definition
Effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Financial asset or financial liability at fair value through profit or loss (FVTPL)	A financial asset or financial liability that meets either of the following conditions: (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is: (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or (iii) a derivative (except for a derivative that is a designated and effective hedging instrument). (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. Any financial asset or financial liability within the scope IAS 39 may be designated when initially recognized as a financial asset or financial liability at fair value through profit or loss except for investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured.
Hedging instrument	A designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated nonderivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Appendix A (cont'd)

Glossary of Terms

Terminology	Definition
Hedged item	An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.
Held-to-maturity investments (HTM)	Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than: (a) those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity designates as available for sale; and (c) those that meet the definition of loans and receivables.
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale. An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

APPENDIX B
Accounting for Financial Instruments: IAS 39 versus SFAS 19/19A[25]

IAS 39	SFAS 19 / 19A	Major Impact on FS
	Loans and Receivables	
Loans and receivables are initially recorded at fair value plus transaction cost[26]. It is subsequently measured at amortized cost using the effective interest method[27]. Impairment loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding credit losses that have not been incurred) discounted at the original effective interest rate. The carrying amount of the asset shall be reduced directly or through the use of an allowance account. The amount of loss shall be recognized in profit or loss[28]. Impairment losses recognized in prior periods may be reversed if the decrease is related to an event occurring after impairment was recognized. However, the increase in the carrying value of the asset due to the reversal may not exceed what the amortized cost would have been had the impairment not been recognized at the date the impairment was reversed. The amount of reversal shall be recognized in profit or loss[29]. Recognition of interest income is not suspended for loans and receivables measured at impaired value.	SFAS 19 Loans are valued at the outstanding balance at which they are to be collected. This amount is reduced by an estimated allowance for loan losses, which amount is necessary to state the carrying amount of loans at net realizable value[30]. The allowance for loan losses should be determined after a qualitative review of the collectibility of loans based on the net realizable value of the collateral, credit history, industry trends, the borrower' financial abilities, financial responsibility of guarantors, and other factors.[31] Recognition of periodic interest income is suspended for non-accruing loans. Loans are classified as non-accruing when there are indications that collectibility of the loan is doubtful.[32]	Impact on the financial statements will result from the following: (1) Change from straight-line to effective interest method of amortization. (2) Recognition of additional impairment losses.

Appendix B (cont'd)

Accounting for Financial Instruments: IAS 39 versus SFAS 19/19A

IAS 39	SFAS 19 / 19A	Major Impact on FS
Investment Accounts – Trading Account Securities		
Trading account securities are classified under Financial Assets at Fair Value Through Profit or Loss. Classification is based on management's intention on the date of acquisition. Transfer in and out of this class is prohibited by this standard.	SFAS 19A allows for securities to be reclassified to and from this account. Specific guidelines are provided by the standard for the accounting of the transfers.	Transition provisions allowed final reclassification within the various investment accounts. As a result, those transferred into FAFVTPL recognized effects of marked to market valuation in Surplus.
Investment Accounts – Held to Maturity (HTM)		
Held to maturity (HTM) investments shall be measured at amortized cost using the effective interest method. The standard did not mention any other acceptable method of amortization or accretion. The tainting provision prohibits the sale or reclassification of HTM securities. Such actions by management, whether from change in intention or ability, will render the entity disallowed from using the HTM classification for two years[33].	Classified as Investment in Bonds and Other Debt Instruments. The effective interest method is the prescribed method to be used in amortizing premiums or discounts. However, the straight-line or other methods of amortization or accretion may be used if the results obtained do not vary materially from those that would be obtained through the use of effective interest method.	Major impact on the financial statements include: (1) Reclassification of some investment to available for sale financial assets. (2) Change in amortization method from straight-line method to effective interest method. (3) Recognition of impairment losses.
Financial Liabilities		
IAS 39 requires liability to be measured at amortized cost using the effective interest method except for financial liability at fair value through profit or loss, financial guarantee contracts, commitments to provide a loan at below-market rates and financial liabilities that arise when a transfer of assets does not qualify for derecognition or continuing involvement approach applies[34].	SFAS 19 states that deposit liabilities are generally stated at face value of principal. When interest for time deposits have been prepaid, the liability on the principal is still shown at gross, and the prepaid interest will be included as part of "Other Resources". Other liabilities such as interbank loans payable, bills payable, due to BSP, due to other banks and outstanding acceptances are stated at either face value or the amount in which they are to be paid[35].	There will be no significant impact on the financial statements for short term liabilities because the time value effect of money is deemed immaterial. However, the effect of present value computation will have significant effects on the valuation of long term liabilities.

APPENDIX C
List of New Transactions Covered by IAS 39

IAS 39	Major impact on FS
Derecognition of Financial Assets **Sale of loans and receivable** **Securitization – Issuance of pass-through securities**	
A financial institution may opt to cash in on their existing loans and receivables before maturity through outright sale of receivable or through more creative securitization of receivables. Securitization involves issuing financial instruments that essentially transfers the issuer's claims to specific cash flows to the holder of the security. The resulting securities may take some form of pass-through security such as mortgage-backed notes, asset-backed securities, credit-linked notes or collateralized debt obligation. If the issuing entity already surrendered its claim to the cash flows, should the issuing entity derecognize the assets in its books or instead recognize a liability for the proceeds of the issuance of the pass-through securities? According to IAS 39, financial assets shall be derecognized if the contractual claim to the cash flows from the financial asset expires. If the financial asset or contractual claim to the cash flow is transferred, the asset may be derecognized only if the entity was able to fully transfer all the risk and rewards of ownership of the financial asset, otherwise, the entity accounts for both the financial assets and the issued liability separately in its books[36].	Republic Act No. 9182 and BSP Resolution No. 135 allowed the transfer of NPL to Special Purpose Vehicle. These transfers were accounted for as derecognition of assets. Some of the transfers do not substantially transfer all the risk and rewards of the asset to the transferee that will merit derecognition. However, IAS 39 allowed entities not to re-recognize assets derecognized prior to the effectivity of IAS 39 on January 1, 2005.
Hybrid Instruments[37]	
A hybrid instrument is one that is composed of a non-derivative host contract and an embedded derivative, the effect of which is that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. Accounting for hybrid instrument requires that the embedded derivative and the host contract be separated if (1) the economic characteristics and risk of the embedded derivative are not closely related to that of the host contract and (2) a separate instrument as the embedded derivative would meet the definition of a derivative. Upon separation, the embedded derivative is classified as fair value through profit or loss while the host contract may be accounted for as AFS, HTM and Loans and Receivable. The issuer and the holder of a hybrid instrument also have the option of not separating the embedded derivative from the host contract and instead account for the whole instrument as fair value through profit or loss.	This will have a major effect on bank's financial statements. In recent years, banks were very creative in packaging various forms of investment instrument that may include an embedded derivative. Banks also need to look on their existing loan portfolio to determine whether existing contracts and traditional products include embedded derivative such as prepayment options and automatic grace periods. Credit line facilities with fixed interest rates offered by banks may contain embedded option on a forward rate agreement. In this case, the banks need to account for the host contract separately from the embedded derivative.

Appendix C (cont'd)

List of New Classifications and Transactions Covered by IAS 39 (cont)

IAS 39	Major impact on FS
Derivatives[38]	
A derivative is a financial instrument that (1) changes in value in response to the changes in a specified underlying condition such as interest rates, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable; (2) requires no net initial investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (3) settled at a future date. Derivatives are classified as financial assets or liabilities through profit or loss unless otherwise the derivative is a financial guarantee contract or is a designated hedging instrument in a hedging relationship that qualifies for hedge accounting.	Prior to IAS 39, there was no definitive GAAP on derivatives. Some follows the FASB 133 (Financial Accounting Standards Board - United Stated GAAP). IAS 39 requires that derivatives be recognized in the books on trade date (contract date) and re-valued at fair market value on balance sheet date. The effect of the change in fair market value is reported in the income statement if the derivative is classified as "fair value through profit or loss" or a designated hedging instrument in a fair value hedge. If used as a hedging instrument in a cash flow hedge, the effect of change in fair market value is reported as separate line in the equity section of the balance sheet.
Financial Liabilities at Fair Market Value Through Profit or Loss	
Financial liabilities held for trading include (a) derivative liabilities that are not accounted for as a hedging instrument; (b) obligation to deliver financial assets borrowed by a short seller; (c) financial liabilities that are incurred with an intention to repurchase them in the near term; (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.	Effects of changes in fair market value of the liabilities are reported in the income statement.

NOTES

[1] IAS 39 Basis for conclusion, BC5

[2] IAS 39 Basis for conclusion, BC7

[3]Consolidated Financial Position, Philippine Banking System, December 31, 2005 www.bsp.gov.ph/banking/pbs_archives/2005/table17a.htm

[4]Consolidated Results of Operations, Philippine Banking System, December 31, 2005 www.bsp.gov.ph/banking/pbs_archives/2005/table17a.htm

[5] SEC Memorandum 19 Series of 2004

[6] Given the focus of this study, only parent company (not consolidated) financial statements were evaluated.

[7] See Appendix A for the definitions of terms used in this study.

[8] Consolidated Financial Position, Universal Banks, December 31, 2005 www.bsp.gov.ph/banking/pbs_archives/2005/table17a.htm

[9] Consolidated Results of Operations, Universal Banks, December 31, 2005 www.bsp.gov.ph/banking/pbs_archives/2005/table17a.htm

[10] Two universal banks, Banco de Oro and Equitable PCI bank, merged in 2007. Because the study will cover the year 2005, financial statements of Banco de Oro and Equitable PCI were still analyzed separately.

[11] Figures enclosed in parentheses indicate a decrease.

[12] Refer to Appendix B and C for a summary of the main accounting rules embodied in IAS 39.

[13] Previous GAAP estimated Allowance for Doubtful Accounts and Bad Debts Expense using Percentage of Loans, Aging of Receivables and Percentage of Sales.

[14]IAS 39, paragraph 63. If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in profit or loss.

[15] IAS 39 prescribes the following classifications for financial assets and liabilities: (1) Financial Assets or Liabilities at FVTPL, (2) Available for Sale Investments, (3) Held to Maturity Investments, and (4) Loans and Receivables.

[16] BPI did not use the account title financial assets at FVTPL. Instead, BPI used the title Trading Account Securities and separately disclosed the definition and valuation policy of this account. This practice is not in violation of IAS 39. On the other hand, the account title Held to Maturity Investment was in use prior to January 1, 2005.

[17] Figures enclosed in parentheses indicate a transfer out.

[18] In order to isolate the impact of reclassification from that of remeasurement, the transfers were analyzed using their carrying values based on previous GAAP.

[19] IAS 39, paragraph 9. An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held to maturity investments) other than sales or reclassifications that:

(i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;

(ii) occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or

(iii) are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

[20] Computed based on Regular Corporate Income Tax rate of 35%.

[21] Computed based on Regular Corporate Income Tax rate of 35%.

[22] Total positive fair value derivatives reported by banks as of December 31, 2005.

[23] IAS 39, Paragraph 107
[24] Definitions are from IAS 39, paragraph 9
[25] SFAS 19 A (Accounting for Investments in Debt and Marketable Equity Securities of Banks) and SFAS 19 (Summary of Generally Accepted Accounting Principles for the Banking Industry) are the rules superseded by IAS 39 for the banking industry in the Philippines.
[26] IAS 39, paragraph 43
[27] IAS 39, paragraph 46
[28] IAS 39 paragraph 63
[29] IAS 39, paragraph 65
[30] SFAS 19A paragraph 4
[31] SFAS 19A paragraph 5
[32] SFAS 19A paragraph 10
[33] IAS 39 paragraph 9
[34] IAS 39 paragraph 47
[35] SFAS 19
[36] IAS 39, paragraphs 15 - 37
[37] IAS 39, paragraphs 10 - 13
[38] IAS 39, paragraph 9