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TECHNICAL ASSISTANCE  
PROGRAMME

**REVIEW OF POLISH AND INTERNATIONAL  
ACCOUNTING STANDARDS IN SCOPE OF  
FINANCIAL INSTRUMENTS**



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# 1. COMPARISON OF ACCOUNTING PROVISIONS IN SCOPE OF FINANCIAL INSTRUMENTS IN POLAND

## 1.1. The Accounting Act of September 29, 1994

### 1.1.1. The Accounting Act of September 29, 1994

The Accounting Act of September 29, 1994 (as amended), is the main piece of legislation regulating accounting principles in Poland. The Act sets forth principles governing, *inter alia*:

- accounting,
- keeping the books of account,
- stocktaking,
- measurement of assets, liabilities, and determination of financial result,
- business combinations,
- preparation of separate and consolidated financial statements,
- audit, submission to a relevant court register, and publication of financial statements,
- data protection,
- bookkeeping services,
- penal liability.

Pursuant to Article 2 of the Act, the provisions of Accounting Act apply to the following entities whose registered office or place of executive management is located in the territory of the Republic of Poland:

- commercial companies, civil partnerships and other legal persons, except for the State Treasury and the National Bank of Poland,
- natural persons, civil partnerships established by natural persons, general partnerships established by natural persons, professional partnerships and social cooperatives, if their net revenue from the sales of goods, products and financial transactions for the prior financial year amounted to at least the Polish zloty equivalent of EUR 1,200,000,
- business units which operate pursuant to the Banking Law and the regulations on:
  - trading in securities,
  - mutual funds,
  - insurance and reinsurance,
  - credit unions,

- organization and operation of pension funds,
- municipalities, districts, regions and their associations, as well as:
  - state, municipal, district and regional budgetary entities,
  - municipal, district and regional budgetary establishments,
  - special purpose state funds,
- business units without the status of a legal person, except for partnerships referred to in points 1 and 2,
- foreign persons, foreign branches and offices in the meaning of the provisions of the Act on the Freedom of Economic Activity,
- entities not mentioned above, if they receive subsidies or subventions from the state budget, budgets of local authorities or special purpose funds in connection with the assignments commissioned to them – from the beginning of the financial year in which such subsidies or subventions were granted.

Natural persons, civil partnerships established by natural persons, general partnerships established by natural persons and professional partnerships may apply accounting principles specified in the Act from the beginning of the following financial year, if their net revenue from the sales of goods, products and financial transactions for the prior financial year is less than the Polish zloty equivalent of EUR 1,200,000, provided that they have notified the relevant tax office.

### 1.1.2. International Accounting Standards in Poland

On May 1, 2004, when Poland joined the European Union, Poland also accepted the responsibilities prescribed under the EU law, including those prescribed in the Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards. Pursuant to Article 4 of the Regulation, for each financial year starting on or after 1 January 2005, companies governed by the law of a Member State must prepare their consolidated accounts in conformity with the international accounting standards adopted by the EU (hereinafter: 'IAS'), if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State. Under Article 5 of the Regulation No 1606/2002, Member States may permit or require that other entities should also prepare their separate or consolidated accounts in compliance with IAS.

On August 27, 2004, amendments to the Accounting Act were adopted, effective as of January 1, 2005, with the purpose to harmonize applicable provisions with the wording of the Regulation No 1606/2002. Pursuant to Article 55, paragraph 5 of the Accounting Act, the obligation to prepare IAS-compliant consolidated financial statements is applicable to companies whose securities are admitted to trading on a regulated market of any Member

State. In Poland this obligation has been extended and it also applies to consolidated bank statements.

Based on Article 5 of the Regulation No 1606/2002, the Accounting Act admits the application of IAS in preparation of consolidated financial statements of:

- issuers of securities intending to file for admission to or issuers of securities pending admission to trading on one of the regulated markets of the European Economic Area (EU, Iceland, Liechtenstein, Norway) (Article 55, paragraph 6);
- entities being part of a capital group where a higher-level parent company prepares consolidated financial statements under IAS.

A decision on the preparation of IAS-compliant consolidated financial statements is taken by an approving body of the parent company (Article 55, paragraph 8). With the exception of banks, the approving body may also decide to stop using IAS in the preparation of consolidated financial statements when the circumstances which enabled the application of IAS are no longer in effect (Article 55, paragraph 9).

Separate financial statements compliant with IAS may be prepared in Poland solely and exclusively by:

- issuers of securities admitted to trading on one of the regulated markets of the European Economic Area,
- issuers of securities intending to file for admission to trading on one of the regulated markets of the European Economic Area (Article 45, paragraph 1a),
- entities being part of a capital group where a higher-level parent company prepares financial statements under IAS (Article 45, paragraph 1b).

A decision on the preparation of IAS-compliant separate financial statements and on discontinuing IAS application when the circumstances which enabled the application of IAS are no longer in effect is taken by an approving body of the parent company (Article 405, paragraphs 1c and 1d). Further, under the Accounting Act, the branches of a foreign entrepreneur who is using IAS are allowed to prepare their financial statements in accordance with IAS (Article 45, paragraph 1e).

As prescribed in Article 3 of the Accounting Act, International Accounting Standards (IAS) are defined as the following items, published as European Commission regulations:

- International Accounting Standards,
- International Financial Reporting Standards,
- related interpretations (interpretations of the Standing Interpretations Committee – SIC, and the Committee on International Financial Reporting Interpretations - IFRIC).

Until December 31, 2013, IAS applicable in the European Union and governing the principles of accounting for financial instruments included the following items:

- **IAS 32** *Financial Instruments: Presentation*,
- **IAS 39** *Financial Instruments: Recognition and Measurement*,
- **IFRS 7** *Financial Instruments: Disclosures*,
- **IFRIC 9** *Reassessment of Embedded Derivatives*,
- **IFRIC 16** *Hedges of a Net Investment in a Foreign Operation*,
- **IFRIC 19** *Extinguishing Financial Liabilities with Equity Instruments*.

IFRS 9: *Financial Instruments*, which will replace IAS 39, was not endorsed in the form of a regulation by the European Union, even though two of the three phases of the project have been completed and announced by International Accounting Standards Board (IASB) (Phase 1 – *Classification and Measurement of Financial Assets and Financial Liabilities*, and Phase 3 – *Hedge Accounting*), so it cannot be applied by entities that prepare financial statements in accordance with IAS pursuant to EU legislation. IFRS 9 endorsement procedure has been suspended until the final phase of the project is completed and announced by IASB (Phase 2: *Impairment*).

Entities preparing their financial statements in line with IAS, in the scope not regulated by IAS apply the provisions of the Accounting Act.

### 1.1.3. Other provisions pertaining to accounting for financial instruments

As set forth in Article 81, paragraph 2, point 4) of the Accounting Act, the Regulation of the Minister of Finance of December 12, 2001, sets out the detailed rules for recognition, methods of measurement, scope of disclosures, and presentation of financial instruments (hereinafter: Financial Instruments Regulation). In line with the hierarchy of legislative acts in Poland, the provisions specified in Financial Instruments Regulation cannot go beyond, alter or contradict the wording of the Act. Unless it exerts significant negative impact on true and fair presentation of financial situation and financial result, the entities whose financial statements are not subject to mandatory audit in accordance with the Accounting Act are allowed not to apply the provisions of Financial Instruments Regulation (paragraph 2.2 of Financial Instruments Regulation). These entities are defined as such that, in a prior financial year, did not meet at least two of the following three conditions:

- average annual employment exceeding 50 people,
- total assets equivalent to at least EUR 2,500,000,
- net revenues from sales of goods and services and financial transactions equivalent to at least EUR 5,000,000.



All other entities should adhere to the provisions of Financial Instruments Regulation, with the reservation that the entities for which special accounting principles have been defined in accordance with Accounting Act regulations should apply Financial Instruments Regulation in the scope not included in special provisions. This applies to the following entities:

- banks (Article 81, paragraph 2, point 8),
- insurance and reinsurance companies (Article 81, paragraph 2, point 6),
- credit unions (Article 81, paragraph 2, point 8),
- mutual funds (Article 81, paragraph 2, point 1),
- pension funds (Article 81, paragraph 2, point 6),
- brokerage houses (Article 81, paragraph, 2 point 2).

Financial instruments accounting principles resulting from the regulations mentioned above are discussed in subsequent sections of the Report.

#### 1.1.4. Financial instruments accounting principles resulting from the Accounting Act

Detailed principles of accounting for financial instruments have been prescribed in Financial Instruments Regulation, but some general principles in that area have also been outlined in the Accounting Act.

According to Article 3, paragraph 1, point 23 of the Accounting Act, financial instrument is defined as any contract giving rise to financial assets of one entity and a financial liability or an equity instrument of another entity, on condition that the contract concluded by two or more parties clearly results in economic effects, irrespective of whether the execution of contractual rights or obligations is unconditional or conditional.

Financial assets include (Article 3, paragraph 1, point 24):

- monetary assets (assets in the form of domestic currency, foreign currencies and foreign exchange instruments and other financial assets, in particular accrued interest on financial assets (Article 3, paragraph 1, point 25),
- equity instruments issued by other entities,
- contractual right to receive monetary assets or to exchange financial instruments with another entity under favorable conditions.

Financial liabilities are defined as an obligation of an entity to deliver financial assets or to exchange financial instruments with another entity under unfavorable conditions (Article 3, paragraph 1, point 27).

Equity instruments are defined as contracts which give right to assets of an entity which remain after satisfying or securing all its creditors, as well as an obligation of an entity to issue or deliver its own equity instruments, in particular shares, share options or warrants.

The definitions of financial assets and financial liabilities presented in the Accounting Act do not take into account regulations concerning the contracts settled in the entity's own equity instruments. Pursuant to IAS 32, after the 2003 amendments, such contracts are also regarded as financial assets or financial liabilities, provided that they are (IAS 32.11):

- a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments, or
- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

In consequence, according to IAS, the entity's own equity instruments do not include the instruments which represent contracts for future receipt or issuance of entity's own equity instruments. As discussed in the section dedicated to special accounting principles pertaining to mutual funds (Section 1.4.3), the differences between definitions used under IAS and those presented in the Accounting Act may be observed, in particular, in the case of contributions from the shareholders to certain mutual funds, which according to IAS will represent financial liability, and according to Polish regulations will represent the equity of the fund.

Financial assets acquired in order to derive economic benefit resulting from an increase in the value of these assets, generation of income in the form of interest, dividends or other rewards are classified as investments (Article 3, paragraph 1, point 17). International Accounting Standards regulate the issues related to financial instruments accounting principles in separation from other investments. The Accounting Act does not regulate the issue of division of financial instruments into categories depending on the purpose of their acquisition by the entity along the lines presented in IAS 39 and Financial Instruments Regulation. Under the Accounting Act, financial assets are classified either as investments held as fixed assets, or as short-term investments.

Financial assets acquired or created as well as other investments are recognized in the books of account as at their purchase or creation date, at the cost of acquisition or purchase, if the transaction costs are not material (Article 35, paragraph 1).

Investments, including shares in other entities, included in non-current assets (except for real property and intangible assets classified as investments) are measured at the cost of acquisition, less cost of accumulated permanent impairment losses, or at fair value or revalued cost of acquisition (if the asset has a defined maturity date). The cost of acquisition may be revalued to market price (Article 28, paragraph 1, point 3). The effects of the revaluation of investments to their market prices are credited to the revaluation reserve in

equity. A decrease in the value which offsets a surplus for the same investment previously credited to the revaluation reserve in equity and subsequently not cleared as at the measurement date, is debited to the revaluation reserve in equity. In other cases, the effects of a decrease in the value of investments are recognized as financial costs. An increase in the value of a given investment directly related to a previous decrease in the value of the same investment which was recognized as financial expense, is recognized as financial income to the extent to which it offsets the previously recognized financial expense (Article 35, paragraph 4).

Short-term investments are measured at the lower of the market price (value) or the cost of acquisition, or at revalued cost of acquisition if the asset has a defined maturity date, and short-term investments for which there is no active market are measured at their fair value determined in another way (Article 28, paragraph 1, point 5). The effects of an increase or decrease in the value of a short-term investment measured at a market price are recognized as financial income or expense, respectively. If an entity applies short-term investment valuation principles other than those referred to above, the results of the decrease in their value are recognized as financial expense in full, whereas the results of the increase in their value are recognized as financial income in the amount that is not higher than the differences which were previously recognized as financial expense (Article 35, paragraph 1, point 3).

Investments classified as non-current assets are revalued as at the date when they are reclassified to short-term investments (Article 35, paragraph 6):

- at the lower of their carrying amount and the cost of acquisition – if short-term investments are measured at the lower of the market price and the cost of acquisition,
- at their book value – if short-term investments are measured at the market price.

Any surplus on the revaluation recognized in equity is recognized as financial expense or income.

Investments reclassified from short-term to long-term are measured at their reclassification date in accordance with the same rules, but if a short-term investment was measured at its market price, then its value remains unchanged despite reclassification (Article 35, paragraph 7).

Pursuant to the wording of Article 28, paragraph 11, point 2, receivables and liabilities, including loans, are recognized as at their acquisition or creation date at their par value. This provision does not apply to banks.

Receivables and loans, as well as liabilities, are measured at the amount due, with the provision that receivables and loans recognized as financial assets, and financial liabilities, can be measured at revalued cost of acquisition, and if they are held for sale by the entity within 3 months, then at their market value or at the fair value determined in another manner. International Accounting Standards do not distinguish between receivables and loans and

liabilities which are financial instruments and those that are not, thus applying the same measurement approach to all. The discrepancy between IAS and Polish regulations may pertain to, in particular, trade receivables and payables, which are not recognized in financial assets or financial liabilities under the Accounting Act.

Disposal of investments deemed to be the same due to the similarity of their nature and purpose are measured according to the method chosen by the entity, such as:

- average cost,
- FIFO,
- LIFO (approach forbidden under IAS).

According to the provision of Article 35a, paragraph 1 of the Accounting Act, as at the contract date, an issuer of a financial instrument should recognize in its books of account the issued instrument as well as its components, classified as equity instruments in equity, or as part of short-term or long-term liabilities, respectively, even when the liability element does not represent a financial liability. Gains or losses on the revaluation of a financial instrument, as well as income earned or costs incurred in accordance with the classification of a given financial instrument, are recognized in the financial result or the revaluation reserve in equity.

Measurement of hedged assets or liabilities should take into account the value of related hedging instruments and changes in their value if, at least (Article 35a, paragraphs 3 and 4):

- a contract objective was set prior to the contract date, and it was specified which assets or liabilities are to be hedged under the contract,
- the hedging financial instrument and the assets or liabilities that are hedged by such instrument have similar characteristics, in particular a par value, maturity date, sensitivity to interest or foreign exchange rate fluctuations,
- the degree of certainty concerning the expected cash flows due to a contract is significant.

Detailed rules governing measurement of hedged and hedging items are set forth in Financial Instruments Regulation.

## **1.2. Regulation of the Minister of Finance of 12 December 2001 on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments**

Based on statutory delegation under Article 81, paragraph 2, point 4 of the Accounting Act, on December 12, 2001, the Minister of Finance set out, by the way of a Regulation, detailed

principles of recognition, valuation methods, the scope of disclosure and the way of presenting financial instruments (hereinafter: Financial Instruments Regulation). Financial Instruments Regulation came into effect on January 1, 2002 and it is mandatory for all entities, however, with respect to the entities for which special accounting principles were set out by the way of a Regulation (banks, insurance and reinsurance companies, mutual funds, pension funds, brokerage houses, credit unions), it is mandatory only in the scope not regulated under such special provisions.

In consequence of the modification introduced on February 23, 2004, the provisions of Financial Instruments Regulation (paragraph 2.2) are not mandatory for the entities which are not required to have their financial statements audited. Such entities should include in the notes to financial statement the information on (paragraph 2a.2):

- the fair value, type and characteristics of each group of derivatives,
- for long-term financial assets recognized in the carrying amount in excess of the fair value - the carrying amount and the fair value of those financial instruments or their groups, and the reasons for refraining from valuation allowances.

The provisions set forth in Financial Instruments Regulation were developed on the basis of IAS 32 and IAS 39, according to their 2001 version. The Regulation does not take into account the revision of the standards introduced in 2003, and it has not been updated in line with the new versions of IAS 32 and IAS 39. By the same token, the scope of required disclosures concerning financial instruments has not been modified following the publication of a new IFRS 7. IAS 39 amendments which were taken into consideration in Financial Instruments Regulation pertain to the principles governing reclassification of financial instruments, implemented in 2008 in connection with financial crisis.

### 1.2.1. Classification of financial instruments

Pursuant to Financial Instruments Regulation (paragraph 5), financial instruments are classified under the following categories:

- financial assets and financial liabilities held for trading,
- loans and receivables,
- financial assets held to maturity,
- financial assets available for sale.

Financial assets held for trading are classified as financial assets acquired in order to benefit from short-term price changes and fluctuations of other market factors, as well as the short duration of the acquired instrument. This category also includes financial instruments constituting a portfolio of similar financial assets for which there is a high probability that economic benefits will be obtained in the short term (paragraph 6.1). Financial liabilities held

for trading include the obligation to deliver the borrowed securities and other securities in the case of a short sale agreement (paragraph 6.2).

Financial instruments held for trading also include derivatives which were not classified as hedging instruments in the case when the entity applies hedge accounting (paragraph 6.2).

IAS 39.9 introduces a new category of financial instruments – financial assets and financial liabilities measured at fair value through profit or loss. This category includes financial instruments that are held for trading which are defined in a manner similar to the approach presented in Financial Instruments Regulation, but it also includes financial instruments that are designated upon initial recognition as ones to be measured at fair value in profit or loss, if:

- the fair value option designation eliminates or significantly reduces an accounting mismatch arising from measuring assets and liabilities or recognizing the gains and losses on them on different bases,
- a group of financial instruments is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally to the entity's key management personnel,
- it applies to a hybrid contract with embedded derivatives.

Financial Instruments Regulation does not include such fair value measurement option, and this category may only contain financial instruments that meet the definition of FIs held for trading.

The definition of loans and receivables includes financial assets, irrespective of their maturity (payment) date, originating from direct delivery of cash to the other party under the contract (paragraph 7.1). This definition is different from the new definition under IAS 39.9, according to which loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. In consequence, for some financial instruments the classification as per Financial Instruments Regulation may vary from the classification as per IAS. The discrepancy may be visible, for example, in the case of financial assets:

- purchased in the primary market (e.g. treasury bills and bonds),
- acquired from the previous owner (e.g. factoring).

Definition of loans and receivables was also different from the previous version of IAS 39, under which this category included financial assets resulting not only from direct delivery of cash to the other party, but also from direct delivery of goods and services. In consequence of the fact that the scope of the definition was narrowed down, financial instruments



accounting principles specified in Financial Instruments Regulation do not apply to trade settlements, which are governed by the Accounting Act.

Financial assets held to maturity include financial assets not classified as loans and receivables in the case of which par value repayment maturity dates, side by side with the right to obtain economic benefits (e.g. interest) on pre-agreed dates in a fixed or determinable amount, are defined in the contracts, provided that the entity has the intention and the ability to hold these assets until maturity (paragraph 8.1). This category is defined analogically to IAS 39.9. Furthermore, similar principles apply in the case of premature disposal, issuing in exchange for other assets, exercising the option of sale, or reclassification to another category of assets previously classified as held-to-maturity ('tainting'). Under the circumstances, the entity must reclassify all financial instruments from that portfolio to assets available for sale, and in that financial year as well as in two subsequent financial years the entity cannot classify any financial assets as held-to-maturity (paragraph 8.4), with the exception of a situation when the transaction took place close to maturity date, after the date on which 90% of par value was repaid, or due to unforeseeable events beyond entity's control (paragraph 8.5).

Financial assets not classified under any of the categories above are designated as assets available for sale (paragraph 9). Financial Instruments Regulation, in contrast to IAS 39.9, does not allow for direct designation of financial assets in that category on initial recognition.

Financial assets held for trading, with the exception of derivatives, can be reclassified into another category of financial assets if they are no longer held for sale in the short term in the following cases:

- for loans and receivables, provided that the entity has the intention and the ability to hold these assets for the foreseeable future or until they are due (paragraph 6.5),
- for other categories only in exceptional circumstances resulting from a single, extraordinary event which is extremely unlikely to occur again in the future (paragraph 6.4).

The possibility of reclassification of financial assets held for trading was introduced to the wording of Financial Instruments Regulation in 2008, at the same time when these changes were introduced in the IAS 39. It must be noted, however, that even though the wording of Financial Instruments Regulation provision is similar to that in the IAS 39, due to different definitions of loans and receivables category, it may apply to different types of financial instruments. For example, treasury bonds purchased on the primary market may be reclassified as loans and receivables according to Financial Instruments Regulation whereas according to the IAS 39.9 they do not satisfy the definition of loans and receivables because they are quoted in an active market.

Reclassification from other categories to instruments held for trading is not allowed (paragraph 6.3).

Financial instruments held to maturity must be reclassified as available for sale through tainting. If, upon expiry of the grace period, an entity still has the instruments it has the intention and ability to hold to maturity, the entity may reclassify the instruments again (paragraph 8.6).

Under IAS 39.50F, a financial asset classified as available for sale may be reclassified to the loans and receivables if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity. Financial Instruments Regulation does not provide for such a possibility due to the fact that, unlike IAS 39.9, it does not permit designation of financial assets as available-for-sale at initial recognition, and only such financial assets that do not meet the definitions of other categories may be classified as available-for-sale. In particular, they do not meet the definition of loans and receivables, i.e. they cannot be reclassified under that category.

### 1.2.2. Measurement of financial instruments

Financial asset is recognized on contract conclusion date at the cost of acquisition, i.e. at the fair value of expenses incurred or other assets transferred in exchange, and financial liability – at the fair value of the amount earned or the value of other assets received. Transaction costs incurred should be taken into account in fair value determination (paragraph 13.1). According to IAS 39.43, at initial recognition a financial instrument is measured at its fair value plus transaction costs (this does not apply to financial instruments measured at the fair value through profit or loss). In most cases, the cost of acquisition will represent the fair value of the instrument and the initial value under Financial Instruments Regulation will be the same as under IAS 39. Inconsistency may arise in the case of transactions concluded at the value different from the fair value (e.g., intra-group loans with low interest rate). Then, the price at initial recognition in accordance with Financial Instruments Regulation (fair value of the consideration) and in accordance with IAS 39 (fair value of the financial instrument) will not be identical. As prescribed in IAS 39.OS64, the difference between the fair value of the instrument and the fair value of the consideration received or transferred is recognized immediately as income or expense of the first day, unless it can be recognized as another category of assets (e.g. in the case of an intra-group loan as shares in subsidiaries).

Financial assets acquired through transactions effected on the regulated market are recognized in the books of account as at the date of transaction conclusion or settlement (paragraph 4.3).

Financial assets are measured at fair value determined in a reliable manner, except for (paragraph 14):

- loans and receivables not held for sale by the entity,
- financial assets held to maturity,

- financial assets for which there is no fixed market price determined on an active regulated market, or whose fair value cannot be determined in another reliable manner,
- hedged items.

Loans and receivables are measured at amortized cost determined using the effective interest method. Receivables with short maturity for which no interest rate is defined can be measured at the amount of consideration due, if the present value of expected future cash flows is not significantly different from the amount of consideration. Financial assets with fixed maturity are measured at amortized cost using the effective interest method. If maturity date is not fixed, financial assets are valued at the cost of acquisition (paragraph 16).

Financial liabilities are measured at amortized cost, except for financial liabilities held for trading and derivatives measured at the fair value (paragraph 18).

The effects of periodic revaluation of financial assets and liabilities held for trading are classified as profit or loss in the period in which valuation adjustment took place (paragraph 21.1).

In the case of financial assets available for sale, an entity has a choice and may classify the effects of fair value adjustment to profit or loss in the period in which the valuation adjustment took place or to the revaluation reserve in equity, with the provision that the interest accrued according to the effective interest rate is recognized in income (paragraph 21.2 and paragraph 25.3). According to IAS 39, only the latter of the two approaches is allowed.

The effects of the revaluation of financial assets and financial liabilities measured at amortized cost (excluding hedging instruments and hedged items) are recognized in profit or loss in the period in which valuation adjustment took place (paragraph 22).

At the point of reclassification of financial assets held for trading to another category, the fair value as at the date of reclassification becomes the new purchase price or the adjusted purchase price (paragraph 22a).

Financial assets held to maturity as at the date of reclassification to assets available for sale are measured at their fair value, and the difference is recognized in profit or loss or in the revaluation reserve in equity, depending on which method of recognition of the effects of changes in fair value measurement of assets available for sale is adopted by the entity (paragraph 23.1). Upon expiry of the grace period related to tainting, the entity may again reclassify financial assets as held to maturity. In this case, the current fair value becomes the new adjusted purchase price, while the effects of revaluation recognized until this point in the revaluation reserve in equity are accounted for in the period until maturity with the use of effective interest rate (paragraph 23.3).

With regard to financial assets measured at cost, as at the date on which fair value estimation becomes possible, revaluation to that value is effected, and the difference is recognized in profit or loss or in the revaluation reserve in equity (paragraph 23.2). If fair value measurement is no longer possible, the present value becomes the new purchase price, and the previous effects of revaluation recognized in the revaluation reserve in equity are accounted for in the period until maturity with the use of effective interest rate for assets with a fixed maturity date, or recognized in profit or loss when the asset is derecognized, if such asset has no specified maturity date (paragraph 23.3).

### 1.2.3. Derecognition of financial instruments

A financial asset is removed from the books of account if the entity has lost control over the asset. Loss of control occurs when the contractual rights to economic benefits have been realized, have expired, or the entity has abandoned these rights.

The disposal or sale of financial assets is not deemed to incur a loss, if the entity (paragraph 11.2):

- has the right to repurchase such assets or the right of first refusal to repurchase, and the price differs from the fair value of the assets as at the date of repurchase, or such assets are not readily available on the market,
- has the right and obligation to repurchase or redeem the assets, under terms and conditions that guarantee to the acquirer the return in the amount that the entity could obtain by providing a loan secured with the acquired assets,
- entered into a swap contract in consequence of which the entity bears substantial credit risk and retains the right to a substantial portion of economic benefits associated with the asset, as if the entity was the owner of the assets, in exchange for commitment to pay to the acquiring entity the amount specified in the contract, and contractual assets are not readily available on the market,
- bears substantial risks associated with the assets, as if the entity was the owner of the assets, as a result of issuing an unconditional put option to sell these assets, and such assets are not readily available on the market.

In the new IAS 39, after 2003 amendments, the principles governing derecognition of financial assets from the balance sheet were expanded to a significant extent. According to IAS 39.16, an entity determines whether derecognition principles should be applied to a part of financial assets (or a part of a group of similar financial assets), or a financial asset (or a group of similar financial assets) in its entirety (specifically identified cash flows, fully proportionate (pro rata) share in cash flows, or fully proportionate (pro rata) share of specifically identified cash flows). An entity shall derecognize a financial asset when, and only when (IAS 9.17):

- the contractual rights to the cash flows from the financial asset expire, or

- the entity transfers the financial asset (IAS 39.18):
  - transfers the contractual rights to receive the cash flows of the financial asset,
  - retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows.

In line with IAS 39.20, the transferred financial asset shall be derecognized if the entity transfers substantially all the risk and rewards of ownership of the financial asset. If the entity retains substantially all the risk and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset. In the entity neither transfers nor retains substantially all the risk and rewards of ownership of the financial asset, the entity shall derecognize the financial asset if it has not retained control over the asset. If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset.

Enhanced requirements concerning the analysis of financial assets from the standpoint of their potential derecognition under IAS 39 may, in consequence, result in identification of transactions which, under paragraph 11.2 of Financial Instruments Regulation, would not be derecognized. In particular, this may apply to such contracts in result of which the entity retains partial involvement in the financial asset. Such cases are not provided for in paragraph 11.2 of Financial Instruments Regulation. Then again, it cannot be stated that partial derecognition of an asset in justified cases has been forbidden. It appears that in such cases the entity should adhere to the overriding principle prescribing that business transaction should be recognized in accordance with its economic substance (Article 4, paragraph 2 of the Accounting Act). As prescribed in Article 10, paragraph 3 of the Accounting Act, for matters not regulated by the Act, while adopting their accounting principles (policies), the entities - if there is no applicable domestic standard - may apply International Accounting Standards.

Financial liability is derecognized, in whole or in part, as at the day on which the entity has provided the benefit under the contract, was released from the provision of such benefit, or commitment has expired (paragraph 12.1). Signing an agreement with a third party, upon creditor's consent, in which a third party commits to take over all or part of the debt is considered as a release from financing obligation (paragraph 12.3).

In the event of exchange of a debt financial instrument subject to financial liability for another, substantially different financial instrument, the liability is deemed as satisfied, and a new liability is recognized in connection with the new financial instrument (paragraph 12.4). A new liability is also recognized when there are changes in the contract resulting in at least 10% difference between discounted present value of cash flows arising from the new contract and those arising from the old one (paragraph 12.5).

As at the day of derecognition of a financial asset or financial liability, in whole or in part, transaction result is determined as the difference between the amount of payment and the

value of derecognized financial instrument. In the case of financial assets that were classified as available for sale, the value of financial instrument is adjusted with revaluation deduction recognized until the day of derecognition as revaluation reserve in equity (paragraph 18.4 and 19.1). If a financial asset is derecognized in part, the derecognized and the remaining part are determined in proportion to their fair value (paragraph 19.2). If it is not possible to determine the fair value remaining on the books of account, the value shall be determined as nil (paragraph 19.3).

In accordance with paragraph 20, when a financial instrument is derecognized and another financial instrument is recognized in its place, the newly created financial asset or financial liability is measured at fair value. Transaction result is determined as the difference between the actual proceeds and the balance sheet value of a financial instrument, adjusted for the fair value of the newly created financial asset or financial liability. If it is not possible to determine the fair value of the newly created financial instrument, the following items shall be put in the books of account:

- financial asset – at nil value;
- financial liability – at the amount of profit that would be generated from the sale of the asset. Should the transaction result in a loss, the loss is recognized as expense.

#### 1.2.4. Permanent impairment<sup>1</sup>

Pursuant to Article 28, paragraph 7 of the Accounting Act, permanent impairment takes place when it is very likely that an asset controlled by an entity will not bring, in whole or in part, expected economic benefits in the future.

Impairment loss of a financial asset or a portfolio of similar financial assets is recognized as a loss in the period in which permanent impairment was incurred. Impairment loss is determined (paragraph 24.2):

- in the case of financial assets measured at amortized cost - as the difference between the carrying value and the realizable amount determined as the present value of cash flows expected by the entity, discounted at the effective interest rate applied to date;
- in the case of financial assets held for sale, for which the effects of fair value measurement are recognized in the revaluation reserve in equity - as the difference between the cost of acquisition and its fair value, with the provision that the fair value of debt instruments is defined as the present value of future cash flows expected by the entity, discounted at the current market interest rate applicable to similar financial instruments. The cumulative loss recognized until that day in the revaluation reserve in

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<sup>1</sup> When translating the Report into English, the translator is relying on the original terminology from IAS, but whenever Polish Accounting Act is quoted, the existing English version of the Act is used. As a result, on some rare occasions, inconsistencies in vocabulary may arise.



equity is reflected as expense in the amount not smaller than the impairment loss net of the part reflected directly as expense,

- in the other cases - as the difference between the carrying amount and the present value of cash flows expected by the entity, discounted at the current market interest rate applicable to similar instruments.

In line with the provisions outlined above, the fair value of debt instruments is determined using a discount method, although it seems that, in principle, the active market price should represent a better reflection of the fair value in the case of listed debt instruments.

Starting from the date on which impairment loss is incurred, the interest income is accrued using the rate discounting future cash flows used to determine the recoverable amount.

The value of receivables is written down depending on the probability of their collection and, in accordance with Article 35c of the Accounting Act, the entity should recognize a write-down with regard to:

- amounts due from debtors who were put into receivership or were declared bankrupt – up to the amount not guaranteed or secured in another manner, as reported to the receiver or judge-commissioner during bankruptcy proceedings;
- amounts due from debtors for whom filing for bankruptcy was dismissed, if the debtor's assets are not sufficient to cover the cost of bankruptcy proceedings – in full;
- receivables disputed by debtors as well as overdue receivables, where a review of the debtor's financial position indicates that the collection of a contractual amount due is unlikely – up to the amount not guaranteed or secured in another manner;
- receivables which represent equivalents of amounts added to receivables which were previously written down – at these amounts, until they are received or written-off,
- overdue receivables or non-overdue receivables which are very unlikely to be collected, in the cases justified by an entity's business model or client structure – at an amount of a reliably estimated write-down, including a general write-down, in respect of uncollectable receivables.

Write-downs of receivables are reflected in other operating expense or in financial expense, respectively – depending on the type of receivables subject to the write-down. If the reason for recognizing a write-down ceased to exist, the whole or a part of the previously recognized write-down increases the value of a given asset and is recognized in operating income or financial income, respectively. In the case of assets measured at amortized cost, the reversal of the write-down cannot result in an increase of asset value in excess of the amount of amortized cost which would have been determined had the write-down not been recognized at the date the write-down is reversed.

Under IAS 39, an entity should assess at the end of each reporting period whether there is any objective evidence of impairment and, if any such evidence exists, an entity should determine the amount of any impairment loss. On top of that, it is required under IAS 39 that significant financial assets should be assessed for impairment on an individual basis. If an entity determines that no objective impairment evidence exists for an individually assessed financial asset, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. An analogical procedure is not required under the provisions of Financial Instruments Regulation, but it is not in conflict with these provisions, so it can be applied by the entities.

There is a difference between Polish GAAP and IAS in that IAS 39 does not permit reversal of impairment on equity instruments through profit or loss.

#### 1.2.5. Embedded derivatives

In accordance with paragraph 10 of Financial Instruments Regulation, an embedded derivative should be recognized separately from the host contract, if the following conditions are met jointly:

- the entire contract is not classified as a financial asset or financial liability held for trading or as a financial asset held for sale in the case of which revaluation effects are recognized in financial income or expense,
- the nature of embedded instrument and related risks are not closely linked to the nature of the host contract and related risks,
- a separate instrument, with characteristics similar to the characteristics of the embedded instrument, satisfies the definition on a derivative instrument,
- the fair value of the embedded derivative can be determined in a reliable manner.

The host contract representing financial instrument from which an embedded derivative was separated is classified under a relevant category of financial instruments. If the host contract is not a financial instrument, it is subject to relevant provisions of the Accounting Act.

The separated embedded derivative is recognized as a financial asset or financial liability held for trading. Entities that apply hedge accounting may also designate a separate embedded instrument as a hedging instrument. If reliable measurement of the fair value of the embedded instrument is not possible, the entity should designate the entire contract as held for trading.

The wording of paragraph 10 of Financial Instruments Regulation concerning embedded derivatives is aligned with the requirements of IAS 39, but Appendix A do IAS 39 contains extensive explanations on the application of those provisions. Likewise, IFRIC 9 on the *Reassessment of Embedded Derivatives*, published in 2009, contains additional guidance as to

when an entity may change the initial decision concerning the separation of embedded instrument (significant change in contract terms and conditions, reclassification from the category of items measured at fair value through profit or loss).

In 2004 some changes were introduced to Financial Instruments Regulation, and examples were added to illustrate when the nature of an embedded derivative and related risks are regarded as closely linked to the nature of the host contract and related risks (paragraph 10.1a). These examples are derived from the examples quoted in IAS 39 (currently, Appendix A OS33). Due to the fact that the wording of paragraph 10 of Financial Instruments Regulation is quite general and non-specific, pursuant to the provision of Article 10, paragraph 3 of the Accounting Act, the entities usually refer to solutions described in IAS 39 when adopting their accounting policy in the area of embedded derivatives.

#### 1.2.6. Hedge accounting

According to Article 35a, paragraph 3 of the Accounting Act, contracts on financial instruments are regarded as hedging instruments which mitigate the risk related to entity's assets or liabilities if, at least:

- a contract objective was set prior to a contract date, and it was specified which assets or liabilities are to be hedged under the contract,
- a hedging financial instrument and the assets or liabilities that are hedged by such an instrument have similar characteristics, in particular a par value, maturity date, sensitivity to interest or foreign exchange rate fluctuations,
- the degree of certainty concerning the expected cash flows under the contract is significant, i.e. (paragraph 28.2 of Financial Instruments Regulation):
  - forecast transaction hedged is highly probable and may be jeopardized by changes in cash flows, which may impact profit or loss,
  - effectiveness of the hedge can be reliably measured on the basis of a reliably determined fair value of the hedged item or associated cash flows, and the fair value of the hedging instrument,
  - in the reporting period, the effectiveness of the hedge is measured on a continuous basis and maintained at a high level, and it does not differ significantly from the assumptions made in a documented risk management strategy.

If the above conditions are met, when measuring the value of hedged assets or liabilities one should take into account the value of financial instruments purchased to hedge those assets or liabilities, and changes in their value. Detailed methods for the measurement of hedging instruments and hedged items are defined in Section 4 of Financial Instruments Regulation.

Prior to the inception of the hedge, an entity develops documentation including, *inter alia* (paragraph 28.1):

- definition of risk management objective and strategy,
- identification of the hedging instrument and the hedged item,
- description of hedged risk,
- term of the hedge,
- description of the selected method of measurement of hedge effectiveness.

Hedge effectiveness is determined taking into account the time value of money and is considered to be high if, throughout the term of the hedge, almost the entire amount of the change in the fair value of the hedged item or related cash flows is offset by the changes in the fair value or cash flows of the hedging instrument. This requirement is satisfied when the level of effectiveness is in the range of 80% to 125% (paragraph 28.4).

As specified in paragraph 29, any derivative instrument whose value can be measured in a reliable manner (except for written options) can be used as a hedging instrument. An entity may also designate a separate embedded derivative as a hedging instrument. According to Financial Instruments Regulation, a separated intrinsic value of the option and the spot price of a forward contract can be designated for hedging. In other cases, the fair value of the derivative cannot be separated (paragraph 31). Non-derivative financial assets or liabilities, including those classified as financial assets held to maturity, can be designated as hedging instruments only for foreign currency risk, provided that the currency component can be measured in a reliable manner.

A single hedging instrument may be designated to hedge more than one type of risk, if the risk can be identified, it is possible to determine the link between the hedging instrument and each type of the hedged risk, and it is possible to measure reliably the effectiveness of the hedge for each risk. A part of a selected financial asset, financial liability, or a group of financial assets or financial liabilities can be designated as a hedging instrument.

According to Article 35a, paragraph 3, point 1, the purpose of the hedging instrument should be defined and hedged items should be listed prior to contract conclusion. Under IAS 39, it is allowed to designate derivatives as hedging instruments at subsequent periods after contract conclusion. However, hedging relationship cannot be designated for only a portion of the time period during which a hedging instrument remains outstanding.

The hedged item can be a single asset or a single liability, an unrecognized firm commitment, highly probable forecast transaction, or a group of items with similar characteristics of hedged risk (paragraph 30.1 and 30.2). The following items cannot be used as hedged items (paragraph 30.4):

- derivative instruments,

- financial assets held to maturity for interest rate risk,
- assets measured according to equity method, if the hedge applies to the fair value,
- firm commitment to acquire another entity through merger of commercial companies (with the exception of the hedge of foreign currency risk related to the transaction).

If the hedged item is a financial instrument, an entity may designate only one risk factor for hedging, provided that the effectiveness of the hedge can be measured in a reliable manner for this risk factor (paragraph 30.3). As far as non-financial items are concerned, an entity may designate them as hedged items only for foreign currency risk or in its entirety for all the risks (paragraph 30.5).

In line with paragraph 27, an entity may follow the principles of hedge accounting, if its aim is:

- the fair value hedge – a hedge of the exposure to changes in fair value attributable to a particular risk connected with recognized assets and liabilities or a portion thereof,
- the cash flow hedge – a hedge of the exposure to variability in cash flows attributable to a particular risk connected with recognized assets and liabilities, firm commitments or forecast transactions,
- the hedge of a net investment in a foreign operation the activity of which does not represent an integral part of entity operation.

Hedging the forecast transaction and firm commitment to buy or sell assets at a fixed price is accounted for as a cash flow hedge, even if it entails the risk of fair value changes (paragraph 27.2). As prescribed in IAS 39.87, a hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge. Hedging the firm commitment prior to other risks is accounted for as a fair value hedge.

The new IAS 39.81A, amended in 2003, permits fair value hedge of the interest rate exposure of the portfolio of financial assets or financial liabilities. In such a case, the portion hedged may be designated in terms of an amount of currency rather than as individual assets or liabilities. Financial Instruments Regulation has not been amended after the introduction of a portfolio hedge model under IAS 39, and no such hedging model is provided for in Financial Instruments Regulation.

In the case of a fair value hedge, the gains or losses from fair value revaluation of the hedging instrument or the foreign currency component of the hedging instrument (for a non-derivative hedging instrument) are recognized in financial income or expense. The effects of the revaluation of the hedged item with the gain or loss resulting from the hedged risk adjust (increase or decrease) the carrying amount of the item and are recognized in financial income or expense. This is also applicable to hedged items which, had the entity not applied hedge accounting, would have been measured at the cost of acquisition, or the fair value revaluation

would have been recognized in the revaluation reserve in equity (paragraph 32.1). Valuation adjustment of an interest-bearing financial instrument is accounted for in the period starting from the date of revaluation or such revaluation is discontinued by the entity until maturity, and it is recognized in financial income or expense (paragraph 32.2). An entity shall discontinue the application of cash flow hedge from the moment when the hedging instrument expires or is sold, terminated or exercised, or the hedge no longer meets the criteria of hedge accounting.

In the case of a cash flow hedge, the gains or losses from fair value revaluation of the hedging instrument or the foreign currency component of the hedging instrument (for a non-derivative hedging instrument), in the portion determined to be an effective hedge, are recognized in revaluation reserve in equity. The absolute value of the amount recognized in revaluation reserve in equity cannot exceed the amount of the fair value of future cash flows changes related to the hedged item, calculated cumulative from the effective date of the hedge. The ineffective portion of revaluation of the hedging instrument is recognized in profit or loss (paragraph 33.1).

The effects of revaluation of the hedging instrument recognized in revaluation reserve in equity are recognized as financial income or expense, respectively, of the reporting period in which the hedged firm commitment or forecast transaction generate profit or loss (paragraph 33.3). If the firm commitment or forecast transaction generate assets or liabilities, as at the date of their recognition in the books of account the gains and losses recognized until that date in revaluation reserve in equity are written down and added to the cost of acquisition or the initial value of recognized assets and liabilities determined in another manner. According to IAS 39.98, an entity may make such initial value adjustment only if the hedge results in the recognition of a non-financial asset or liability. If the hedge results in the recognition of a financial asset or financial liability, the amounts recognized in revaluation reserve in equity should be transferred to profit or loss in the same periods in which the acquired asset or assumed liability affected the profit or loss (IAS 39.97).

In accordance with paragraph 33.5, an entity discontinues cash flows hedges from the date on which the hedging instrument expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for hedge accounting. Under such circumstances, the cumulative gain or loss on the hedging instrument should remain in the revaluation reserve in equity until the firm commitment or forecast transaction is recognized in the books of account. If it is determined by an entity that the forecast transaction or firm commitment will not be performed, the cumulative gain or loss on hedging instrument measurement recognized in revaluation reserve in equity should be recognized in financial income or expense.

An entity which hedges a net investment in a foreign operation should recognize foreign currency differences arising as at the date of measurement of hedged investment in the revaluation reserve in equity. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized in the revaluation reserve in equity and



accounted for as at the date of derecognition of the hedged investment as a value adjustment of distributed assets. The absolute value of the amount recognized in revaluation reserve in equity cannot exceed cumulative foreign currency differences from the valuation of the hedged investment. The ineffective portion of the effects of revaluation of the hedging instrument is recognized in financial income or expense.

### **1.3. Special accounting principles for banks**

The Regulation of the Minister of Finance of October 1, 2010, on Specific Accounting Principles for Banks, apart from the matters related to recognition and measurement of financial assets and financial liabilities and determination of profit or loss, regulates the issues connected with keeping the books of account, stocktaking and data storage, as well as recognition in the books of account and presentation in the financial statement of brokerage office transactions and measurement of financial instruments and rights to stock market commodities of brokerage office clients.

Annex 2 to the Accounting Act specified the scope of information that should be presented in the financial statements of banks (balance sheet, off-balance sheet items, income statement, statement of changes in equity, cash flow statement). The information that should be disclosed by the banks in the introduction to the financial statement and in the notes and disclosures is listed in the Attachment to the Regulation on Specific Accounting Principles for Banks.

#### **1.3.1. Classification of financial instruments**

Financial instruments, at the time of acquisition or establishment, are classified into the following categories (paragraph 30.1):

- financial assets and financial liabilities measured at fair value through profit or loss, including financial assets or financial liabilities held for trading,
- loans and other bank receivables,
- financial assets held to their due date,
- financial assets available for sale.

Financial assets and financial liabilities measured at the fair value through profit or loss include (paragraph 2.15) financial assets and financial liabilities held for trading and designated to that category by the bank at initial recognition, provided that it leads to more useful information or minimizes differences, including those pertaining to the methods of measurement and presentation of revenues or expenses related to those assets or liabilities, or allows for the assessment of fair value measurement results in accordance with investment

strategy or risk management principles documented by the bank. Pursuant to the Regulation on Detailed Rules for Recognition, Methods of Measurement, Scope of Disclosures and Presentation of Financial Instruments (hereinafter: Financial Instruments Regulation), this category can only include financial instruments held for trading. The option of fair value measurement through profit or loss at initial recognition was introduced to the Regulation on Specific Accounting Principles for Banks in accordance with IAS 39 after 2003 amendment.

Loans and other bank receivables (paragraph 2.16) are financial assets with fixed or determinable payments, which are not quoted on the market, with the exception of financial assets that the bank intends to sell in the short term, classified as financial assets or financial liabilities held for trading, and financial assets which were accounted for by the bank at initial recognition as financial assets and financial liabilities measured at fair value through profit or loss, as well as loans and other bank receivables which are non-recoverable for the bank for reasons other than non-payment, which are classified as assets available for sale. Definition of that category was also revised in line with IAS 39. According to Financial Instruments Regulation, the category of loans and receivables includes financial assets arising from the transfer of cash to the other party to the contract. Inconsistencies may arise, in particular, in the case of debt instruments acquired on the primary market, or factoring.

Financial assets held to their due date (paragraph 2.17) are defined analogically to the approach used in Financial Instruments Regulation (cf. financial assets held to maturity). These instruments are also subject to similar 'tainting' principles in the case of an earlier sale, transfer or exercise of the put option.

Financial assets available for sale (paragraph 2.18) are financial assets that were not classified in other categories. Under the Regulation on Specific Accounting Principles for Banks, analogically to Financial Instruments Regulation, financial assets cannot be designated directly to that category at initial recognition. However, such designation is allowed under IAS 39.9.

Financial assets measured at fair value through profit or loss can be reclassified to other categories of financial assets in exceptional circumstances resulting from a unique, extraordinary event which is very unlikely to occur in the near future (paragraph 32.2). Financial assets from that category which meet the definition of loans and other bank receivables, which were not accounted for at fair value upon initial recognition, can be reclassified to another category if the bank has changed the intention or ability to hold the financial asset to a fixed date or to maturity (paragraph 32.3). Financial assets under other categories cannot be reclassified to financial assets measured at fair value through profit or loss.

Financial assets available for sale can be reclassified as loans and other bank receivables provided that the bank has the intention and ability to hold these assets in the foreseeable

future or to maturity, or as financial assets held to maturity if they do not meet the definition of loans and other bank receivables (paragraph 32.5).

If financial assets classified as loans and receivables no longer meet the definition of that category due to the fact that they are quoted in an active market, they should be reclassified as assets available for sale.

### 1.3.2. Measurement of financial assets

At initial recognition, financial instruments are measured at cost (cost of acquisition), i.e. the fair value of consideration made or received (paragraph 33). Analogically to the situation observed in the case of Financial Instruments Regulation, there is a difference in comparison to IAS 39.43, according to which initial recognition is based on the fair value of the financial instrument rather than the consideration (the difference will emerge, for example, in the case of transactions that were not concluded on a market basis).

With the exception of financial assets and financial liabilities measured at fair value through profit or loss, transaction costs that are directly attributable to the financial asset increase its cost (cost of acquisition).

Financial assets and financial liabilities, as well as off-balance sheet liabilities, are recognized in the books of account as at the transaction date (paragraph 33.2). In the case of standardized buy or sell transactions involving a financial asset, it is not allowed under the Regulation on Specific Accounting Principles for Banks to recognize the transaction as at the settlement date.

Assets and liabilities at the balance sheet date are measured in accordance with the principles set out in paragraph 36.

Financial assets and financial liabilities are measured at fair value through profit or loss with the changes accounted for in financial transaction income or expense, with the exception of the liabilities to be settled by the transfer of an equity instrument whose value cannot be reliably determined (measurement at amortized cost).

Financial assets available for sale are measured at the fair value, with changes recognized in revaluation reserve in equity. In contrast to Financial Instruments Regulation, the Regulation on Specific Accounting Principles for Banks does not provide for the possibility to recognize changes in the fair value of assets available for sale in profit or loss (in line with IAS 39.55). However, the interest accrued is recognized in interest income. When financial assets available for sale are derecognized from the balance sheet, cumulative changes in the fair value recognized in revaluation reserve in equity are recognized in financial income or expense, respectively. In the case of permanent impairment of an asset, the loss recognized in revaluation reserve in equity should be recognized as impairment due to valuation

allowance. The dividends due are recognized as income from stock or shares, other securities and other financial instruments.

Loans and other receivables of the bank, not classified as held for trading, and financial assets held to maturity, are measured at amortized cost using the effective interest method.

Financial liabilities not classified as measured at fair value through profit or loss are measured at amortized cost using the effective interest method.

Financial liabilities arising from bank's continued involvement in transferred financial assets or from the transfer of a financial asset, such as were not derecognized from the balance sheet, are measured at amortized cost or at fair value, depending on the measurement approach used in relation to the transferred asset.

If the fair value cannot be determined in a reliable manner, financial assets are measured at the cost of acquisition, taking into account valuation allowance, and financial liabilities are measured at amortized cost, with valuation effects recognized in financial transaction income or expense. When fair value measurement becomes possible, revaluation is incurred, and the difference is accounted for in revaluation reserve in equity.

Assets and liabilities as well as off-balance sheet liabilities and specific provisions for receivables in a foreign currency are translated at the average exchange rate announced by the President of the National Bank of Poland as at the balance sheet date. Exchange differences are recognized in foreign exchange item income or expense (paragraph 37).

Disposal of financial assets purchased at different prices, with identical or similar features, is accounted for in accordance with the FIFO method (paragraph 38).

Interest income does not include interest payable matured and unmatured, including the discount and capitalized interest, on the receivables that are 'at risk', which represent the interest in suspension until they are received or written off.

As far as all other issues pertaining to the measurement of financial instruments are concerned, banks should adhere to accounting principles set out in Financial Instruments Regulation.

### 1.3.3. Derecognition of financial instruments

Principles governing derecognition of financial instruments presented in paragraph 35 of the Regulation on Specific Accounting Principles for Banks are based on the solutions applied in the new IAS 39, after amendments introduced in 2003. Having said that, the Regulation does not prescribe limitations on the possibility to derecognize a part of a financial asset. According to IAS 39.16, derecognition of a part of a financial asset is appropriate only in the case of:

- specifically identified cash flows,

- full proportionate (pro rata) share of the cash flows,
- full proportionate (pro rata) share of specifically identified cash flows.

In all other cases, derecognition principles are applicable to a financial asset in its entirety.

Financial liabilities are derecognized, in whole or in part, when financial liability expires, i.e. the obligation specified in the contract has been satisfied, cancelled, or its term has expired.

A financial asset or its part is derecognized when at least one of the following conditions is met:

- expiry of contractual rights to the cash flows from the financial asset,
- the transfer of the asset to the buyer meets derecognition requirements.

An asset is transferred when at least one of the following conditions is met:

- contractual rights to the receipt of cash flows from a financial asset are transferred,
- contractual rights to the receipt of cash flows from a financial asset are retained, but there is obligation under the contract to transfer them to the buyer of the asset, and the following criteria are met jointly:
  - the bank is not obliged to transfer the cash flows prior to their receipt,
  - the bank cannot sell or encumber the transferred financial asset in any other way than through the establishment of a lien or other limited right for the buyer, as a security for the obligation to transfer the cash flows,
  - the bank is obliged to provide the buyer, without delay, with all the cash flows received, and until these cash flows are transferred, the bank cannot use the cash flows received to purchase other assets except for money assets.

If the buyer accepts substantially all the risk and rewards of ownership of the transferred financial asset, the bank shall derecognize the asset from its balance sheet and shall recognize all retained or new rights and obligations arising from the transfer. If the bank retains substantially all the risk and rewards of ownership of the transferred financial asset, the bank shall continue to recognize the financial asset. If the bank does not retain substantially all the risk and rewards of ownership of the financial asset, the bank shall determine whether it has retained control over the financial asset. If such control is retained, the bank shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset. Otherwise, the financial asset is not derecognized. Control is defined as the right to dispose of the transferred financial asset.

#### 1.3.4. Permanent impairment

In accordance with the Regulation of the Minister of Finance of 16 December 2008 on the Establishment of General Banking Risk Provisions, banks establish provisions for risks associated with their activity (the so-called 'specific provisions').

Banks establish specific provisions for risks associated with credit exposure arising from (paragraph 3):

- retail loans classified as 'regular' in the amount of at least 1.5% of provisioning base,
- 'under observation' category in the amount of at least 1.5% of provisioning base,
- 'substandard' category in the amount of at least 20% of provisioning base,
- 'doubtful' category in the amount of at least 50% of provisioning base,
- 'lost' category in the amount of 100% of provisioning base.

Credit exposures are classified into individual categories on the basis of timeliness of repayment of the principal and interest, and financial and economic status of the debtor.

Specific provisioning base is the carrying amount of credit exposure without regard to established specific provisions, but with regard to the amount of a write-off of a part of credit exposure anticipated in connection with debt restructuring (paragraph 4.1). Specific provisioning base related to credit exposure risks can be reduced in accordance with the hedges applied (paragraph 4.2).

Specific provisions are billed to costs (paragraph 8) and revalued and released not later than on the last day of the month ending the quarter in which credit exposure was reviewed and classified.

Specific provisioning principles outlined above are not compliant with the approach required under IAS 39.58, where the impairment of financial instruments is determined when there is objective evidence that a financial asset of a group of financial assets is impaired in result of events occurring after the initial recognition of the asset. Provisioning for general risks and for losses expected as a result of future events, no matter how likely, is not allowed (IAS 39.59). When determining impairment loss, an entity should estimate realizable future flows from the asset and, taking into account the time value of money, discount them with relevant interest rate (IAS 39.63). Significant items should be assessed individually for impairment. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment (IAS 39.64). Provisioning based on arbitrarily adopted rates for groups of credit exposures is not permitted under IAS 39.

However, after obtaining the approval of Polish Financial Supervision Authority, which should also notify the minister responsible for financial institutions, a bank may adopt a different classification of credit exposures, in particular on the basis of internal rating systems and methods for estimating expected losses - the so-called credit risk models (paragraph 2.5). The Bank may also obtain the approval for the creation of specific provisions in different amounts, in particular on the basis of credit risk models (paragraph 3.3). Pursuant to paragraph 10 and paragraph 2, the carrying amount of credit exposure arising from the application of the model should be consistent with the measurement resulting from the application of International Accounting Standards.

### 1.3.5. Hedge accounting

Requirements concerning the application of hedge accounting by a bank in scope of (paragraph 45.2):

- preparation of formal documentation including risk management objective, hedging strategy, designation of the hedging instrument and the hedged item, and description of the risk being hedged and the method to measure effectiveness of the hedge,
  - confirmation that the hedging instrument and the hedged item are characterized by similar features,
  - expectation of high effectiveness of the hedge,
  - confirmation of high probability of forecast transactions in the case of a cash flow hedge,
  - capacity for a reliable assessment of hedge effectiveness,
  - ongoing assessment and confirmation of high effectiveness of the hedge (80%-125%),
- are similar to the requirements set out in Financial Instruments Regulation.

A financial asset or financial liability whose fair value cannot be reliably measured cannot be used as a hedging instrument, with the exception of a non-derivative financial instrument which meets the following criteria, jointly (paragraph 45.3):

- it is denominated in a foreign currency,
- it is designated for hedging against foreign currency risk,
- its currency components can be measured in a reliable manner.

In contrast to the wording of IAS 39 and Financial Instruments Regulation, the Regulation on Specific Accounting Principles for Banks does not restrict the use of non-derivative financial instruments whose fair value can be reliably determined only and exclusively to hedging foreign currency risk. Thus, a question arises as to whether the banks should follow general provisions, or whether they may also designate non-derivative financial instruments to hedge other risks.

A similar issue arises with respect of hedged items. According to the Regulation on Specific Accounting Principles for Banks, the hedged items can include assets or liabilities, firm commitments or highly probable forecast transactions not recognized in the balance sheet, but it is not indicated which hedging model should be used for a specific hedged item. For example, under the Financial Instruments Regulation an unrecognized firm commitment is accounted for in line with the cash flow hedge model, even if it entails the risk of changes in the fair value, whereas under IAS 39.86 an unrecognized firm commitment is accounted for in line with the fair value hedge model (with the exception of foreign currency risk, where IAS 39.87 offers a choice).

According to the Regulation on Specific Accounting Principles for Banks, there are three hedging models, as follows:

- the fair value hedge,
- the cash flow hedge,
- the hedge of a net investment in a foreign operation.

The fair value hedge is accounted for analogically to the approach presented in Financial Instruments Regulation. However, paragraph 46 of the Regulation on Specific Accounting Principles for Banks does not provide detailed information on how to account for the adjustment in the value of the hedged item arising from fair value changes related to the hedged risk. Pursuant to Financial Instruments Regulation (paragraph 32.3), such value adjustment is recognized in financial income or expense in the period starting from the date of:

- revaluation of the fair value of the hedged instrument attributable to the hedged risk,
- discontinuance of revaluation,

until maturity.

With respect to a cash flow hedge, in accordance with paragraph 47.1, the effects of measurement of the hedging instrument regarded as an effective hedge are recognized in revaluation reserve in equity. Both the Financial Instruments Regulation (paragraph 33.1) and IAS 39.96 restrict the level of the cumulative amount recognized in revaluation reserve in equity to the amount of the fair value of the cumulative changes in cash flows related to the hedged item from the inception of the hedge. The Regulation on Specific Accounting Principles for Banks does not provide for such restriction, which may lead to the recognition of ineffectiveness arising from over-hedging in the revaluation reserve in equity.

In line with paragraph 47.4, when hedge accounting is discontinued, the effects of hedging instrument measurement which were recognized in the revaluation reserve in equity are reflected in profit or loss, whereas under Financial Instruments Regulation (paragraph 33.5) and under IAS 39.101, the cumulative gains or losses remain separately in a revaluation reserve in equity until the hedged transaction affects profit or loss. Direct transfer of amounts



recognized in the revaluation reserve in equity to profit or loss can be done only when the hedged transaction is no longer forecasted.

Hedge of a net investment in a foreign operation is accounted for similarly to a cash flow hedge. Effects of the measurement of the hedging instrument relating to the effective portion of the hedge are recognized in financial income or expense on disposal of the net investment in a foreign operation (paragraph 48)

## **1.4. Specific accounting principles applicable to other entities**

### **1.4.1. Insurance and reinsurance companies**

Regulation of the Minister of Finance of 28 December 2009 on Specific Accounting Principles for Insurance and Reinsurance Undertakings regulates the issues associated with:

- keeping the books of account of insurance and reinsurance undertakings,
- insurance and reinsurance records,
- specific principles for accounting for investment (deposits),
- specific principles for the establishment of technical provisions,
- specific principles for preparation of financial statements of insurance and reinsurance undertakings,
- consolidated financial statements of capital groups.

Annex 3 to the Accounting Act specifies the scope of information that should be presented in financial statements of insurance and reinsurance undertakings (balance sheet, off-balance sheet items, property and life insurance technical account, general profit and loss account, statement of changes in equity, cash flow statement). The scope of information that should be included in the notes to the balance sheet, life insurance technical account, property insurance technical account, and general profit and loss account of insurance and reinsurance undertakings is listed in the Attachments to the Regulation on Specific Accounting Principles for Insurance and Reinsurance Undertakings.

Categories of financial instruments are defined by reference to the definitions from the Regulation on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments (paragraph 2.1, point 30).

Financial instruments representing investments in an insurance or reinsurance undertaking are measured as follows (paragraph 19.1):

- financial assets held for trading and financial assets available for sale - at fair value, if the fair value can be measured in a reliable manner. If the fair value cannot be reliably measured:
  - in the case of financial assets with fixed maturity – at amortized cost, taking into account permanent impairment losses,
  - in the remaining cases – at cost,
  - financial assets held to maturity as well as loans and receivables – at amortized cost, taking into account permanent impairment losses.

The deposits in the case of which the risk is borne by the policyholder are measured by insurance undertaking operating in life insurance segment at fair value (paragraph 19.2). Short-term investments include the deposits which, in view of their liquidity, are realizable in a period shorter than one year and the undertaking intends to exercise them in that period. Other deposits are classified as long-term investments (paragraph 21).

Deposit receivables from assignors are measured at the amount of consideration due, determined in accordance with the terms and conditions of reinsurance agreement, taking into account – when the deposit is a financial instrument – the measurement of that instrument and potential impairment losses (paragraph 19.3). In determining the impairment loss, financial condition of the entities in which the assets were placed should be taken into consideration, and in the case of financial assets covered by guarantees, financial conditions of the guarantor should also be taken into account (paragraph 19.4). Impairment losses are charged to profit or loss under 'Losses on revaluation of investments/deposits' in the technical life insurance account and in the profit and loss account. The release of previously incurred impairment losses on investments is included under 'Gains on revaluation of investments/deposits' (Attachment 2, point 6 and 15).

In the management of portfolios of financial assets one should take into account, in particular, the existing and projected inflows and outflows related to operating and investment activities, maturities of liabilities arising from concluded insurance and active reinsurance agreements, in compliance with the investment strategy adopted by insurance undertaking, and in the case of insurance under Group 3, Section I, based on the principles laid down in the rules of placement of resources from unit-linked insurance fund.

Differences arising from revaluation of investments are recognized in operating income or expense under 'Unrealized gains on investments/deposits' or 'Unrealized losses on investments/deposits' in the technical account and profit and loss account (Attachment 2, point 7 and 16). This provision does not apply to differences arising from revaluation of assets available for sale, which are not included in the determination of the value of technical reserve and shares in subordinate entities recognized in revaluation reserve in equity (paragraph 22.2). The difference between amortized cost and purchase price, or previously

revalued amount, is recognized directly under 'Investment income' in the technical life insurance account or the profit and loss account (Attachment 2, point 7).

Realized and unrealized gains on investments and operating costs of investment activity are presented by insurance and reinsurance undertakings classified in Section I in a life insurance technical account, with the exception of gains on investments from available funds, net of related costs of investment activity, which are transferred from life insurance technical account to the profit and loss account and recognized in line item: 'Net investment income after taking into account costs, transferred from the life insurance technical account' (paragraph 24).

Investment gains and losses on investment activity are presented by insurance and reinsurance undertakings classified in Section II in the profit and loss account, with the exception of gains on investments net of related costs of investment activity included in the calculation of reserves for capitalized value of annuities and the reserve for bonuses and rebates for the insured, which are transferred from profit and loss account to insurance technical account and recognized in the line item: 'Net investment income after taking into account costs, transferred from the profit and loss account' (paragraph 25).

Realized and unrealized foreign exchange differences related to investment activity are recognized by analogy to investment income and expense (paragraph 26).

Record keeping of investments and related income and expense in insurance and reinsurance undertakings should make it possible to determine the value of different types of investments (including, *inter alia*, those that cover insurance technical reserve), and to determine the different types of operating revenue and costs associated with these investments recognized, respectively, in the technical account, the profit and loss statement, or in the equity (paragraph 27).

In all matters not regulated by the Regulation on Specific Accounting Principles for Insurance and Reinsurance Undertakings the principles set out in the Regulation on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments shall apply (paragraph 29).

#### 1.4.2. Credit unions (SKOK)

The Regulation of the Minister of Finance of 17 September 2013 on Specific Accounting Principles for Credit Unions (SKOK) specifies the principles for measurement of assets and liabilities, but the scope of information to be disclosed in the financial statement (introduction, balance sheet, profit and loss account, statement of changes in equity, cash flow statement, and the notes) is specified in the Attachment to the Regulation.

Credit unions do not classify financial instruments under the categories defined in the Regulation on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments. Instruments are classified only by type, not by purpose.

Assets and liabilities are measured as at the balance sheet date in accordance with the wording of the Accounting Act, and as follows (paragraph 4):

- loans – at the amount due, in keeping with the prudence principle and taking valuation allowances into account,
- shares classified as non-current assets - at cost less accumulated impairment, or at fair value,
- debt securities - at the amount due, in keeping with the prudence principle and taking into account valuation allowances, or at fair value,
- participation units – at fair value,
- liabilities – at the amount due,
- cash and other money assets – at par value.

Under the Regulation on Specific Accounting Principles for Credit Unions (SKOK), it is not allowed to measure debt instruments at amortized cost according to the effective interest method.

SKOK accounting policy should take into account, in particular, the principles governing the allowances to reduce accounts receivable in respect of loans, including the accrued but unpaid interest in the amount of (paragraph 5.1):

- at least 35% of amortization base, if the maturity of at least one installment of a loan or interest has been exceeded by 3 to 12 months,
- 100% of amortization base, if the maturity has been exceeded by more than 12 months.

Amortization base is reduced by the hedges used.

By the same token, the approach to determination of impairment losses is not compliant with Financial Instruments Regulation or IAS 39. The amount of impairment loss is contingent on the period of delay in payment and it is not based on the analysis of realizable cash flows. In the determination of impairment losses, time value of money is not taken into consideration.

Impairment losses are charged to other operating expense, while the reversal of impairment in the event of termination of the reasons for such impairment is recognized in other operating income. Previously incurred impairment losses are reduced by forgiven, aged or uncollectible receivables. The amount of impairment losses is revalued not later than on the last day of the month ending the quarter.

Foreign currency differences on translation of balances of assets and liabilities in foreign currencies are recognized as financial transaction income or expense. Off-balance sheet liabilities denominated in foreign currencies are translated at the average exchange rate announced by the President of the National Bank of Poland as at the balance sheet date.

Operating profit or loss is defined as the difference between operating income (in particular, interest income, income on commissions and fees including fees for financial settlements carried out on behalf of SKOK members, and commissions in respect of insurance brokerage services) and operating expense (in particular, the cost of interest on cash contributed by SKOK members, cost of fees, commission costs, including insurance brokerage services and insurance coverage on savings).

Financial transaction profit or loss is defined as the difference between income from financial transactions (in particular, income from investments, shares, interest on transactions with other entities and gains on disposal of investments and revaluation of investments) and the costs of financial transactions (in particular, the cost of interest and fees on loans, and losses on disposal of investments and revaluation of investments).

#### 1.4.3. Mutual funds

The Regulation of the Minister of Finance of 24 December 2007 on Specific Accounting Principles for Mutual Funds sets out the principles governing bookkeeping, recognition of mutual fund transactions in the books of account, measurement of assets and determination of liabilities and operating profit or loss, as well as the preparation and publication of semi-annual and annual financial statements, combined financial statements, and individual financial statements of sub-funds. Attachment 1 to the Regulation on Specific Accounting Principles for Mutual Funds specifies the scope of information to be disclosed in the financial statement of an mutual fund (introduction, balance sheet, record of investment (deposits), operating profit and loss account, statement of changes in net assets, cash flow statement, notes, additional information). Attachment 2 specifies the scope of information to be disclosed in a combined financial statement (introduction to a combined financial statement, combined record of investment (deposits), combined balance sheet, combined operating profit and loss account, combined statement of changes in net assets, combined cash flow statement).

Capital of the fund is formed by the capital paid in net of the capital paid out. In accordance with paragraph 2, point 10, of the Regulation on Specific Accounting Principles for Mutual Funds, paid-in capital represents payments made in cash, securities, or shares in limited liability companies accepted in return for participation units sold to the participants of the fund or sub-fund or investment certificates issued. Capital paid out (paragraph 2, point 11) represents the amounts paid out for the repurchase of participation units or redemption of investment certificates, which are equivalent to the product of the number of participation

units repurchased or investment certificates redeemed and the net asset value per unit or per certificate at which it was repurchased.

The International Accounting Standards prescribe a different treatment for the amounts in respect of unit acquisition. In accordance with IAS 32.11 after 2003 amendments, a contract that will or may be settled in the entity's own equity instruments and is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments, represents financial liability of the entity. An obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (IAS 32.23). This definition is met by, *inter alia*, participation units issued by mutual funds, in the case of which the redemption amount is a proportionate interest in net assets (IAS32 AG7).

In February 2008 additional amendments were introduced in IAS 32, with more criteria to describe the accounting breakdown of issued puttable instruments into financial liabilities and equity instruments. In line with IAS 32.16A, as an exception to the definition of a financial liability, the following are classified by an entity as equity instruments:

- an instrument that entitles the holder to a pro rata share of the issuer's net residual assets in the event of the issuer's liquidation,
- an instrument that is in a class of instruments that is subordinate to all other classes of issued instruments,
- all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features,
- apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation that would satisfy the definition of a financial liability,
- the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognized net assets, or the change in the fair value of the recognized and unrecognized net assets of the entity over the life of the instruments (excluding any effects of the instrument).

On top of that, for an issued puttable instrument to be classified as an equity instrument, the issuer must have no other financial instrument or contract that has (IAS 32.16B):

- total expected cash flows over the life of the instrument based substantially on the profit or loss, the change in the recognized net assets, or the change in the fair value of recognized and unrecognized net assets of the entity (excluding any effects of the instrument),
- the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

If the above conditions are not satisfied, mutual fund classifies participation units as financial liabilities, not as equity instruments, as prescribed by the Regulation on Specific Accounting Principles for Mutual Funds. IAS 32 examples present a template financial statement of such entities as mutual funds and equity cooperatives whose share capital does not meet the definition of equity – Example 7: *entities without equity* and Example 8: *entities with some equity*.

Purchased components of deposits are recognized in the books of account on the date of the transaction (paragraph 16.1) at the purchase price, and in case of acquisition for free, at zero purchase price. Components of deposits received in exchange for other components are attributed the purchase price resulting from the purchase price of transferred components adjusted for any additional payments or cash received (paragraph 12).

Gains or losses on the sale of deposits (with the exception of receivables or liabilities arising from securities lending) are calculated using the 'most expensive sold first' approach, where sold components are assigned the highest purchase price of the deposit asset or, estimated according to effective interest method, the highest present book value for components measured at amortized cost. In the case of liabilities arising from issued options, those which yielded the lowest premium are subsequently terminated. If a deposit component is sold and purchased on the same day, purchase transaction is given priority in recognition (paragraph 13).

The share warrant for shares quoted in an active market is recognized in the books of account on the date on which, for the purpose of valuation of shares, the price not taking into account the value of such warrant is used for the first time. An unexercised share warrant is regarded as disposed of at zero value on the date directly following the date of warrant expiry. The dividend payable on shares quoted in an active market is recognized on the date on which, for the purpose of valuation of shares, the market price not taking into account such warrant is used for the first time. The share warrant and the right to receive the dividend from the shares not quoted in an active market are recognized on the day directly following the determination of such rights (paragraph 14).

Interest income from debt securities measured at the fair value is calculated in accordance with the principles specified by the issuer. Interest income from bank deposits and interest expense arising from borrowings are calculated using the effective interest rate method (paragraph 22)

The Regulation on Specific Accounting Principles for Mutual Funds does not provide for the division of financial instruments into categories defined in the Regulation on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments. Financial instruments are measured according to their type rather than the entity's intention at the point of purchase.

Assets and liabilities are measured according to a reliably determined fair value. If the deposits are quoted in an active market they are measured at the last available price, or the price adjusted in such a way as to obtain a reliable estimate if the volume of trading in the market is significantly low or the measurement date is not an ordinary business day (par 24).

Debt securities not quoted in an active market are measured at amortized cost with the use of effective interest method. The remaining deposit components not quoted in an active market are measured at a reliably determined fair value estimated (paragraph 30):

- by independent, specialized institutions,
- with the use of measurement approach for which there is data available from the active market,
- with the use of generally accepted estimation methods,
- on the basis of an active market price of a similar component.

Receivables and liabilities in respect of securities loan granted are measured according to the principles adopted for such securities (paragraph 27).

Securities purchased under repurchase agreements are measured from the date of transaction at amortized cost, and liabilities arising from the sale of securities under repurchase agreements are measured according to the method of adjustments of the difference between the repurchase price and the sale price, using the effective interest rate method (paragraph 28).

The assets and liabilities denominated in a foreign currency and quoted in an active market are measured in the currency in which they are quoted, and the assets and liabilities not quoted in an active market are measured in the currency in which they are denominated, with conversion according to the most recent, average National Bank of Poland rate available.

#### 1.4.4. Pension funds

The Regulation of 24 December 2007 on Specific Accounting Principles for Pension Funds sets out the principles governing bookkeeping, accounting for pension fund transactions in the books, the deadlines for preparation and submission for publication, the scope of publication and the deadlines for approval of an annual financial statement, as well as liquidation of an open-end pension fund. Attachment no 1 to the Regulation on Specific Accounting Principles for Pension Funds sets out the scope of information to be disclosed in the financial statement of the open-end fund, and Attachment no 2 regulates the scope of information to be disclosed in the statement of employee and voluntary fund (introduction to the statement, balance sheet, profit and loss account, statement of changes in net assets, statement of changes in equity, statement of investment portfolio, the notes).



Purchased components of the investment portfolio are carried at the purchase price, the components of the portfolio acquired free-of-charge have a zero purchase price. The value of accrued interest is recognized together with the par value of debt securities (paragraph 16).

Securities included in a loan agreement are incorporated in the investment portfolio of the fund for the period covered by the agreement and are measured in accordance with the principles adopted for these securities. Liabilities arising from securities loan agreement are recognized as loans, and the difference between the fixed price of the repurchase of securities and the value of the loan is amortized on a straight-line basis until the date of repayment of securities (paragraph 17). In accordance with the Financial Instruments Regulation, such a difference should be amortized using the effective interest rate method, but in the case of short-term agreements the inconsistency should not be significant.

Profit or loss on disposal of components of investment portfolio and foreign currencies is determined by assigning to the components the highest value at the cost of acquisition, or the highest value at the cost of acquisition plus the depreciation in the case of instruments measured under the straight-line method. This method does not apply to securities purchased with repurchase obligation in a transaction aimed at hedging a deposit or a loan (paragraph 19).

Principles governing measurement of financial instruments are laid out in the Regulation of the Council of Ministers of March 9, 2004, on Specific Principles for Measurement of Pension Fund Assets and Liabilities. Under this Regulation, there is no breakdown of financial instruments into categories analogous to those set out in Financial Instruments Regulation.

Assets and liabilities are measured at market value, following the principle of prudence.

Short-term debt securities not quoted on the valuation market, or in the case when the period to the commencement of quotation does not exceed one month, are measured with the straight-line amortization of the discount or premium in relation to the acquisition cost (paragraph 4.2). Debt securities, between the date immediately following the last quotation on the valuation market and the date of redemption, are measured with the straight-line amortization of discounts or premiums arising as the difference between the redemption price of a security and the price at which this security was valued on the last quotation (paragraph 5). Other securities not quoted on the valuation market are measured at acquisition cost (paragraph 6). In accordance with Financial Instruments Regulation and IAS 39, amortization of discounts or premiums is accounted for with the effective interest method. However, in the case of short-term instruments, the difference between the straight-line and the effective interest rate measurement should not be significant.

Securities purchased under repurchase obligation, in a transaction to hedge a deposit or a loan, as well as the obligation to repurchase the securities sold at a fixed price and date, are measured with straight-line amortization of the difference between the price of repurchase of securities and their acquisition cost or sales price (paragraphs 8 and 9). This approach is

consistent with the general principles governing derecognition under Financial Instruments Regulation and IAS 39. Financial asset is not derecognized from the balance sheet if the entity does not lose control over the asset. The difference between the repurchase price and the sales price, analogically to discount or premium amortization, is accounted for with the effective interest method. However, for short periods between the date of the transaction and the date of repurchase of securities, the difference between the two methods should not be significant.

Interest is added to the value of interest-bearing securities, as long as it is not included in the rate or price of the securities (paragraph 10). Interest is also added to the par value of the debt in respect of a loan, credit or deposit (paragraph 11).

The value of shares admitted to public trading but not quoted on the valuation market is equal to the value of shares of the issuer quoted on the valuation market. If there are differences in rights between newly issued shares and already quoted shares, the value of shares quoted on the valuation market is adjusted with the value of those rights (paragraph 7).

Participation units sold by open-end funds or specialized open-end funds are measured at the last unit repurchase price on the valuation date. In the period between the sale and the first day of repurchase, measurement is done according to the last cost of acquisition, and if there are different acquisition costs on the same date, according to the average weighted with the volume of acquired units. Investment certificates issued by closed-end mutual funds, specialized closed-end mutual funds or balanced funds are measured at the last price of redemption or based on their valuation price if they are quoted and were traded on the valuation market (paragraph 12).

Assets invested abroad are measured in accordance with the same principles as domestic assets. Their value is converted at the average exchange rate of the National Bank of Poland determined on the valuation date. If the securities are listed both on the domestic and foreign valuation market, their valuation is based on Polish market quotations (paragraph 13).

If it is not possible to measure the assets according to the principles outlined above, or such measurement would contradict the principle of prudence or would result in the valuation that deviates significantly from the market value, the pension fund measures the asset in line with its own, detailed valuation methodology. In such circumstances, pension fund must submit a report on the valuation methodology to the supervisory authority, which may require that the methodology be modified at supervisory authority discretion (paragraph 14).

Liabilities that can be measured using asset measurement principles are measured at the book value (paragraph 15)

#### 1.4.5. Brokerage houses

The Regulation of the Minister of Finance of 28 December 2009 on Specific Accounting Principles for Brokerage Houses sets out the principles governing accounting for brokerage house transactions, measurement of assets and liabilities, and preparation of financial statements. Attachment no 1 specifies information to be disclosed in a financial statement of a brokerage house, and Attachment no 2 specifies information to be disclosed in a consolidated financial statement (introduction to brokerage house financial statement, balance sheet and off-balance sheet items, profit and loss account, statement of changes in equity, cash flow statement, the notes).

Financial assets and financial liabilities held for trading include:

- financial instruments acquired in the name and to the account of the brokerage house, or financial liabilities that were acquired or incurred in order to benefit from short-term price fluctuations (up to 3 months),
- financial instruments representing a part of the portfolio which was used to exercise short-term price fluctuations,
- derivative instruments, provided that they do not represent, intentionally and actually, financial assets or financial liabilities used to offset the changes in the fair value or cash flows of the hedged item.

In the Regulation on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments there is no reference to a 3-month period as a limitation for short-term price fluctuations, but in practice other entities have also adopted this period when designing their accounting policy in scope of classification of instruments as held for trading.

Loans and receivables represent non-derivative loans and receivables other than those classified for trading. The Regulation on Specific Accounting Principles for Brokerages Houses contains no limitation as to the classification of financial assets in this category, in contrast to the Financial Instruments Regulation (acquired through direct delivery of cash to the other contractual party – paragraph 7.1) or IAS 39.9 (not quoted in an active market).

Financial assets held to maturity are financial instruments acquired in the name and to the account of the brokerage house, with fixed or determinable payments and fixed maturity, with the exception of loans and receivables. The entities which apply the provisions of Financial Instruments Regulation or IAS 39 may classify as held-to-maturity those debt securities which, due to active market or secondary market restrictions, cannot be classified as loans and receivables, as long as they confirmed the intention and ability to hold them to maturity. If this requirement is not met, tainting principles shall apply. The Regulation on Specific Accounting Principles for Brokerage Houses does not contain such requirement. However, brokerage houses are also free from any limitations as to the classification of

instruments purchased on the secondary or active market as loans and receivables. Therefore, more financial instruments can be classified under that category, and thus the portfolio of financial assets held to maturity will be of much less frequent use for brokerage houses.

Assets available for sale are non-derivative financial instruments that were purchased in the name and to the account of the brokerage house, which :

- are designated to that category, or
- do not meet the definition of other categories.

The option of direct designation of financial assets as available for sale is compliant with the new IAS 39.9 after 2003 amendments. Under Financial Instruments Directive, this category may include only those financial assets which do not meet the definition of other categories.

Financial assets and financial liabilities and the resulting revenues and costs are determined separately. Any offsetting is possible only if the brokerage house (paragraph 10):

- has a legal title to offsetting,
- intends either to settle the transactions on a net basis or to realize the rights arising from the financial instrument and, simultaneously, settle the liability.

Upon initial recognition, financial instruments are measured at the cost of acquisition, i.e. the fair value of consideration made or received, including transaction costs. If transaction costs are not material, they may be reflected directly in the income statement (paragraph 9).

Financial instruments are measured in accordance with the Accounting Act, and the following principles (paragraph 12):

- financial instruments held for trading - at fair value, with changes recognized as income or expense from financial instruments held for trading, with the provision that non-derivative financial liabilities linked to shares and stock for which there is no active market and whose fair value cannot be determined reliably, and which must be settled by delivery of those shares and stock, should be measured at acquisition cost less permanent impairment losses,
- loans and receivables and financial assets held to maturity – at amortized cost,
- assets available for sale – at fair value, with changes recognized in revaluation reserve in equity,
- financial assets whose fair value cannot be determined in a reliable manner – at acquisition cost less permanent impairment losses,
- non-derivative liabilities not held for trading are measured at amortized cost.

Disposal of financial assets measured at the fair value through profit or loss or available for sale, purchased in the name and to the account of the brokerage house at different prices

and characterized by identical or similar features, is permitted according to the following methods (paragraph 13):

- average prices,
- FIFO,
- LIFO.

LIFO approach is not permitted under International Accounting Standards.

In all other matters not provided for in the Regulation, brokerage houses should apply the principles set out in Financial Instruments Regulation.

### **1.5. Problems arising in connection with the application of existing provisions on accounting for financial instruments**

Polish provisions on accounting for financial instruments effective as of 2002 were to a substantial extent based on IAS binding at that time. On one hand, this allowed for adopting the principles of accounting not differing in quality from the best world standards but, on the other hand, obliged Polish entities to face the full complexity of the issue.

Based on statutory delegation, the principles of accounting for financial instruments were regulated under a separate Regulation of the Minister of Finance of 12 December 2001 on Detailed Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments. Interestingly, the Regulation came into force as of 1 January 2002 so entities were given practically no time to become familiarized with the new provisions, implement adequate procedures, train staff etc. Moreover, the Regulation was applicable to all entities, including small ones which use financial instruments only to a basic extent. It was only under the changes made to the Regulation in 2004 that the entities whose financial statements are not subject to mandatory audit were exempted from the obligation to comply with its provisions.

In case of banks, that is institutions which, by the nature of their activity, use financial instruments to the greatest extent, the new principles of accounting for financial instruments were regulated under a separate Regulation on Specific Accounting Principles for Banks. This Regulation was also based on IAS. As it was discussed in previous sections of this report, special accounting principles apply in Poland also to other entities and are governed by separate regulations, which led to a situation where one issue is regulated by several executive acts not always consistent with one another.

As the Financial Instruments Regulation was drafted on the basis of IAS, from the beginning it raised serious doubts as to its conformity with the provisions of the Accounting Act which were in large measure based on valuation according to historical cost principle. And since the

Accounting Act is a superior law, it is unclear whether the accounting principles defined under the Regulation can at all be applicable. Although the Accounting Act has been repeatedly modified since, some issues still remain ambiguous.

The provisions defined new principles of financial instruments valuation – fair value and amortized cost – which had not existed under the Accounting Act so, due to the lack of specialist literature, entities did not know at first how to apply these new requirements. At that time IAS were familiar only to a limited number of the largest enterprises, mostly on account of the obligation to prepare financial statements compliant with international standards while issuing securities in foreign markets.

One of the basic rules of accounting is that in case of a change in valuation principles, balance-sheet items should be calculated retrospectively, as if the new provisions were effective also in previous periods. This caused problems particularly when implementing new principles of financial instruments measurement at amortized cost in case of banks and these problems resulted not even from the complexity of the issue but from difficulties in collecting data for measurement. Measurement at adjusted cost requires that all commissions and fees directly pertaining to a given financial instrument must be taken into account while calculating the effective interest rate and accounted for together with the instrument value. In previous years such commissions and fees were usually recognized in accruals and accounted for on a straight-line basis regardless of the loan value. In order to properly implement measurement principles for existing loans, banks had to retrieve historical data concerning commissions in previous years. Considering the amount of loans in the banks' portfolio and the fact that these data could concern commissions charged many years earlier, at a time when computer systems were used only to a limited degree and the data could only be found in archives in a paper form, projects relating to the implementation of the new measurement method proved to be very challenging. What is more, whereas in case of enterprises with a limited number of loans, measurement could be made using readily available spreadsheets, for banks it was necessary to implement appropriate computer systems, which generated additional costs and required time. For that reason, the requirement obliging banks to measure at amortized cost was postponed several times and finally became effective only as of 1 January 2005 together with the obligation to prepare IAS-compliant consolidated financial statements imposed on banks after Poland joined the European Union.

Another unexpected problem concerned the necessity to separate currency derivatives embedded in lease agreements. In the 1990s, due to a significant inflation rate, most long-term lease agreements were denominated in foreign currencies, particularly in USD. New provisions required the separation of embedded derivative instruments from agreements concluded between Polish entities in a foreign currency. Obviously, the most problematic for entities was lack of any guidelines as to how such a separation should be conducted and accounted for. Moreover, the obligation to adopt a retroactive attitude required the agreements to be measured from the moment of their conclusion, using market data of that

time, including for instance hyperinflation interest rates. As a result, in financial statements appeared significant sums that were not strictly related to financial instruments but concerned ordinary commercial agreements, which had probably not been foreseen while drafting these new laws. The problem of monetary derivatives embedded in lease agreements was solved only after the changes in legislation made in 2004.

Implementation of new rules often caused also operating problems within entities, mostly because their management did not understand the issue. Since the principles of measuring financial instruments were defined in legislation concerning accounting, in many cases the problem was fully assigned to accounting departments, whereas the issue often requires highly advanced knowledge in the field of financial engineering. On the other hand, large entities with specialized treasury departments staffed by professionals in the field of risk management and instruments measurement, encountered problems with information flow between departments. Transactions were made without informing accounting departments which learnt about them only at the time of accounting for transfers. Over the last 10 years, most large entities managed to refine their operating procedures in order to eliminate problems of this kind, many smaller ones, however, are still struggling.

Insufficient understanding of provisions relating to instruments accounting concerned not only accountants but also statutory auditors examining financial statements. As a result, the quality of financial statements was not sufficiently controlled so, in spite of modern regulations, financial statements were still prepared according to the old rules. Regrettably, this state of affairs was often accepted by professional circles inclined to think that since these are complicated provisions pertaining to financial instruments, they should apply only to financial institutions, whereas for other entities they are merely a curiosity and not binding laws. Such an attitude was often observed during audits of financial statements. It was common practice not to disclose information on financial instruments although it was required of all entities subject to mandatory audit of financial statements.

Lack of specialist literature and official interpretations constituted an important problem as well. Not all the publications which started to appear were of highest quality and occasionally, instead of presenting solutions, they caused even greater confusion. Sadly, also transactions were often made by persons lacking sufficient knowledge of financial instruments specificity, which could be observed for instance in 2008, when many Polish enterprises suffered from severe financial problems due to entering into currency option structures.

Fortunately during 10 years of application of the new provisions, the awareness of this subject matter increased significantly. Practical problems still arise as the question of financial instruments is particularly complicated and the development of financial markets constantly brings about new, often very complex, financial instruments. Polish entities, however, are also becoming more and more aware and skilful in this regard. Certainly the translation of IAS and their interpretations into Polish contributed to that process. Also studies which are currently published represent much higher quality, probably due to the fact that the issue attracts not

only accountants but equally professionals from the field of risk management and financial instruments measurement. Moreover, academic circles are becoming increasingly involved in the subject matter.



## 2. REVIEW OF INTERNATIONAL SOLUTIONS CONCERNING ACCOUNTING FOR FINANCIAL INSTRUMENTS

### 2.1. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013

Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, repealing:

- Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies, and
- Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts.

One of the key objectives underlying the adoption of the new accounting directive was to reduce administrative burden on small and medium-sized enterprises (in particular, micro-enterprises) connected with the preparation of financial statements, without compromising protection of shareholders, partners and third parties who may rely on financial statements as the basic source of information about financial condition and assets of the company. EU regulations on accounting strive to balance the interests of users of financial statements and the interests of entities without imposing excessive reporting requirements.

#### 2.1.1. Categories of entities

In order to divide the entities into categories, the criteria of the balance sheet total, net turnover and average number of employees were adopted in the directive as the most objective indicators of entity size.

An entity is included in a category if, at the balance sheet date, it does not exceed at least two of the three following criteria (Article 3):

Category	Balance sheet total	Net turnover	Average number of employees
Micro-undertaking	EUR 350,000	EUR 700,000	10 people
Small undertaking	EUR 4,000,000	EUR 8,000,000	50 people
Medium-sized undertaking	EUR 20,000,000	EUR 40,000,000	250 people
Large undertaking	> EUR 20,000,000	> EUR 40,000,000	>250 people

Irrespective of the size criterion, the directive (Article 2, paragraph 1) distinguishes public interest entities that are:

- governed by the law of a Member State and whose transferrable securities are admitted to trading on a regulated market of any Member State,
- credit institutions,
- insurance undertakings,
- designated by a Member State as a public interest entity (e.g. because of the nature of their business, their size, or the number of their employees).

### 2.1.2. Principles of accounting for financial instruments

Pursuant to a general principle set out in Article 6, paragraph 1i), items recognized in the financial statement are measured in accordance with the principle of purchase price or production cost.

In Article 8, paragraph 1, Member States may, by way of derogation from the general principle of measurement according to purchase price or production cost, permit or require, in respect of all undertakings or any classes of undertakings, the measurement of financial instruments, including derivative instruments, at fair value. Member States may restrict such alternative measurement basis at fair value only to consolidated statements.

Alternative measurement basis at fair value is applicable exclusively to the following liability components (Article 8, paragraph 3):

- held as part of a trading portfolio, and
- derivative financial instruments.

Alternative measurement basis at fair value is not applicable with regard to (Article 8, paragraph 4):

- non-derivative financial instruments held to maturity,
- loans and receivables originated by the undertaking and not held for trading purposes, and
- interests in subsidiaries, associated undertakings and joint ventures, equity instruments issued by the undertaking, contracts for contingent consideration in a business combination, and other financial instruments with such special characteristics that the instruments, according to what is generally accepted, are accounted for differently from other financial instruments.

In accordance with Article 8, paragraph 6, by way of derogation from Article 8, paragraphs 3 and 4, Member States may permit or require the recognition, measurement or

disclosure of financial instruments in conformity with international accounting standards adopted in accordance with Regulation (EC) No 1606/2002.

The fair value is determined by reference to the market value, if a reliable market can readily be identified for the financial instrument. Where the market is not readily identifiable for an instrument, but can be identified for its components or for a similar instrument, the market value can be derived from that of its components or of a similar instrument. In the case of financial instruments for which reliable market is not readily identifiable, generally accepted measurement models and approaches are applied, provided that such models and approaches ensure rational market estimation. Financial instruments that cannot be reliably measured at fair value are measured at purchase price or production cost.

Where a financial instrument is measured at fair value, a change in the value shall be included on the profit and loss account, with the exception of (Article 8, paragraph 8):

- hedging instruments under a system of hedge accounting that allows some or all of the change value not to be shown in the profit and loss account, or
- changes in the value relating to an exchange difference arising on a monetary item that forms part of an undertaking's net investment in a foreign entity.

In those cases, change in the value is included directly in a fair value reserve.

Member States may also permit or require a change in the value of available-for-sale financial asset to be included directly in a fair value reserve.

In accordance with Article 8, paragraph 5, Member States may, by way of derogation from purchase price or production cost measurement, in respect of any assets and liabilities which qualify as hedged items under a fair value hedge accounting system, or identified portions of such assets and liabilities, permit measurement at the specific amount required under that system. In the fair value hedge adopted in accordance with Polish and International Accounting Standards, the measurement of hedged item is adjusted with profit or loss arising from the hedged risk.

Commodity-based contracts that give either contracting party the right to settle in cash or another financial instrument are regarded under the Directive as derivative instruments, except where such contracts:

- were entered into and continue to meet the undertaking's expected purchase, sale or usage requirements at the time they were entered into and subsequently;
- were designated as commodity-based contracts at their inception; and
- are expected to be settled by delivery of the commodity.

Article 36 of the directive specifies a number of obligations from which micro-undertakings can be exempted by the Member States. These exemptions are connected with, in particular,

presentation of accruals, drawing up notes, preparation of a management report, and publication of annual financial statements. Furthermore, micro-undertakings may draw up only an abridged balance sheet and an abridged profit and loss account. However, micro-undertakings which use any of the exemptions cannot apply Article 8 provisions on alternative measurement basis at fair value. Micro-undertakings which do not use the exemptions are regarded as small undertakings.

### 2.1.3. Information disclosure

As prescribed in general provisions under Article 4, paragraph 5, Member States may require undertakings other than small undertakings to disclose information in their annual financial statements which is additional to that required under the directive. On the other hand, Member States may require small undertakings to disclose information which goes beyond the requirements of the directive provided that any such information is gathered under a single filing system and the disclosure requirement is contained in the national tax legislation for the strict purposes of tax collection (Article 4, paragraph 6). In other words, Member States cannot extend disclosure requirements for small undertakings beyond those specified in the directive.

Article 16 describes the content of the notes to financial statements to be disclosed by all undertakings. Undertakings should disclose their adopted accounting policies, in particular those pertaining to financial instruments.

In the case of financial instruments measured at fair value, the following information should additionally be disclosed:

- significant assumptions underlying the valuation models and techniques where fair values have been determined,
- for each category of financial instrument – the fair value, the changes in value included directly in the profit and loss account, and changes included in fair value reserves,
- for each class of derivative financial instrument – information about the extent and the nature of instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows, and
- a table showing movements in fair value reserves during the financial year.

Additionally, it is required under Article 16 to disclose other information applicable to financial instruments, such as:

- the total amount of financial liabilities that are not included in the balance sheet, and the indication of the nature and form of any valuable security which has been provided,
- the amounts of advances and credits granted to the members of administrative, managerial and supervisory bodies,

- the amount and nature of individual items of income or expenditure which are of exceptional size or incidence including, in particular, income or expenditure on interest or valuation change,
- amounts owned by the undertaking becoming due and payable after more than five years, as well as the undertaking's entire debts covered by valuable security furnished by the undertaking, with an indication of the nature and form of the security.

Article 17 of the directive presents additional disclosures for medium-sized and large undertakings and public-interest entities. Pursuant to Article 16, paragraph 2, Member States may require that small undertakings also disclose some of that information. With regard to financial instruments, this may apply to the following disclosures, *inter alia*:

- the nature and business purpose of the undertaking's arrangements that are not included in the balance sheet, and the financial impact on the undertaking of those arrangements (Article 17, paragraph 1p)
- the nature and the financial effect of material events arising after the balance sheet date which are not reflected in the profit and loss account or balance sheet (Article 17, paragraph 1q); and
- transactions that have been entered into with related parties by the undertaking (Article 17, paragraph 1r).

Article 17, paragraph 1c contains additional information required of medium-sized and large undertakings and public-interest entities, but they cannot be required of small enterprises since they were not listed under Article 16, paragraph 2. This pertains to additional disclosures where financial instruments are measured at purchase price or production cost:

- for each class of derivative financial instrument:
  - the fair value of the instruments, if such a value can be determined by any of the methods prescribed in Article 8, paragraph 7, letter a), and
  - information about the extent and nature of the instruments;
- for financial fixed assets carried at an amount in excess of their fair value:
  - the book value and the fair value of either the individual asset or appropriate groupings of those individual assets, and
  - the reasons for not reducing the book value, including the nature of the evidence underlying the assumption that the book value will be recovered.

## 2.2. International Accounting Standards in the European Union

In order to enhance the efficiency of the internal market for financial services, as well as to increase competitiveness and to ensure comparability of financial statements, the European

Council decided that publicly traded companies should be required to apply a single set of high quality international accounting standards for the preparation of consolidated financial statements. Pursuant to the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, 'international accounting standards' shall mean International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB).

The International Accounting Standards can only be adopted, if:

- they allow for the preparation of financial statements giving a true and fair view of the assets, liabilities, financial position, and profit or loss,
- they are conducive to the European public good, and
- they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

In accordance with Article 4 of the Regulation 1606/2002, for each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with the IAS adopted by the EU if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State.

Under Article 5, Member States may permit or require other entities to prepare their consolidated accounts and/or their annual accounts in conformity with IAS.

According to the findings of a study done by the IASB among the countries that apply IAS, out of 27 European Union Member States, eight countries (Bulgaria, Cyprus, Czech Republic, Estonia, Greece, Latvia, Lithuania and Malta) have introduced the obligation to prepare individual financial statements in conformity with IAS by the companies whose securities are admitted to trading on a regulated market. Additionally, Denmark and Portugal require the preparation of individual financial statements in conformity with IAS, if the entity which is the issuer of securities on a regulated market does not draw up the consolidated financial statements in conformity with IAS. Ten countries permit IAS adoption (of which three only for certain entities), and seven countries (Austria, France, Germany, Hungary, Romania, Spain, Sweden) require the preparation of individual financial statements in conformity with national accounting standards.

Three countries (Bulgaria, Cyprus, Slovakia) require that other entities should prepare consolidated financial statements in conformity with IAS. Eight countries require IAS application by some entities (by and large, financial institutions). With the exception of Poland (only the entities applying for admission to public trading and included in the capital group in

which the parent company prepares consolidated financial statements in accordance with IAS), and Finland and Greece (only the entities subject to the audit of financial statements), other EU countries do not impose restrictions on the preparation of consolidated financial statements in accordance with IAS.

The obligation to prepare individual financial statements in conformity with IAS for other entities has been introduced by two countries (Bulgaria, Cyprus). In nine countries it is required that statements should be prepared in line with national accounting standards (Austria, Belgium, Czech Republic, France, Germany, Hungary, Romania, Spain, Sweden). In the group of the remaining countries, eight countries require IAS application by certain entities (by and large, financial institutions) and offer the choice to all other entities (Finland, Greece, Poland, Portugal, Slovakia only for some).

Regulation 1606/2002 also specifies the endorsement procedure and the process of making the International Accounting Standards a part of European Union legislation by way of regulation. Endorsement procedure includes:

- issuing the recommendation on the adoption or rejection of a given standard by the European Financial Reporting Advisory Group (EFRAG) – a private European organization that gives advice to the Accounting Regulatory Committee (ARC),
- approval for standard adoption expressed by the Accounting Regulatory Committee working at the European Commission,
- issuing the opinion by the European Parliament,
- issuing the regulation with the text of the standard by the European Commission, and publishing it in all official languages of the European Union.

According to EFRAG report, as of December 12, 2013, the following International Accounting Standards concerning financial instruments have been adopted in the European Union:

Adoption date	Publication date	
19/11/2004	9/12/2004	IAS 39 <i>Financial Instruments: Recognition and Measurement</i> (without fair value option and a part of hedge accounting)
29/12/2004	31/12/2004	IAS 32 <i>Financial Instruments: Disclosure and Presentation</i>
25/10/2005	26/10/2005	IAS 39 amendment: <i>Transition and Initial Recognition of Financial Assets and Financial Liabilities</i>
15/11/2005	16/11/2005	IAS 39 amendment: <i>The Fair Value Option</i>
21/12/2005	22/12/2002	IAS 39 amendment: <i>Cash Flow Hedge Accounting</i>
11/01/2006	27/01/2006	IAS 39 amendment: <i>Financial Guarantee Contracts</i>
11/01/2006	27/01/2006	IFRS 7 <i>Financial Instruments: Disclosures</i>
8/09/2006	9/09/2006	IFRIC 9 <i>Reassessment of Embedded Derivatives</i>

Adoption date	Publication date	
15/10/2008	16/10/2008	IAS 39 and IFRS 7 amendment: <i>Reclassification of Financial Instruments</i>
21/01/2009	22/01/2009	IAS 32 amendment: <i>Puttable Financial Instruments and Obligations Arising on Liquidation</i>
4/06/2009	5/06/2009	IFRIC 16 <i>Hedges of a Net Investment in a Foreign Operation</i>
9/09/2009	10/09/2009	IAS 39 and IFRS 7 amendment: <i>Reclassification of Financial Assets - Mandatory Effective Date and Transition Disclosures</i>
15/09/2009	16/09/2009	IAS 39 amendment: <i>Eligible Hedged Items</i>
27/11/2009	1/12/2009	IFRS 7 amendment: <i>Improving Disclosures about Financial Instruments</i>
30/11/2009	1/12/2009	IFRIC9 and IAS 39 amendment: <i>Embedded Derivatives</i>
23/12/2009	24/12/2009	IAS 32 amendment: <i>Classification of Rights Issues</i>
23/07/2010	24/07/2010	IFRIC 19 <i>Extinguishing Financial Liabilities with Equity Instruments</i>
22/11/2011	23/11/2011	IFRS 7 amendment: <i>Transfer of Financial Assets</i>
13/12/2012	29/12/2012	IAS 32 and IFRS 7 amendment: <i>Offsetting Financial Assets and Financial Liabilities</i>

As of December 12, 2013, the process of adoption of changes to IFRS 39 *Novation of Derivatives and Continuation of Hedge Accounting* of 27 June, 2013, was also in progress. These changes have already been approved by the Accounting Regulatory Committee and are currently pending adoption and publication by the European Commission.

In contrast, the process of adoption of IFRS 9 *Financial Instruments*, which will replace IAS 39 *Financial Instruments: Recognition and Measurement*, has been postponed until its final completion by the IASB.

## 2.3. British Accounting Standards

In accordance with the Regulation 1606/2002 of the European Commission, consolidated financial statements of entities listed on the regulated market in the United Kingdom must be prepared in compliance with International Accounting Standards, in the version endorsed by the European Union. Additionally, based on internal rules, some exchange markets not regarded as regulated market also require the application of IAS in statement preparation.

The other entities may choose between the UK Accounting Standards (UK GAAP) and the International Accounting Standards. It should be noted, however, that currently binding



standards governing financial instruments accounting are based on International Accounting Standards:

- FRS 25 'Financial Instruments: Presentation' – equivalent to IAS 32;
- FRS 26 'Financial Instruments: Recognition and Measurement' – equivalent to IAS 39;
- FRS 29 'Financial Instruments: Presentation' – equivalent to IFRS 7.

FRS 25 is applied by all entities, whereas FRS 26 and FRS 29 are applied by issuers of equities and the entities which adhere to fair value measurement principles as prescribed in the UK Company Law.

Small entities and capital groups which prepare their financial statements in accordance with FRSSE (Financial Reporting Standard for Smaller Entities) are exempt from the application of generally accepted accounting principles. Small entities are defined as the entities which, in a given financial year, do not exceed two of the following criteria:

<b>Revenue</b>	GBP 6,500,000
<b>Balance sheet total</b>	GBP 3,260,000
<b>Number of employees</b>	50 people

For small capital groups, these criteria are as follows:

<b>Revenue</b>	GBP 6,500,000 after exemptions or GBP 7,800,000 without exemptions
<b>Balance sheet total</b>	GBP 3,260,000 after exemptions or GBP 3,900,000 without exemptions
<b>Number of employees</b>	50 people

According to the simplified principles for small entities, investments are carried at the cost of acquisition. Alternatively, investments can be measured at the market price of the last revaluation or at another value that the management considers to be appropriate for the entity. When the current value of the investment is greater than the purchase price, the losses arising from revaluation to the market price are recognized in the statement of total recognized income and expenses. Impairment losses are recognized in the income statement. Revaluation gains, in the amount in excess of losses recognized in prior periods in the income statement, are recognized in the statement of total recognized income and expenses.

Financial instruments are carried as financial assets, financial liabilities or equity instruments in accordance with their economic substance rather than legal form.

Loans are carried at fair value of consideration received or paid. Borrowing costs are amortized at a fixed rate in proportion to the outstanding carrying amount and recognized in the income statement. Fees are accounted for analogically to borrowing costs, if they represent a significant part of such costs. In other cases they are recognized directly in the income statement.

In 2012/2013, the United Kingdom Financial Services Commission (FSC) revised existing accounting standards and replaced them with new standards:

- FRS 100 'Application of Financial Reporting Requirements'
- FRS 101 'Reduced Disclosure Framework'
- FRS 102 'The Financial Reporting Standard Applicable in the UK and the Republic of Ireland'

The new accounting standards will be applicable to all entities except for those that prepare their financial statements in line with IAS and small entities following FRSSE, effective as of January 1, 2015 (with the option of earlier application with regard to financial statements ending after December 31, 2012).

The FRS 102, which sets forth accounting principles, has been based on the International Financial Reporting Standard for Small and Medium-sized Entities (IRFS for SMEs) published in 2009. Financial instruments accounting principles are included in Section 11 – 'Basic Financial Instruments', and in Section 12 – 'Other Financial Instruments'. These accounting standards are discussed in this report in Section 3.1, dedicated to IRFS for SMEs.

## **2.4. German Accounting Standards<sup>2</sup>**

In recent years, German Accounting Standards were modernized to a significant extent in the Act of May 29, 2009, on the Modernization of Accounting Law (*Bilanzrechtsmodernisierungsgesetz – BilMoG*).

Under German regulations, capital groups listed on the regulated market have been allowed to apply IAS or US GAAP since January 1, 1998. Starting from January 1, 2005, IAS in the version endorsed in European Commission regulations is mandatory in the preparation of consolidated financial statements of issuers of securities. Consolidated statements of other entities can be prepared in accordance with IAS. Separate statements, however, must be drawn up in compliance with German Accounting Standards (German GAAP), and IAS-compliant statements can only be used for presentation purposes.

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<sup>2</sup> Based on 'IFRS versus German GAAP (revised) Summary of similarities and differences', published by PriceWaterhouseCoopers in 2010

In German GAAP there is no division of financial assets into the categories equivalent to IAS 39 structure. Financial assets are divided into short- or long-term assets, based on the purpose of the operating use in the long term, and the life of the financial instrument is one of the criteria underlying the division.

Upon initial recognition, financial assets are measured at the cost of acquisition, taking into account the cost of purchase.

Short-term financial assets are subsequently measured at the lower of the cost of acquisition or the market price. If the fair value is below the carrying amount, impairment loss is incurred.

Long-term financial assets are measured at amortized cost. Permanent impairment loss is reflected in the income statement, and if temporary impairment is expected, impairment loss is optional.

Financial asset is derecognized from the balance sheet if all substantial risks and rewards associated with the asset are transferred.

A financial instrument is recognized as an equity instrument, if it meets all of the following criteria, jointly:

- subordination;
- compensation as a share in profits and loss limited to the amount of capital;
- long-term financing.

Financial liabilities are divided into short- and long-term liabilities.

Upon initial measurement, financial liabilities are measured at the amount payable. The difference between the initial value and the value at maturity is amortized over time or carried directly as financial expense. When a compound financial instrument is separated into a financial liability component and an equity component, the financial liability component is carried at the amount payable.

Derivatives are recognized from the moment when the entity becomes a party to the agreement. Derivative financial assets which are recorded as off-balance sheet unrecognized firm commitments. However, commissions paid for options purchased and the initial payments on the instruments which were not incurred with zero initial value are recognized as an asset.

Subsequently, unrealized losses from the valuation of purchased options are recognized as a reduction in the value of the initial premium. Unrealized losses from the valuation of written options are recognized as a separate item in the part which is not offset by the initial premium received. Unrealized gains from the valuation of the remaining instruments are not recognized, while unrealized losses are recognized as a liability or reduction in financial assets.

In general terms, hedge accounting should be applied if the relationship between the hedged item and the hedging instrument is rooted in internal risk management policy and the following criteria are met:

- initial designation confirms the intention and the ability to hedge,
- the hedged item and the hedging instrument are eligible for hedging,
- risks are uniform and they offset one another,
- the likelihood of the future transaction has been confirmed,
- the effectiveness of the hedge has been confirmed prospectively.

Hedged items may include: assets, liabilities, unrecognized firm commitments or forecast transactions. It is also permitted to designate for hedging a part of the items, a separated risk or time, if hedge effectiveness can be confirmed. Financial assets and liabilities are not distinguished from non-financial assets and liabilities. Derivatives can be designated as hedged items.

Hedging instruments may only include financial instruments, but there is no limitation as to the derivatives only. Similar to IAS 39, an entity may designate for hedging solely the intrinsic value of the option or a spot component of a forward or futures contract.

Under German GAAP it is allowed to hedge individual transactions or groups of similar transactions. Hedging of the risk exposure of the entire portfolio, net items included, is also permitted. In the case of a portfolio hedge, an effective risk identification and mitigation system must be put in place.

Entities must confirm hedge effectiveness according to a prospective approach only. Furthermore, it is not required to confirm the effectiveness range on the basis of an arithmetic calculation. Instead, the entities should demonstrate the relationship between the schedule and the face value of the hedged item and the hedging instrument.

German GAAP does not provide for hedging models similar to those set forth in IAS 39. When an entity creates a hedging relationship, general accounting principles cease to apply to the hedging instrument and the hedged item as separate instruments. For the effective portion of the hedge, a separate, jointly measured item is formed. Two possible approaches are prescribed for the joint hedged item, in the portion representing an effective hedge:

- the net approach – offsetting valuation changes are recognized neither in the balance sheet nor in the income statement,
- the gross approach – offsetting valuation changes decrease and decrease, concurrently, the value of the hedging instrument and hedged item in the balance sheet.

For the ineffective portion of the hedge or the portion pertaining to valuation changes resulting from the risk not covered by the hedge, the hedging instrument and the hedged item are treated as separate items in accordance with general principles.

## 2.5. French Accounting Standards<sup>3</sup>

In France, the assumptions for accounting principles are specified in the Commercial Code, which also refers to EU Directives. A government organization called *Comité de la Réglementation Comptable* is responsible for defining detailed accounting principles. In France all entities must prepare their financial statements in accordance with the uniform chart of accounts, the same accounting principles and the same layout for financial statements. All these requirements are set forth in the General Chart of Accounts published pursuant to CRC 99-03 regulation.

In accordance with Article L233-24 of the Commercial Code, issuers of securities prepare their consolidated financial statements on the basis of International Accounting Standards endorsed in the Regulation of the European Commission. All other entities may apply IAS for their consolidated financial statements. Separate financial statements are drawn up in accordance with the French Accounting Standards (French GAAP).

French GAAP does not distinguish between categories of financial assets in the same way as it is prescribed in the IAS 39. Financial asset definition is limited to:

- interest in subordinate and affiliated entities,
- loans extended to subordinate and affiliated entities,
- shares in a long-term investment portfolio,
- other long-term investments,
- quoted securities.

Upon initial recognition financial instruments are carried at the cost of acquisition, and transactional costs are reflected directly in the income statement.

Long-term investments are defined as shares from which the entity expects economic benefits by holding them in the long term. These include shares in subsidiaries, affiliates and jointly controlled entities which are not subject to consolidation. Long-term investments are measured at amortized cost.

Short-term securities are measured at the lower of:

- cost of acquisition,

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<sup>3</sup> Based on 'IFRS compared with US GAAP and French GAAP', published by KPMG in 2003

- average price from the last month for quoted securities, or expected sales price in the remaining cases.

Unrealized losses on valuation are recognized directly in profit or loss. Unrealized valuation gains are not recognized.

Impairment loss on long-term investments is incurred if the current factors indicate such impairment. Impairment of short-term investments is incurred automatically if the current market price or the expected sales price falls below the purchase price. Impairment loss can be reversed if the underlying reason has ceased to exist.

Financial asset is derecognized when the entity has transferred the rights to this asset, regardless of control issue.

Financial liabilities are defined as any external resources acquired by the entity in exchange for compensation. They include long- and short-term credits and loans, as well as accrued interest.

Financial liabilities are carried at the amount payable. Premiums and discounts granted are not recognized in the measurement of financial liabilities, but represent a separate asset line and are recognized over time throughout the life of a financial liability, in proportion to interest payments or on a straight-line basis.

Under French GAAP there are no regulations on the initial separation of the value of compound instruments into a financial liability and an equity instrument. Financial instrument is recognized as a financial liability if it contains commitment to transfer the funds. If, in accordance with the contract, the creditor cannot require repayment of the funds transferred, the instrument is recognized as equity component if, in the event of insufficient profit, dividend or interest may not be required, or as a separate liability item (outside of financial liabilities) if, even in the event of insufficient profits, the minimum interest is due.

Financial liabilities are derecognized upon expiry. In addition, French GAAP includes specific provisions for the situations when financial liabilities can be derecognized if an entity transfers securities to another party in order to service these liabilities. In the case of restructuring or refinancing, financial liability is derecognized in its entirety, and a new liability arising under the circumstances is recognized.

Derivatives are measured depending on whether they are speculative instruments or hedging instruments. Speculative instruments quoted on a regulated market are measured at fair value with changes recognized in the income statement. For derivative instruments outside the regulated market (OTC), unrealized valuation gains are not recognized. Unrealized losses are reflected in the portfolio of instruments.

Derivatives can be classified as hedging instruments:

- if they were acquired or written in order to reduce the risk of changes in the value of the hedged item,
- the hedged item includes assets, liabilities, certified commitments or planned transactions, if they are well defined and their occurrence is probable,
- there is correlation between changes in the value of the hedged item and the hedging instrument.

A derivative is designated for the hedge and recognized accordingly from the moment of transaction conclusion until the moment of its expiry. Under French GAAP, all hedging relationships are accounted for in accordance with one hedging model. Hedging gains or losses are recognized in a separate line of the balance sheet as short-term financial instruments, and then transferred to the income statement in accordance with the terms of the hedged item. When the hedged item is realized, in future periods the derivative is accounted for as a speculative instrument.





### 3. DEVELOPMENT DIRECTIONS FOR INTERNATIONAL ACCOUNTING STANDARDS CONCERNING FINANCIAL INSTRUMENTS

#### 3.1. International Financial Reporting Standard for Small and Medium-sized Entities (IRFS for SMEs)

International Accounting Standards Board (IASB) aims to develop high-quality accounting standards to enable preparation of comparable general-purpose financial statements. This applies, in particular, to issuers of securities in regulated markets, who are obligated by the law to include in their financial statements (including issue prospectuses, annual and interim financial statements) a wide range of information concerning their financial position and their accounting policies. Due to the development of financial markets and the areas of economics related to risk management, observed in recent years, there was an increase in information requirements for issuers of securities. These changes are also reflected in the continuous improvement and development of the International Accounting Standards.

On the other hand, however, these changes mean that IAS become come and more detailed and complicated, and their implementation and subsequent application require the allocation of increasing resources. This can be particularly burdensome for smaller enterprises which are not listed and are obliged to prepare their financial statements along the same requirements as the issues of securities in regulated markets.

This problem has been identified by IASB and, since 2003, efforts have been undertaken in order to enable the preparation of high quality financial statements by small and medium-sized entities with concurrent reduction of outlays required for their preparation.

In July 2009, IASB published International Financial Reporting Standard for Small and Medium-sized Entities (IRFS for SMEs). It is important to emphasize that the criterion for classification in a category of small and medium-sized entities subject to the new standards was not based on assets, revenues or employment, but on the following two conditions (paragraph 1.2.). Small and medium-sized entities:

- are not **public interest entities**, and
- publish **general-purpose financial statements** for external users, including owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

In other words, regardless of the size of entity's operations, small and medium-sized entities in the meaning of IFRS for SMEs do not include, in particular (paragraph 1.3):

- entities whose debt or equity instruments are traded in a public market or entities which are in the process of issuing such instruments for trading in a public market, or
- entities which hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (banks, credit unions, insurance companies, mutual funds, etc.).

Requirements concerning financial instruments have been much simplified and limited in comparison to the requirements under the following, present-day standards: IAS 32: *Financial Instruments: Presentation*, IAS 39: *Financial Instruments: Recognition and Measurement*, and IFRS 7: *Financial Instruments: Disclosures*.

IFRS for SMEs contains two sections regulating the subject matter of financial instruments, namely:

- Section 11 – *Basic Financial Instruments*;
- Section 12 – *Other Financial Instruments Issues*.

Entities applying IFRS for SMEs have a choice (paragraph 11.2) in that they follow either:

- the provisions of both Section 11 and Section 12 in full, or
- the recognition and measurement provisions of IAS 39 and the disclosure requirements of Section 11 and 12.

The application of IFRS 7 for small and medium-sized enterprises is not permitted.

### 3.1.1. Basic financial instruments

Basic financial instruments include (paragraph 11.8):

- cash,
- a debt instrument (such as an account, note, or loan receivable or payable),
- a commitment to receive a loan that:
  - cannot be settled net in cash, and
  - when the commitment is executed, it is expected to meet the conditions in paragraph 11.9,
- an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.

Pursuant to paragraph 11.9, debt instruments that satisfy all the conditions below are accounted for in accordance Section 11:

- returns to the holder are:
  - a fixed amount;

- a fixed rate of return;
- a variable return;
- a combination of a fixed and variable rate of return, provided that both are positive;
- there are no provisions that could result in loss of principal amount or interest;
- provisions that permit prepayment are not contingent on future events;
- there are no conditional returns or prepayment provisions except for the variable rate and prepayment provisions.

In particular, basic financial instruments do not include, for example, puttable or convertible shares, derivative instruments, investments in convertible debt, etc.

### 3.1.2. Initial recognition and measurement

A financial asset or financial liability is recognized only when the entity becomes a party to the contractual provisions of the instrument.

When a financial instrument is measured initially, an entity measures it at the transaction price including transaction cost (except for financial instruments measured at fair value though profit or loss). In the case of a financing transaction (e.g. payment deferred beyond normal business terms, interest rate that is not a market rate), financial instrument is measured at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Subsequently, at the end of each reporting period an entity measures financial instruments as follows (paragraph 11.14):

- debt instruments – at amortized cost using the effective interest method, with the exception of short-term debt instruments which are measured at the undiscounted amount of consideration expected to be paid or received, and arrangements that constitute a financing transaction, which are measured at the present value of the future payments discounted at a market rate of interest for a similar debt instrument,
- commitment to receive a loan – at cost less impairment,
- investments in non-convertible preference shares and non-puttable ordinary or preference shares are measured at fair value, if the shares are publicly traded or their fair value can otherwise be measured reliably. In other cases, such investments are measured at cost less impairment.

Section 11 is also dedicated to the issues related to measurement at amortized cost using effective interest method (paragraphs 11.15-11.20) and to fair value measurement (paragraphs 11.25-11.32). IAS 39 contains more detailed guidance on measurement

approaches, but the requirements towards small and medium-sized enterprises are similar in that regard.

### 3.1.3. Impairment

Analogically to the requirements set forth in full IAS, the wording of Section 11 (paragraph 11.21) stipulates that, at the end of each reporting period, an entity should assess whether there is objective evidence of impairment of a financial asset and recognize an impairment loss in profit or loss immediately. Permanent impairment is considered for financial assets measured at cost or at amortized cost, and for the instruments measured at cost. IAS 39 provides for permanent impairment of financial assets available for sale (fair value measurement with changes reflected in equity), but no such category has been prescribed for small and medium-sized enterprises.

Under IFRS for SMEs, it is permitted to reverse the previously recognized impairment loss if the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized. This also applies to equity instruments, but under IAS 39 the reversal of impairment losses on financial assets measured at cost is not permitted (IAS 39.66), and neither is the reversal of impairment losses on assets available for sale through profit or loss (IAS 39.69)

### 3.1.4. Derecognition of financial instruments

Pursuant to paragraph 11.33, an entity should derecognize a financial asset only when:

- the contractual rights to the cash flows expire or are settled, or
- the entity transfers to another party substantially all of the risks and rewards of ownership of the asset, or
- the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party.

Financial liability should be derecognized only when the obligation specified in the contract is discharged, cancelled, or expires.

Solutions adopted for SMEs in that regard are similar to those applied under IAS 39.

### 3.1.5. Disclosures

The scope of disclosures concerning small and medium-sized enterprises in the area of financial instruments has been reduced quite substantially in comparison to the full IAS. Under IFRS for SMEs, it is not permitted that the entities apply IFRS 7.

Entities should disclose the following information:

- carrying amounts for each category of financial assets and financial liabilities,
- that enables users of financial statements to evaluate the significance of financial instruments for entity's financial position and performance (e.g., interest rate, repayment schedule, restrictions, etc.),
- the basis for determining fair value,
- equity instruments which can no longer be measured at fair value,
- transactions in the case of which financial assets do not qualify for derecognition,
- pledged financial assets as collateral for liabilities,
- cases of breach of terms or default in loan contracts,
- items of income, expense, gains or losses in respect of changes in fair value, interest and impairment.

### 3.1.6. Other financial instruments

Provisions of Section 12 apply to all financial instruments except for the following:

- instruments covered in Section 11,
- interests in subsidiaries,
- employee benefit plans,
- insurance contracts,
- entity's own equity,
- some leases,
- contracts for contingent consideration in a business combination.

Most contracts to buy or sell a non-financial item (e.g. inventory, property, plant and equipment, etc.) are not financial instruments, but the provisions of Section 12 shall apply to such contracts if they impose risks on the buyer or seller that are not typical for such contracts, i.e. other than changes in the price, changes in the foreign exchange rates, or a default by one of the counterparties.

Financial instruments covered by Section 12 are recognized when an entity becomes a party to the contractual provisions and are measured at fair value upon initial recognition.

Subsequently, at the end of each reporting period, an entity measures financial instruments covered by Section 12 at fair value, and recognizes changes in fair value in profit or loss. In the case of equity instruments that are not publicly traded and whose fair value cannot

otherwise be measured reliably, and in the case of contracts linked to such instruments, measurement is done at cost less impairment.

### 3.1.7. Hedge accounting

Under IFRS for SMEs, analogically to IAS 39, an entity may designate a hedging relationship between the hedging instrument and the hedged item in order to have the gains or losses on both instruments recognized in profit or loss.

Prior to hedging, an entity should officially designate and document the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are identified. The entity must expect the hedging instrument to be highly effective (paragraph 12.16). However, in contrast to IAS 39 which requires that an entity should evaluate effectiveness prospectively and retrospectively at least as at the balance sheet date and confirm the effectiveness in the range of 80-125%, IFRS for SMEs does not specify the required range of effectiveness. Likewise, it is not required that an entity should measure the effectiveness in value terms throughout the lifetime of the hedge.

In line with paragraph 12.17, hedge accounting is permitted only for the following risks:

- interest rate risk for a debt instrument measured at amortized cost,
- foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction,
- price risk of a commodity that the entity holds or in a firm commitment or a highly probable forecast transaction to purchase or sell a commodity,
- foreign exchange risk in a net investment in a foreign operation.

IAS 39 does not restrict the types of risks to be hedged. It only requires that it is possible to identify and measure the exposure to the hedged risk, and the risk has impact on the income statement (it is not permitted to hedge, for example, the general business risk).

In IFRS for SMEs there are restrictions concerning hedging instruments that can be designated. As specified in paragraph 12.18, hedging instrument must meet all of the following terms and conditions to be designated for the hedge:

- it is an interest rate swap, a currency exchange swap, a foreign currency forward exchange contract, or a commodity forward exchange contract that is expected to be highly effective in offsetting hedged risk,
- it involves a party external to the reporting entity (i.e., external to the group, segment or individual entity being reported on),
- its notional amount is equal to the designated amount of the principal or the notional amount of the hedged item,

- it has a specified maturity date not later than:
  - the maturity of the financial instrument being hedged,
  - the expected settlement of the commodity purchase or sale commitment, or
  - the occurrence of the highly probable forecast foreign currency or commodity transaction being hedged,
- it has no prepayment, early termination or extension features.

Under IFRS for SMEs it is forbidden, in particular, to designate options as hedging instruments, even if they are purchased options, not written options.

In IAS 39.72 there are no restrictions as to the circumstances in which a derivative instrument can be designated as a hedging instrument (except for some written options). Further, it permits designation of a non-derivative financial asset or financial liability as a hedging instrument for a hedge of a foreign currency risk. As prescribed in IAS 39.76, a single hedging instrument may be designated as a hedge of more than one type of risk. Moreover, a combination of two or more derivatives can be jointly designated as the hedging instrument (IAS 39.77).

IAS 39 prescribes no restrictions as to the notional amount, maturity dates and prepayment, or termination or extension of hedging instruments. It only requires that the entity should be able to confirm that these elements do not affect high effectiveness of the hedge.

### 3.1.8. Hedge of a fixed interest rate risk of financial instruments or commodity price risk of a commodity held

Hedge of a fixed interest rate risk of financial instruments or commodity price risk of a commodity held by the entity is treated in a similar way as a fair value hedge under IAS 39. The entity shall recognize:

- the hedging instrument as an asset or liability and the change in the fair value of the instrument in profit or loss, and
- the change in the fair value of the hedge item related to the hedged risk in profit or loss and as an adjustment to the carrying amount of the hedged item.

If hedge accounting is discontinued, any gains or losses recognized as adjustments to the carrying amount of the hedged item are amortized using effective interest method over the remaining life of the hedged item.

### 3.1.9. Hedge of a variable interest rate risk of a financial instrument, foreign exchange risk or commodity price risk in a firm commitment, highly probable forecast transaction, or a net investment in a foreign operation

This hedge operates analogically to a cash flow hedge under IAS 39. An entity recognizes in other comprehensive income the portion of the change in the fair value of the hedging instrument that was effective in offsetting the change in the fair value of expected cash flows of the hedged items. Any excess of the fair value of the hedging instrument is recognized by the entity as hedge ineffectiveness in profit or loss.

Gains or losses recognized in other comprehensive income are reclassified to profit or loss when the hedged item is recognized in profit or loss, or when the hedging relationship ends.

### 3.1.10. Additional disclosures

An entity applying Section 12 makes all of the disclosures required in Section 11. In addition, if an entity uses hedge accounting, it makes the additional disclosures in respect of all types of its hedges. Such disclosures, however, are not as granular as those required under IFRS 7.

## 3.2. International Financial Reporting Standard no 9 – Financial Instruments

In spite of several amendments to IAS 39: *Financial Instruments: Recognition and Measurement*, IASB was receiving numerous comments pointing at problems with proper understanding of the standard and its practical application. In order to address the needs of IAS users and users of financial statements, a decision was made to initiate a project as a result of which IAS 39 would be replaced with a new standard - IFRS 9: *Financial Instruments*. Financial crisis and resulting discussion on the need to design better solutions which would better safeguard financial statements from violent fluctuations caused by the challenges financial market were struggling against in recent years worked as an additional incentive which stepped up the process of replacement of IAS 39.

International Accounting Standards Board divided the project into 3 phases:

- Phase 1 – *Classification and Measurement of Financial Assets and Financial Liabilities*;
- Phase 2 – *Impairment*;
- Phase 3 – *Hedge Accounting*.

Thanks to such a breakdown, the work on each phase can progress on an individual basis – once a phase is completed, relevant sections of IFRS 9 are published and they replace the



requirements of IAS 39 in the scope involved. With this approach, the work on Phase 2 concerning impairment, which gives rise to most controversy and comments, does not impede earlier application of the other phases, once completed and published.

It should be noted, however, that the issuers of securities from European Union Member States who are obliged to prepare their consolidated financial statements in accordance with International Accounting Standards must adhere to the standards endorsed under EU regulation. In consequence, even though earlier partial application of IFRS 9 upon completion of a phase is possible and encouraged by IASB, such an approach will not be available for Member State entities until IFRS 9 is officially adopted as part of EU legislation. And, most probably, the process of IFRS 9 endorsement will not start until the entire project is finalized.

Initially, IFRS 9 project was scheduled for completion in such a way to make sure that it would be binding in the case of financial statements starting as of January 1, 2013; but then the deadline was moved forward to January 1, 2015. However, in view of protracted work on impairment, in the most recent standard publication dated November 2013, IASB decided not to announce the new scheduled standard implementation date until all project phases are completed.

### 3.2.1. Phase 1 – Classification and measurement of financial assets and financial liabilities

In November 2009, IASB published the first part of Phase 1: IFRS 9 on classification and measurement of financial assets. In November 2010 a subsequent part was added, dedicated to classification and measurement of financial liabilities. All published parts of the standard should be applied in conjunction, but in November 2013 IASB permitted the application of requirements related to entity's own credit risk of financial liabilities measured at fair value through profit or loss regardless of the application of other requirements under IFRS 9 (paragraph 7.1.2).

Under IAS 39, classification of financial assets was based on entity's intention underlying the acquisition of the financial instrument. This approach is no longer applicable under IFRS 9. An entity classifies financial assets as measured at:

- amortized cost, or
- fair value,

depending on the business model that was adopted in connection with financial assets management and characteristics of contractual cash flows related to the financial asset. The business model concept is a broader concept than the previous criterion of intention underlying the acquisition of the financial asset. An entity does not group individual financial assets, but classifies them in accordance with the business model adopted for the entire entity or its units responsible for managing the portfolio of financial instruments. IFRS 9 provides for

situations where one entity may be composed of units operating under different business models, and thus applying different measurement methods for the same type of financial assets.

As entity measures financial assets at amortized cost, if the two conditions are met:

- entity's business model objective is to hold financial assets in order to obtain contractual cash flows related to those assets,
- contractual terms and conditions of financial assets allow for obtaining cash flows, on certain dates, which are solely the payments of the principal or the interest on the outstanding principal.

Thus, IFRS 9 eliminated the division of assets measured at amortized cost into two portfolios: loans and receivables, which included debt instruments not quoted in an active market, and assets held to maturity, where the entity could classify debt instruments only upon confirmation that the entity has the ability and intention to hold the asset to maturity. Under the present-day approach such a division is not necessary because an entity may classify financial assets as measured at amortized cost only when its business model is based on financial assets held for contractual cash flows and not for earlier resale – i.e., analogically to the case of the existing portfolio of financial assets held to maturity. Under the new approach, however, there is no need to reclassify assets from that portfolio in the case of tainting, as long as entity's business model remains unchanged.

Other financial assets are measured at fair value.

Reclassification of financial assets is only allowed when the business model is changed, and it applies to all financial instruments managed under this model.

Irrespective of the business model adopted, an entity may also, upon initial recognition, designate a financial asset irrevocably as measured at fair value through profit or loss, if this will help minimize the inconsistency (accounting mismatch) caused by different measurement approaches or different methods of recognition of assets and liabilities.

Financial assets are classified as measured at amortized cost, except for:

- financial liabilities measured at fair value through profit or loss (including derivative liabilities),
- financial liabilities arising as a result of a transfer of a financial asset not eligible for derecognition, or when there is continued involvement in the transferred financial assets,
- financial guarantee contracts,
- commitment to provide a loan with interest rate below market rate.

At initial recognition, an entity may also make an irrevocable designation of a financial asset as measured at fair value through profit or loss, if:

- it eliminates or substantially reduces accounting mismatch resulting from different measurement approaches or different methods of recognition of assets and liabilities, or
- the portfolio of financial liabilities or financial assets and liabilities and its performance is evaluated on a fair value basis, in accordance with a documented investment or risk management strategy, and such information is provided internally to key management of the entity.

Financial liabilities are not reclassified.

Gains or losses arising from fair value measurement of financial instruments are recognized in profit or loss, except for:

- financial instruments designated for hedging,
- investments in equity instruments for which the entity chose the fair value through other comprehensive income measurement (FVOCI),
- changes in credit risk of financial liabilities measured at fair value through profit or loss, which must be recognized by the entity through other comprehensive income.

The principles governing derecognition of financial instruments have not changed – they are substantially similar to those prescribed in IAS 39.

A financial asset is derecognized from the balance sheet when, and only when:

- the contractual rights to the cash flows from the financial asset expire,
- an entity transfers the financial asset and the transfer qualifies for derecognition.

When assessing whether the transfer qualifies for derecognition, an entity examines whether, in spite of:

- retaining the rights to receive the cash flows from the asset, the entity has the contractual obligation to transfer those cash flows to another entity,
- transferring the rights to receive the cash flows from the asset, the entity has retained substantially all the risks and rewards of ownership of the asset,
- not transferring and not retaining substantially all the risks and rewards of ownership of the asset, the entity has retained control of that asset (continued involvement).

Derecognition may apply the entire financial asset or its part (if it applies to specifically defined cash flows, a fully proportionate share of the cash flows, or a fully proportionate share of specifically defined cash flows).

A financial liability is derecognized only when it is extinguished, i.e. when the obligation specified in the contract is discharged, cancelled, or expires.

In the case of hybrid instruments with an embedded derivative which include a host contract which is a financial asset, an entity follows measurement principles specified in IFRS 9 for the entire hybrid instrument, without the need to separate the embedded derivative.

However, IFRS 9 has retained the requirement to separate embedded derivatives from hybrid contracts which include a host contract that is not a financial asset, if the following three criteria are met jointly:

- the economic risks and characteristics of the embedded derivative are not closely related to the economic risks and characteristics of the host contract,
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative,
- the hybrid instrument is not measured at fair value through profit or loss.

Having said that, an entity may designate a hybrid instrument which includes a host contract that is not a financial asset for fair value measurement through profit or loss in its entirety, unless:

- the embedded derivative does not modify, to a substantial extent, the cash flows which would otherwise be required under the contract,
- it is obvious without an in-depth analysis that upon initial recognition of a similar hybrid instrument, it would be forbidden to separate the embedded derivative.

### 3.2.2. Phase 2 – Impairment

In accordance with IAS 39.59, an entity assesses at the end of each reporting period whether there is objective evidence of financial asset impairment as a result of one or more events that occurred after the initial recognition of the asset, and the loss event has impact on the estimated future cash flows of the financial asset that can be reliably estimated. Losses expected as a result of future events, no matter how likely, are not recognized.

The model of incurred losses was strongly criticized in connection with the financial crisis, since in the perception of many users of financial statements, impairment losses on financial assets were recognized in financial statement too late. By the same token, recognition of impairment loss in its full amount only upon occurrence of events confirming impairment has exerted dramatic and negative impact on financial results of many entities.

In view of numerous signals from the market during financial crisis, calling for changes in accounting standards, both IASB and FASB (US Financial Accounting Standards Board) started working on a new model permitting recognition of likely impairment losses during the lifetime

of a financial instrument, and not only when there is objective evidence of such impairment. Work on the new impairment model was incorporated under Phase II to the new IFRS 9 project.

In November 2009, IASB published the first Exposure Draft under Phase II: *Financial Instruments – Amortized Cost and Impairment*. In line with the first proposal, upon initial recognition of an asset entities should modify effective interest rate with initial credit risk expectations, and such modified effective interest rate should be applied in the measurement of financial assets. All subsequent changes in the carrying amount resulting from the conversion of expected future cash flows should be recognized in the income statement. This approach, however, was questioned on the grounds of serious complications arising from the attempts at practical application of the model.

Afterwards, in January 2011, IASB together with FASB published a Supplementary Document: *Financial Instruments – Impairment*. Under this approach, impairment was not recognized through adjustment of effective interest rate according to credit risk for individual categories of financial assets, but it was recognized as a cumulative loss in respect of expected credit losses in the amount dependent on whether a financial asset was in a good book or in a bad book. In the case of a bad book, entities were supposed to account for credit losses throughout the entire lifetime of the financial instrument, and in the case of the good book, at the greater of:

- credit losses expected in the foreseeable future,
- proportional amount of expected losses throughout the entire lifetime of the financial instrument.

The last Exposure Draft: *Financial Instruments – Expected Credit Losses* was published in March 2013. Consultation period for the latest amendments ended in July 2013. Following the review of feedback, in November 2013 IASB decided to postpone the scheduled date of implementation of the new IFRS 9 (January 1, 2015) until the work under Phase II of the project is completed. Even though the new date has not been announced, it is estimated that the time needed for practical implementation of the new standard including, *inter alia*, development of new operating procedures, adjustment of IT systems, obtaining appropriate input data etc. may actually amount to 3 years, approximately.

Pursuant to the draft of July 2013, the new impairment model should be applied in respect of the following financial assets:

- measured at amortized cost,
- measured at fair value through other comprehensive income (FVOCI),
- commitments to provide a loan with a present obligation to increase credit (except for fair value measurement through profit or loss),
- financial guarantees (except for fair value measurement through profit or loss),

- lease receivables.

Entities should recognize expected losses in the statement of financial position as:

- loss allowance in the case of financial assets measured at amortized cost, and lease receivables,
- provisions, in the case of loan commitments and financial guarantees.

With respect to financial assets measured at fair value through other comprehensive income, impairment is recognized in the statement of financial position in the measurement of financial instrument, and impairment valuation is necessary in order to recognize the loss in the income statement.

An entity should calculate expected credit losses in the amount equal to the expected credit losses for a period of 12 months, unless the credit risk associated with a financial instrument has not increased significantly since its initial recognition. In this case, the expected credit losses are calculated for the entire lifetime of the instrument. However, if the credit risk is still low despite the increase since the initial recognition of a financial instrument, an entity recognizes expected credit losses for the period of 12 months.

If an entity calculates the expected credit losses for the entire lifetime of the instrument, and in subsequent periods the credit risk is significantly reduced, the entity translates the allowance or provision for expected credit losses to the amounts corresponding to the size of the expected credit losses for the period of 12 months.

With regard to trade receivables (that are not financial transactions), an entity applies a simplified approach and calculates the expected credit losses for the entire lifetime of the instrument. In the case of trade receivables that are financial transactions and in the case of lease receivables, an entity may choose a simplified approach, and then it must follow this approach with regard to all such financial assets.

When assessing whether credit risk has significantly increased, an entity should compare the probability of default over the remaining lifetime of the instrument on the balance sheet date and on the date of its initial recognition. For this purpose, information regarding anticipated future events should be used, rather than the information about past events. Nevertheless, it is prescribed in the standard that, unless there are other indications, a 30-day delay in payments can already indicate a significant deterioration of credit risk.

Estimation of the expected credit losses should be determined in an impartial manner and it should reflect the probability-weighted amount determined by estimating various possible outcomes. The calculation must also take into account the time value of money. An entity does not have to take into account all possible scenarios, but it should consider the probability of credit losses, even if it is very low. For the 12-month expected credit losses the probability of default over the next 12 months is estimated, whereas in the case of expected credit losses

throughout the lifetime of the instrument the probability of insolvency over the remaining lifetime of the financial instrument should be estimated. The maximum period for which the expected credit risk is estimated is the maximum period during which an entity is exposed to this risk, in accordance with the terms of contract. In making estimates, an entity should rely on the best available information on past events, current conditions, and reasonable forecasts of future events and economic conditions that are available as at the balance sheet date.

In the case of renegotiation of the terms of agreement or other modifications which do not meet derecognition criteria, an entity should estimate the new carrying amount based on the cash flows arising from the new contractual terms, and recognize the changes resulting from modifications in the income statement. If an entity does not expect to recover the financial asset, the entity should immediately reduce its carrying amount. In calculating the value of the write-down, the entity takes into account the amounts that are recoverable, e.g. in respect of the hedges applied.

Interest income is presented in a separate line item in the statement of comprehensive income, and calculated using the effective interest method on the gross carrying amount of the asset, with the exception of:

- acquired or incurred financial assets with initial impairment: effective interest rate is adjusted to take into account the initial impairment, and interest income is calculated on the net value at amortized cost,
- other assets for which – as at the balance sheet date – there is objective evidence of impairment: interest income is calculated with the use of the original effective interest rate on the net value at amortized cost.

### 3.2.3. Phase 3 – Hedge accounting

Hedge accounting principles set out in IAS 39 were frequently criticized as too strict and not reflecting the unique nature of managing financial risk of entities. Large financial institutions involved in portfolio risk management were particularly challenged by the need to match stringent requirements of the standard to their operation. In that context, it often happened that the entities which used financial instruments to hedge certain financial risks did not adhere to hedge accounting principles. In consequence, financial statements sometimes failed to reflect the actual economic effect of hedging activities, and thus failed to provide relevant information about risk management in the entity for users of financial statements. Furthermore, due to rapid development of financial markets and risk management methodologies, observed in recent years, the existing hedge accounting principles were becoming more and more detached from market practice.

In course of work on IAS amendment in 2003, the International Accounting Standards Board took into account the arguments stipulating that hedge accounting should be applied for macro hedging. Existing hedging models were supplemented with the fair value macro-hedge

for a portfolio of financial assets or financial liabilities against the interest rate risk. Those changes, however, did not fully respond to market needs in that regard.

The objective of Phase III of the project that consists in replacing IAS 39 with a new standard is to make hedge accounting principles less strict and more broadly applicable, and to make them more consistent with the market practice in the area of risk management with the use of financial instruments. Sections dedicated to hedge accounting were published in November 2013. Yet, these changes do not include macro-hedging provisions, due to the fact that IASB decided to launch a separate project dedicated to macro-hedging. It is expected that the first discussion papers on new macro-hedging regulations will be available in 2014.

Since macro-hedging was isolated from IFRS 9 project, upon publication of IFRS 9 the entities which hitherto applied portfolio fair value hedge model would not be able to continue to apply this model. Taking this into consideration, IASB allowed for the application of macro-hedging regulations under IAS 39 in conjunction with the application of other provisions under IFRS 9, until the work on the new macro-hedging standard is completed. In order to avoid complications during transition, the entities which apply IFRS 9 for the first time are allowed to continue the application of hedge accounting principles set out in IAS 39, instead of the requirements prescribed in section 6 of IFRS 9.

Hedging instruments may include derivatives (with the exception of some written options), but they may also include non-derivative financial assets or financial liabilities measured at fair value through profit or loss (except for such financial liabilities for which fair value change resulting from entity's own credit risk is reflected in other comprehensive income). IAS 39 permitted designation of non-derivative financial assets or financial liabilities as hedging instruments only in respect of foreign currency hedge risk. In IFRS 9 this restriction is removed for instruments measured at fair value through profit or loss. However, in the case of risk other than foreign currency risk, such an instrument can be designated for hedging only in its entirety or in proportion, but not for separate types of risks (paragraph B6.2.5).

IFRS 9 extends the number of items that can be designated as hedged items. Apart from recognized financial assets, financial liabilities, firm commitments and highly probable forecast transactions, the standard also allows to hedge aggregated items composed of the combination of exposure and derivative instrument. Under IAS 39, it was not allowed to designate derivatives as hedged items (except for a specific situation when the option purchased is hedged with an option written on fair value hedge) (IAS 39 IG F.2.1).

If an entity applies credit derivatives with the purpose to manage its credit risk exposure, it can designate for hedging a financial instruments (or its part) managed in that way, if:

- the entity exposed to credit risk is the same as the entity to which credit derivative is applied,



- payment priority on the financial instruments is the same as on the instrument to be delivered in accordance with the credit derivative.

Exposure to credit risk of financial instruments can also represent a hedged item.

IAS 39.82 specifies that if the hedged item is a non-financial asset or non-financial liability, it can be designated as a hedged item only for foreign currency risks or in its entirety for all risks. This point was frequently criticized because it did not permit designation of solely price risk for hedging, for example, as a result of which entities could not designate e.g. only commodity futures contracts denominated in a foreign currency (typically, USD). There is no such restriction under IFRS 9. A non-financial asset or non-financial liability (analogically to a financial instrument) can be designated for hedging individual risk components, provided that they can be identified separately and measured reliably.

A hedging relationship qualifies for hedge accounting if the following conditions are met:

- a hedging relationship consists of such hedging instruments and hedged items that can be designated in accordance with the standard,
- at the inception of the hedge there is formal designation and documentation of the hedging relationship, and the entity's risk management objective and strategy for undertaking the hedge,
- requirements concerning hedge effectiveness are met.

Hedging relationship documentation should include: identification of the hedging instrument, hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness, including the review of potential sources of ineffectiveness of the hedge and the methodology behind hedge ration designation.

One of major changes in comparison to IAS 39 is the approach to hedge effectiveness requirements. In IFRS 9, numerical testing of effectiveness is replaced with the verification of effectiveness that is more consistent with the methods applied by entities that actively manage their financial risk. Hedging relationship is considered as effective, if:

- there is an economic relationship between a hedging instrument and a hedged item,
- the effect of credit risk does not dominate the value changes that result from that economic relationship,
- hedge ration is designated based on the actual quantities of the hedged item and the hedging instrument.

The standard requires that the entity confirms compliance with hedge effectiveness criterion prior to the inception of the hedge and at least at the balance sheet date or in the case of significant events that may affect the effectiveness of the hedge. However, effectiveness is tested only prospectively and it pertains to entity's expectations as to the future

effectiveness. Entities do not test effectiveness retrospectively and they do not have to demonstrate that is within the 80%-125% range, which was required under IAS 39. Moreover, in the case when the hedge no longer meets the effectiveness requirements and the risk management objective assumed at the inception of the hedge continues to be satisfied, the entity should adjust a hedge ratio for risk management purposes (rebalancing) and continue hedge accounting for this hedging relationship. IFRS 9 does not allow terminating a hedge relationship voluntarily when risk management objective is still met – it permits termination only when hedge criteria are no longer met (taking rebalancing into account) (paragraph B.5.23) (in particular, expiry of the hedging instrument).

Under IFRS 9, there are three types of hedging relationships:

- fair value hedge,
- cash flow hedge,
- hedge of a net investment in a foreign operation.

Under fair value hedge model, the gains or losses on the hedging instrument are recognized in the income statement, and the gains or losses on the hedged item adjust the carrying amount of this item and are also recognized in the income statement. The exception is the hedge of equity instruments for which the entity chose to present gains and losses resulting from fair value measurement in other comprehensive income. Under such circumstances, gains or losses on hedging instrument measurement are reflected in other comprehensive income. This is different from the treatment prescribed under IAS 39, where – in the case of a hedge of financial assets held for sale – gains or losses on hedged item measurement were reflected in income statement. This gave rise to certain inconsistency between initial designation related to entity's intention and hedge accounting requirements.

Cash flow hedge model is similar to the model set forth in IAS 39. The separate component of equity (reserve capital on cash flow hedges) related to the hedged item is adjusted to the lesser of the following:

- the cumulative gain or loss on the hedging instrument from inception of the hedge, and
- the cumulative change in fair value of the hedged item from inception of the hedge.

The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge and corresponds to the portion reflected in cash flow hedge reserve capital is recognized in other comprehensive income, and the ineffective portion is recognized in profit or loss.

The amount recognized in cash flow hedge reserve capital is recognized:

- as an adjustment of the initial value when the forecast transaction incurs a non-financial asset or liability, or a firm commitment designated for fair value hedge;

- in the remaining cases - in the income statement at the same time when the hedged transaction is recognized in the income statement.

If a loss is recognized in the cash flow hedge reserve capital and the entity expects it will not be recovered in subsequent periods, in whole or in part, the amount should be immediately recognized in the income statement.

The model of the hedge of a net investment in a foreign operation works similarly to the cash flow hedge model. Gains or losses on the hedging instrument that represent the effective portion of the hedge are reflected in other comprehensive income, and the ineffective portion is recognized in the income statement. The effective portion of the hedge is transferred to income statement upon total or partial sale of the foreign operation.

The standard permits separation of the fair value of the options designated for hedging into the intrinsic value and the time value, and it allows for designation of the intrinsic value solely. By the same token, in the case of forward transactions it is allowed to separate the spot price and the interest element, and in the case of a currency instrument the standard permits separation of the base spread. Similar solutions were provided for under IAS 39; such solutions were applied by the entities with the purpose to increase the effectiveness of the hedge, and the separated part was treated as ineffectiveness of the hedge and was recognized in the income statement.

IFRS 9 prescribes more detailed principles of recognition of the time value of an option. Fair value change in the time value element of an option is recognized in other comprehensive income and accounted for depending on whether the option hedges the hedged item that is:

- transaction-based: accounted for analogically to the cash flow hedge model (i.e., as initial value adjustment in the case of a non-financial item hedge, or in the income statement at the same point in time when the hedged item, in the case of financial instruments),
- time-based: amortized over the period in which the hedging effect related to intrinsic value of the option affects the income statement (or other comprehensive income in the case of equity instrument hedge measured at fair value through other comprehensive income).

A similar approach can be applied by an entity with regard to the separation of interest element in a forward transaction, or base spread in the case of a currency financial instrument.

Under IAS 39.83, similar assets of similar liabilities could be aggregated and hedged as a group if the individual assets or individual liabilities in the group shared the risk exposure that was designated as being hedged, and the change in the fair value attributable to the hedged risk for each individual item in the group was expected to be approximately proportional to the

overall change in the fair value attributable to the entire group. However, a hedge of an overall net position did not qualify for hedge accounting (IAS 39 AG 101).

Under IFRS 9 it is permitted to designate a group to be hedged (including a group that represents a net position), provided that the following conditions are met:

- the group is composed of positions which can individually be designated as hedged items,
- positions in the group are managed jointly on a group basis, in accordance with risk management objectives,
- in the case of a cash flow hedge in the group of positions for which it is not expected that cash flow volatility will be approximately proportional to the volatility of cash flows of the group, foreign currency risk hedge and net position designation are determined by the periods in which forecast transactions are expected to be recognized in the income statement, and by the character and volume of those transactions.

Group component that meets the criteria of a hedged item can be a hedged item if it is compliant with entity's risk management objective. Group layer component meets the criteria of a hedged item if, and only if:

- it can be identified separately and measured reliably,
- layer component hedging is a risk management objective,
- items in the group comprising the layer component are exposed to the same risk, which is why it is quite insignificant for the measurement of the hedged component which items in the group are included in the component,
- in the case of hedging of recognized items, an entity is able to identify the items of the group from which the layer component was defined, for proper accounting treatment of the hedged item,
- each element of the group containing prepayment option takes it into account in connection with fair value measurement.

An entity can also designate a nil net position as being hedged, if the value of that position can change in time and the risk management strategy provides for current hedging of that position in time. In such circumstances, hedge accounting is applicable if the application of conventional accounting principles might result in inadequate presentation of offsetting risk effect on the net positions in the financial statement.

In the case of a hedge of a group with offsetting risk exposure for which the risk being hedged affects different items in the income statement or other comprehensive income, income or expense arising from the hedge should be presented in a separate line item. Under the fair value hedge model, gains or losses on the hedge in the statement of financial position adjust the value of individual components in the group.





## 4. RECOMMENDATIONS

### 4.1. Consideration of the option to divide entities into two groups

One of the requirements concerning the scope of this report is that it considers the option of dividing entities keeping the books of account and preparing financial statements in compliance with the Accounting Act, into two groups:

- a) group 1 – small and micro-undertakings (for which regulations concerning financial instruments would be defined in the Accounting Act in respect of simplified principles of their recording, measurement and presenting in financial statements)
- b) group 2 – medium-sized undertakings, large undertakings and public interest entities (which would be required to comply with IFRS as regards financial instruments)

It should be noted that pursuant to the currently binding regulations, entities whose financial statements are not subject to mandatory audit in accordance with Article 64, paragraph 1 of the Accounting Act are allowed not to apply the provisions of Regulation on Principles of Recognition, Valuation Methods, the Scope of Disclosures and the Way of Presenting Financial Instruments. Paragraph 2.2 of the Regulation was added in 2004 following numerous comments emphasizing the excessive complexity of financial instruments accounting principles and a very detailed scope of disclosures required by the Regulation. They concerned in particular small entities using financial instruments to a very limited extent which – according to the original version of the Regulation of 2001 – were obliged to apply the same accounting principles as other entities. Entities which benefitted from the possibility of exemption apply general principles of measurement arising from the Accounting Act and disclose information on financial instruments in a limited scope as determined in paragraph 2a of the Regulation.

Distinguishing a group of entities allowed to apply simplified principles of financial instruments accounting seems by all accounts legitimate. All the more so because this solution was adopted in 2004 as a result of numerous suggestions of the professional circles and expectations of the market in this respect.

Another argument is found in the preamble to Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 which strongly emphasizes the necessity to reduce administrative burdens resulting from accounting legislation in particular for small and medium-sized enterprises.

The following part of the report presents suggestions concerning the rules of assigning entities to group 1 and proposals for simplified principles of financial instruments accounting which could pertain to this group.

The fact of distinguishing group 1 of entities subject to simplified rules entails the necessity of determining principles of accounting for financial instruments applicable to other entities. As it was described in Section 1.1 of this report, pursuant to the Regulation No 1606/2002, Poland imposed the obligation to comply with IAS but it concerned, first, only consolidated financial statements, and second, exclusively banks and entities whose securities are admitted to trading on a regulated market of European Union Member States. The Accounting Act does not oblige any entities to prepare separate financial statements. Thus, entities which under Article 45 are excluded from the possibility of applying IAS or had not decided to apply IAS in preparation of separate financial statements, are subject to provisions of the Financial Instruments Regulation or – if they exist in their case – of regulations on specific accounting principles applicable to special groups of entities (banks, insurance and reinsurance companies, credit unions, mutual funds, pension funds, brokerage houses).

It is possible to adopt a solution consisting in relating the provisions on the principles of accounting for financial instruments directly to IAS pursuant to Article 8 paragraph 6 of the Directive which allows Member States to permit or require the recognition, measurement and disclosure of financial instruments in conformity with IAS adopted under Regulation No 1606/2002. It should be pointed out however, as it was discussed in detail in Section 1.2 of this report, that Financial Instruments Regulation was to a great extent based on IAS solutions effective at the time of its drafting (2001). Due to the lack of direct reference to IAS not all changes made in IAS after 2001 are reflected in Financial Instruments Regulation (e.g. modified definitions of financial instruments categories, option of fair value measurement, principles of derecognition from the balance sheet, portfolio hedge model, extended scope of disclosures resulting from IFRS 7). On the other hand, Financial Instruments Regulation was amended in 2008, after the financial crisis, so as to allow reclassification of financial instruments, and the solutions adopted in Poland have been based on the changes introduced to IAS 39. The Regulation on Specific Accounting Principles for Banks is adapted to currently binding IAS to an even greater degree, which was discussed in Section 1 of this report. That being so, it would be unjustified to claim that due to the lack of direct reference to IAS, Polish regulations on financial instruments accounting very significantly differ from IAS. Whereas the effects of adopting such a solution will be discussed in a subsequent part of this report.

## **4.2. Rules of classifying entities subject to the principles of financial instruments accounting**

According to the currently binding provisions, the criterion for distinguishing entities exempted from the requirement to comply with the provisions of Financial Instruments Regulation and applying general solutions arising from the Accounting Act, is the obligation to have their financial statements audited pursuant to the Article 64, paragraph 1 of the



Accounting Act. Polish regulations do not refer in this context to small or micro-undertakings as in the above suggested “group 1”.

However, Article 64, paragraph 1, point 4 says that financial statements auditing is mandatory for entities which meet at least two of the following three conditions:

- average annual employment of at least 50 people
- total assets equivalent to EUR 2,500,000
- net revenues equivalent to EUR 5,000,000

This point allows for a division of entities into small and larger ones, while the remaining points of the Article 64 regulate the requirement of mandatory financial statements audit not regarding the size of an entity but the type of its activity or its legal form. As a result, the current rules of distinguishing entities allowed to apply simplified principles of financial instruments accounting cannot be considered identical to the suggested criterion of “small undertakings”.

Banks, insurance and reinsurance companies, credit unions, mutual funds and pension funds, because of a unique nature of these entities as public trust organizations, are subject to regulations on specific accounting principles and apply Financial Instruments Regulation only in the scope not regulated in special provisions. Public limited liability companies however, which in accordance with Article 63, paragraph 1, point 4 are subject to mandatory audit of financial statements, may not apply simplified principles of financial instruments accounting, even in case of small-sized operations.

The suggested distinction of small and micro-undertakings as “group 1” is a solution that seems to be in line with Directive 2013/34/EU which differentiates public interest entities according to the nature of their operations, their size or number of employees, whereas does not mention their legal form (Article 2, paragraph 1). This way, public limited liability companies with small-sized operations which are not public interest entities, could be as well considered as small undertakings and would be entitled to apply simplified principles of financial instruments accounting.

It should be additionally noted that in accordance with the definition arising from the Directive, small undertakings are undertakings which on their balance sheet date do not exceed the limits of at least two of the three following criteria:

- average annual employment of at least 50 people
- total assets equivalent to EUR 4,000,000
- net revenues equivalent to EUR 8,000,000

Apart from the average employment these figures are higher than the currently binding Polish criterion for mandatory audit of financial statements. This means that adoption of small

undertakings definition as determined in the Directive would extend simplified accounting principles not only to a part of small public limited liability companies but also other companies whose size of operations is higher than defined in Article 64, paragraph 1, point 4 of the Act, but lower than the limits set forth in the Directive (total assets between 2.5 and 4 million euro, net revenues between 5 and 8 million euro).

It appears however, that it would be advantageous to adopt the limits defined in the Directive and thereby increase the number of entities entitled to apply the simplified accounting principles because the Directive does not allow Member States to impose on small undertakings an obligation to prepare, disclose and publish information in the financial statements which goes beyond the requirements of the Directive (except for some tax information) (Article 4, paragraph 6 of the Directive). Thus, applying to “group 1” the currently binding lower limits could consequently involve the necessity to create an additional group of small companies which are now subject to the mandatory audit (e.g. requirements concerning the scope of disclosures under Article 17 of the Directive are more restricted for small undertakings than for medium-sized and large undertakings and public interest entities). Adopting the definition of small undertakings resulting from the Directive as the criterion for distinguishing entities would allow to avoid those additional complications.

Another question concerns public interest entities which are currently subject to regulations on specific accounting principles. In case of these entities it seems necessary to maintain separate provisions in the scope related to the unique nature of their operations in order to secure the public interest. However, as it was emphasized at working meetings with representatives of professional circles, general principles governing for instance classification and measurement of financial instruments should be unified for all those entities. According to the currently binding provisions those principles are to a significant extent incoherent, as described in Section 1 of this report. Moreover, as due to the type of their operations, financial instruments constitute an important part of these entities’ balance sheet items, they should not rather apply the simplified principles of accounting for financial instruments. Therefore, regardless of the size of their operations, in general part relating to accounting principles, they should be treated as “group 2” entities subject to specific principles governed by separate regulations. This is in line with the Directive which allows Member States to determine public interest entities on the grounds of the type of their operations, regardless of their size.

### **4.3. Adoption of a direct reference to IAS**

Adoption of a direct reference to IAS may, pursuant to the Regulation No 1606/2002, concern full adoption of IAS or, in accordance with Article 8, paragraph 6 of Directive 2013/34/EU of 26 June 2013, may be limited to recognition, measurement and disclosure of financial

instruments. As the scope of this report is restricted to provisions concerning financial instruments, from its point of view both solutions are equivalent.

This means that in case of “group 2” entities a direct reference to IAS is formally possible. It is worth considering however, what would be the consequences of this solution and whether real benefits would exceed costs related to referring the principles of financial instruments accounting to IAS.

An unquestionable advantage of this solution is a direct reference to regulations on accounting for financial instruments which, together with US GAAP, are considered the most developed and advanced in the world. Apart from European Union Member States, IAS are also applied in many other countries on different continents. This solution would mean that financial statements prepared by Polish companies would be internationally comparable and acceptable as regards financial instruments, without the need of further modifications that are often necessary for instance in case of entities which operate in international markets but are currently not allowed to prepare IAS-compliant statements. It would be also advantageous to foreign users of financial statements who may not be familiar with Polish accounting principles pertaining to financial instruments but are interested in cooperation or investments in Poland.

It would as well eliminate internal differences between financial statements of Polish entities which are allowed to apply IAS and those which have to comply with Polish accounting principles. This solution would undoubtedly increase transparency and comparability of financial statements, which usually boosts competitiveness of enterprises and thereby strengthens and develops the capital market.

Moreover, Polish entities would be able to directly benefit from interpretations, explanations on the application, implementation guidelines or justifications of proposals to IAS which in case of financial instruments accounting principles are especially extensive. It is true that currently these principles may be applied if there is no relevant national accounting standard but entities which had never used IAS before, apart from their content often do not know much in this regard and are unaware that they can seek further explanations.

On the other hand, the adoption of a direct reference to IAS would involve application of full standards at least as regards recognition, measurement and disclosure of financial instruments, so it would cover IAS 32, IAS 39, IFRS 7 and related interpretations. Financial Instruments Regulation is to a large extent based on solutions taken from IAS 32 and IAS 39, but in the versions binding at the time of its publication. Subsequent changes to the standards have been only partially included in Polish regulations. IFRS 7, effective since 2007, has not been taken into account in the changes to the Regulation while, due to a very elaborate part concerning disclosures in the context of financial risks management, this standard is considered as extremely laborious.

A reference to IAS would mean that all modifications of the standards, after their adoption by the European Union, would automatically become binding in Poland without the need to amend the Accounting Act or implementing provisions. This situation would concern in particular the new standard IFRS 9 when its drafting is finished and if it is adopted by the European Union. Taking into account its controversy and numerous remarks made during works on this standard, pertaining for example to the proposed changes in methods of recognizing permanent impairment, it might be well to consider beforehand what could be the consequences of its adoption by Polish entities (e.g. costs of developing new measurement models, implementing computer systems etc.).

It should be additionally noted that banks i.e. financial institutions which are the most concerned by the principles of accounting for financial instruments, are anyway obliged to prepare consolidated statements in compliance with IAS. Other financial institutions subject to control by the Polish Financial Supervision Authority have their accounting principles stipulated in regulations on specific accounting principles which are also very extensive in the part relating to financial instruments accounting.

Non-financial institutions which by the nature of their operations are less reliant on financial instruments, are nonetheless obliged to prepare IAS-compliant consolidated statements if they are issuers of securities on a regulated market. So a significant part of Polish largest enterprises is already subject to this requirement.

Assuming that “group 2”, which would be concerned by the reference to IAS, consists of medium-sized and large undertakings, it should also be considered that adopting IAS by entities previously applying the provisions of Financial Instruments Regulation could increase their administrative burdens related to the preparation of financial statements. This would be contrary to premises of the preamble to Directive 2013/34/EU which advocates reducing administrative burdens, particularly for small and medium-sized enterprises. Indeed, large undertakings are not mentioned, but in case of medium-sized entities this could involve a necessity to include them in “group 1” or to create a separate group of entities not applying the simplified accounting principles but as well not incurring additional burdens in comparison with those imposed by the currently binding Financial Instruments Regulation.

To sum up, the solution consisting in the adoption of a direct reference to IAS in Polish regulations concerning financial instruments accounting could cause a significant increase in burdens for Polish enterprises, which – in case of entities using financial instruments to a limited extent – would not be justified nor would bring any additional benefits.

It seems more advantageous to adopt a solution similar to the one applied in 2001, while drafting the Financial Instruments Regulation, i.e. keeping separate Polish regulations but adapting them in crucial aspects to IAS. Since financial institutions in Poland are already allowed to apply IAS (banks and other listed entities) or are subject to specific accounting principles governed by separate regulations, it could be considered to allow for some

simplifications of general provisions as regards IAS in view of the fact that they would concern mostly entities for which financial instruments do not constitute a core activity (e.g. scope of disclosures, hedge accounting etc).

There still remains one question, often raised at working meetings with representatives of professional circles, that is the issue of entities for which the adoption of IAS would be beneficial regardless of the resulting increase in administrative burdens. This is particularly the case of the above-mentioned entities operating in international markets and the ones looking for foreign investors or other sources of finance which, under currently binding provisions of the Accounting Act, may not apply IAS. The most sensible solution for them would be to extend the scope of entities optionally allowed to prepare their financial statements in accordance with IAS.

#### **4.4. Proposals for changes in provisions concerning financial instruments accounting**

##### **4.4.1. Classification of financial instruments**

Current classification of financial instruments resulting from Financial Instruments Regulation was drafted on the basis of IAS 39 effective in 2001 and has not been updated following the changes made to IAS in 2003. Main doubts concern the definition of the loans and receivables category. It includes financial assets originating from direct delivery of cash to the other party under the contract (paragraph 7.1). This definition was narrowed down comparing to IAS 39, under which instruments included in this category resulted not only from direct delivery of cash to the other party, but also from direct delivery of goods and services. This restriction of the definition often raised questions whether the provisions of Financial Instruments Regulation should apply to trade receivables which originate from delivery of goods and services and not from delivery of cash. What is more, the Accounting Act distinguishes receivables and loans measured at the amount due following the principle of prudence (Article 28, paragraph 1, point 7) from receivables and loans recognized as financial assets measured at adjusted purchase price, and if they are held for sale within 3 months, then at their market value or at the fair value determined in another manner. This suggests that trade receivables and loans are not financial assets, which however is inconsistent with the definition of financial assets (Article 3, paragraph 1, point 24) stating that they can be construed among others as contractual right to receive monetary assets. Trade receivables are a special kind of a contract which gives right to receive payment in cash at a specified date so the criteria of financial assets definition are met.

A similar problem concerns trade payables. They fulfil the definition of financial liabilities rising from Article 3, paragraph 1, point 27 – should they be then considered as financial

liabilities and measured pursuant to Article 28, paragraph 1, point 8a or treated as liabilities according to Article 28, paragraph 1, point 8?

In compliance with IAS, trade receivables and payables are regarded as financial instruments, and thus are subject to the same principles of measurement, recognition and disclosure as other financial instruments. It seems that adopting this solution and applying measurement at purchase price for financial instruments e.g. up to 3 months, would be reasonable, as it would unify accounting principles for all financial instruments and at the same time would not cause problems with measuring trade receivables and payables which are usually of a short-term nature.

Another problem often reported by entities concerns the differentiation between the category of financial assets held to maturity on one hand and that of loans and receivables on the other hand. International Accounting Standards Board appears to resign from differentiating these categories of instruments. According to the new classification of financial assets resulting from IFRS 9, both categories are defined as one, measured at amortized cost. Also IFRS for SMEs does not provide for such a distinction. Following this logic and merging both categories would be an important simplification for enterprises.

On the other hand, neither IFRS 9 nor IFRS for SMEs have been adopted by the European Union, whereas the currently binding IAS 39 still maintains the division of financial instruments into 4 categories. Moreover, also Directive 2013/34/EU in its Article 8 refers to these categories of financial instruments, therefore it seems legitimate to keep the current classification of financial instruments. The Directive however, does not regulate the above-discussed principles of “tainting” caused by premature disposal of financial assets previously classified as held-to-maturity. There is a question whether these principles should be regulated in general provisions or only in the specific ones as it is now in the case of banks (paragraph 31 of the Regulation). This way, entities using financial instruments to a limited extent would not be obliged to reclassify and calculate at fair value the instruments held to maturity in case of tainting, which would considerably simplify the principles pertaining to these entities.

It seems that categories of financial instruments should be defined directly in the act and not in secondary regulations. It would also allow for harmonization of definitions among different groups of entities as now there are differences for instance in the definitions of individual categories of financial assets between the Regulation on Specific Accounting Principles for Banks and the Financial Instruments Regulation. Since the definitions resulting from Regulation on Specific Accounting Principles for Banks have been updated after modifications in IAS 39, it seems preferable to use the provisions of this regulation as the basis for new definitions in the Act, e.g. by directly transferring points 2.14-2.18 to Article 3, paragraph 1 of the Act. The definition of assets available for sale could be additionally extended to include instruments designated to that category by the entity as the current wording of point 2.18 differs in this regard from the definition under IAS.

It is suggested to add the following points to Article 3, paragraph 1:

- **X1.** financial assets and financial liabilities held for trading - financial assets or financial liabilities acquired or incurred in order to obtain economic benefits from short-term (up to 3 months) price changes and fluctuations of other variables; a financial asset is classified as asset held for trading if - irrespective of the reason for its acquisition - it constitutes a group of assets which has been recently used to obtain economic benefits from price changes and fluctuations of other variables; derivative instruments being financial assets or financial liabilities are considered as held for trading, except for hedging derivative instruments constituting an effective hedge;
- **X2.** financial assets and financial liabilities measured at fair value through profit or loss - financial assets and financial liabilities held for trading or accounted for as such at initial recognition, provided that it leads to more useful information or minimizes differences, including those pertaining to the methods of measurement and presentation of revenues or expenses related to those assets or liabilities, or allows for the assessment of fair value measurement results in accordance with documented investment strategy or risk management principles;
- **X3.** loans and other receivables - financial assets with fixed or determinable payments, which are not quoted on the market, with the exception of financial assets that the entity intends to sell in the short term, classified as financial assets or financial liabilities held for trading, and financial assets which were accounted for at initial recognition as financial assets and financial liabilities measured at fair value through profit or loss, as well as loans and other receivables which are non-recoverable for the entity for reasons other than non-payment, which are classified as assets available for sale;
- **X4.** financial assets held to their due date - financial assets with fixed or determinable payments or fixed due date that the entity has the intention and the ability to hold until due date, with the exception of financial assets classified as loans and other receivables, financial assets available for sale and financial assets and financial liabilities measured at fair value through profit or loss;
- **X5.** financial assets available for sale - financial assets designated as available for sale or other than:
  - financial assets measured at fair value through profit or loss,
  - loans and other bank receivables,
  - financial assets held to their due date;

The above points may replace the following paragraphs of Financial Instruments Regulation:

- paragraph 5.1 – regarding categories of financial instruments,



- paragraphs 6.1-6.2 – regarding definitions of financial assets and financial liabilities held for trading,
- paragraphs 7.1-7.4 – regarding definitions of loans and receivables,
- paragraph 8.1 – regarding definitions of financial assets held to their due date,
- paragraph 9 – regarding definitions of financial assets available for sale.

Adoption of definitions from the Regulation on Specific Accounting Principles for Banks would cause a change in the definition of loans and receivables thereby eliminating differences compared to IAS as regards for instance trade receivables, factoring, debt instruments purchased on the active market.

Adoption of the definition of financial assets held to their due date from the Regulation on Specific Accounting Principles for Banks would also require to unify the terminology as Financial Instruments Regulation uses the term “maturity” and not “due date”.

Paragraphs 8.4-8.6 of Financial Instruments Regulation concern the principles of “tainting” in case of disposal, exchange or reclassification of financial assets previously classified as held-to-maturity. These principles arise from IAS 39 but are not regulated in the Directive, therefore, it is suggested to transfer them from the general provisions of Financial Instruments Regulation into regulations on specific accounting principles for financial institutions. As these principles are not particularly relevant to entities for which financial instruments do not constitute a core activity, their removal from the general principles would considerably simplify classification and measurement of financial instruments. In that case also paragraph 23.1 of the Regulation would not be necessary.

The principles governing reclassification of financial assets to another category take into account the changes to IAS 39 made in 2008 following the financial crisis, with the reservation that paragraph 32 of the Regulation on Specific Accounting Principles for Banks is adapted to the modified definitions of financial instruments. If the definitions of financial instruments in the Accounting Act were based on paragraphs 2.14-2.18, the principles of financial assets reclassification could be developed on the basis of paragraph 32. Additionally, transferring the reclassification principles to the Accounting Act would guarantee that they are consistent for all entities. Therefore, it is suggested to add the following article to the Accounting Act:

1. Financial assets classified as financial assets and financial liabilities measured at fair value through profit or loss, if they are no longer held for sale or repurchase in the short term, may be reclassified to other categories of financial instruments referred to in Article 3, paragraph 1, points X3-X5, with the exception of derivatives and financial assets designated by the entity at initial recognition as financial assets and financial liabilities measured at fair value through profit or loss, subject to paragraph 2.



2. Financial assets referred to in paragraph 1 may be reclassified to other categories only in exceptional circumstances resulting from a unique, extraordinary event which is very unlikely to reoccur in the near future.
3. Financial assets classified as financial assets and financial liabilities measured at fair value through profit or loss which meet the definition of loans and other receivables and which were not designated by the entity at initial recognition as financial assets and financial liabilities measured at fair value through profit or loss, may be reclassified to categories referred to in Article 3, paragraph 1, points X3-X5, due to the fact that the entity no longer has the intention or ability to hold the financial asset to a fixed date or to due date.
4. Financial assets classified under the categories referred to in Article 3, paragraph 1, points X3-X5 cannot be reclassified to categories referred to in Article 3, paragraph 1, points X1-X2.
5. Financial assets classified as financial assets available for sale can be reclassified as loans and other receivables provided that the entity has the intention and ability to hold these assets in the foreseeable future or to due date, or as financial assets held to due date if they do not meet the definition of loans and other receivables.
6. If financial assets classified under the category referred to in Article 3, paragraph 1, point X3 become quoted on the market and do not satisfy the definition of loans and other receivables, they should be reclassified into the category referred to in Article 3, paragraph 1, point X5.

The above article would replace paragraphs 6.3-6.5 of Financial Instruments Regulation.

#### 4.4.2. Measurement of financial instruments

Pursuant to paragraph 13.1 of Financial Instruments Regulation financial assets are recognized in books of account as at the contract conclusion date, at the cost of acquisition, i.e. at the fair value of expenses incurred or other assets transferred in exchange, whereas financial liabilities – at the fair value of the amount earned or the value of other assets received. In accordance with IAS not the fair value of the consideration but the fair value of the instrument is considered as initial value. Inconsistency between Polish regulations and IAS arises above all in the case of instruments purchased or concluded at the value different from the fair value (e.g. intra-group loans with low interest rate). IAS approach is more coherent with the principles of instrument measurement at subsequent periods, e.g. instruments which are to be measured at fair value are measured with this method from the moment of initial recognition, whereas under Polish regulations only from the moment of first measurement, while instruments measured at amortized cost are measured with the use of effective interest rate taking into account the discount of the initial value against market conditions, which reflects the actual time value of money. A modification of paragraph 13

according to IAS would eliminate these differences. In case of introducing this change directly to the Accounting Act it would apply to all entities, making it necessary to modify also secondary legislation, e.g. paragraph 33.1 of the Regulation on Specific Accounting Principles for Banks which has not been adapted to the new IAS 39.

One of the biggest problems concerning financial instruments measurement results from the fact that, under the Accounting Act, financial assets are classified as investments. According to Article 3, paragraph 1, point 17, investments are construed as assets held by an entity in order to derive economic benefits resulting from an increase in the value, generation of income in the form of interest, dividends or other rewards (in particular financial assets). Consequently, pursuant to Article 35, paragraph 4 of the Act, an increase in value of long-term investments is recognized in the revaluation reserve in equity, whereas a decrease adjusts the revaluation reserve in equity only to the amount previously recognized in this reserve. In other cases, the effects of a decrease in the value of investments are recognized as financial costs. Whereas, according to paragraph 21.1 of Financial Instruments Regulation gains or losses arising from revaluation of financial assets classified as available for sale and measured at fair value are recognized only in profit or loss or only in revaluation reserve in equity (does not concern permanent impairment). In case of banks, gains or losses arising from revaluation are recognized exclusively in revaluation reserve in equity.

This difference in the method of measuring financial instruments often raises doubts as to whether periodic losses arising from measurement of financial assets available for sale may be recognized in revaluation reserve in equity, or should be rather accounted for in accordance with the superior law, i.e. the Accounting Act.

A suggested solution would be to isolate financial assets from the definition, or at least from measurement methods of investments, as it is in case of investment properties. Thus, measurement principles set out in Article 28, paragraph 1, points 3 and 5, as well as in Article 35 would pertain only to other investments (e.g. works of art, numismatic coins), whereas principles of financial instruments measurement would be defined in the Accounting Act according to their categories. These provisions could be based on paragraph 36 of the Regulation on Specific Accounting Principles for Banks because in Financial Instruments Regulation they appear in different paragraphs of Chapter 3, which seems less clear. Therefore, it is suggested to add the following article to the Accounting Act:

Financial instruments are measured at the balance sheet date according to the following principles:

1. financial assets and financial liabilities measured at fair value through profit or loss are measured at fair value with the effects of changes in the fair value accounted for in financial income or expense, respectively, with the reservation that the liabilities to be settled by the transfer of an equity instrument whose fair value cannot be reliably determined, should be measured at amortized cost;

2. loans and other receivables, not classified as held for trading, are measured at amortized cost using the effective interest method;
3. financial assets available for sale are measured at fair value with the effects of changes in the fair value recognized in revaluation reserve in equity until financial assets are derecognized from the balance sheet in which case cumulative effects of changes in the fair value recognized in revaluation reserve in equity are recognized in financial income or expense, respectively; the interest accrued and the dividends due are recognized in financial income; in the case of impairment of an asset, the cumulative loss recognized in revaluation reserve in equity should be recognized as impairment due to valuation allowance;
4. financial assets held to their due date are measured at amortized cost using the effective interest method;
5. financial liabilities not classified as financial assets and financial liabilities measured at fair value through profit or loss are measured at amortized cost using the effective interest method;
6. if the fair value cannot be determined in a reliable manner, financial assets are measured at the cost of acquisition, taking into account valuation allowance, and financial liabilities are measured at amortized cost, with valuation effects recognized in financial income or expense, respectively;
7. hedged items and hedging instruments are measured according to principles set forth in provisions issued on the basis of Article 81, paragraph 2, point 4.

The above points may replace the following paragraphs of Financial Instruments Regulation:

- paragraph 14 – regarding measurement at fair value,
- paragraph 16 – regarding measurement at adjusted cost and purchase price,
- paragraphs 18.1-18.2 – regarding measurement of financial liabilities,
- paragraph 21 – regarding recognition of financial instruments measured at fair value,
- paragraph 22 – regarding recognition of financial instruments measured at adjusted purchase price.

Reference to paragraph 14 made in paragraph 23.2 should then be replaced by a reference to point 6 suggested above.

Another proposed change is to delete Article 39 paragraph 4 saying that if the amount of received financial assets is lower than the amount of the related liability, including amounts received in respect of securities issued by an entity, the difference represents prepaid expense and is recognized as financial costs in equal rates over the related liability period. This approach is contradictory to the method of measurement at adjusted cost according to

which this difference constitutes the initial value of the financial instrument and is accounted for over time as borrowing costs, using the effective interest method.

Also Article 28 paragraph 11 point 2, saying that receivables and liabilities are recognized as at their acquisition or creation date at their par value, is not in conformity with the principles of initial recognition of financial instruments and would be no longer needed if the above-discussed principles of financial instruments measurement are introduced to the Act.

Many practical problems related to financial instruments measurement were signalled at working meetings with representatives of the National Chamber of Statutory Auditors, the Accountants Association in Poland and Polish Financial Supervision Authority. Nonetheless, it seems that this kind of detailed solutions should not be provided for in general provisions which are to apply to all entities. The best solution would be to draw up a new National Accounting Standard dedicated exclusively to financial instruments. Such a standard could include examples and comments on how to measure individual types of financial instruments. An additional benefit of this solution is that national Accounting Standards can be more easily supplemented or updated, if necessary, than the Accounting Act.

#### 4.4.3. Derecognition of financial instruments

Principles of derecognition of financial instruments set out in Polish legislation comply with IAS. Like in case of classification and measurement, it is suggested to include these principles directly in the Accounting Act. Paragraph 35.1 of the Regulation on Specific Accounting Principles for Banks seems to be a bit too general. Paragraph 12 of Financial Instruments Regulation presents more situations (debt take-over, exchange of liabilities, change in conditions), therefore, using it as a basis for new provisions appears more practical from the perspective of users. In case of transferring provisions on derecognition of financial liabilities into the Act it is suggested to transfer paragraph 12 of Financial Instruments Regulation:

1. Financial liability is derecognized from the books of account, in whole or in part, as at the day on which the entity has provided in whole or in part the benefit under the contract, was released from the provision of such benefit in accordance with the law, or commitment has expired
2. Signing an agreement with a third party which commits to take over all or part of the financial liability is not considered as provision in whole or in part of the benefit nor as release from financial obligation, subject to paragraph 3.
3. The entity is considered released from financial obligation in whole or in part if it signs, upon creditor's consent, a legally binding agreement with a third party in which a third party commits to take over all or part of the debt.
4. In the event if the entity exchanges with the creditor all or part of the debt financial instrument subject to financial liability for another, substantially different financial instrument, the liability existing as at the day of the exchange is deemed as satisfied,

and a new liability resulting from the financial instrument issued in exchange is considered as created on this day.

5. A new liability is also deemed as satisfied when there are changes in the binding contract concerning the debt financial instrument, resulting in at least 10% difference between discounted present value of cash flows arising from the new contract and discounted present value of remaining cash flows arising from the old one. New financial liability should be recognized and the old one derecognized from the books of account as at the day when the changed contract comes into force. The principles of derecognition of financial assets set out in Polish regulations are incoherent. Paragraph 11 of Financial Instruments Regulation is based on the principles of the old IAS 39 whereas paragraph 35 of the Regulation on Specific Accounting Principles for Banks is modelled on the new IAS 39. New IFRS 9 regulates the issue of financial assets derecognition in a similar way to the current IAS 9, which means that, even if the European Union adopts IFRS 9, those principles will not change. Therefore, it is suggested to prepare potential changes in this regard on the basis of paragraphs 35.2-35.7 of the Regulation for banks:
  - a. The entity derecognizes a financial asset or its part from its books of account, subject to paragraphs 2-6, when at last one of the following conditions is met:
    - i. the contractual rights to the cash flows from the financial asset expire;
    - ii. the entity transfers the asset to the buyer in a manner which meets derecognition requirements referred to in paragraph 4, point 1.
  - b. The entity transfers the asset to the buyer when at last one of the following conditions is met:
    - i. the contractual rights to receive the cash flows of the financial asset are transferred;
    - ii. the contractual rights to receive the cash flows of the financial asset are retained, but the entity assumes a contractual obligation to transfer them to the buyer of the financial asset, subject to paragraph 3.
  - c. When the entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to transfer them to the buyer of the financial asset, the financial asset is deemed transferred if the following criteria are met jointly:
    - i. the entity is not obliged to transfer the cash flows to the buyer of the financial asset prior to their receipt;
    - ii. the entity cannot sell or encumber the transferred financial asset in any other way than through the establishment of a lien or other limited right for the buyer of the financial asset, as a security for the obligation to transfer the cash flows;

- iii. the entity is obliged to provide the buyer, without delay, with all the cash flows received, and until these cash flows are transferred to the buyer of the financial asset, the entity cannot use the cash flows received to purchase other assets except for money assets.
- d. When the entity transfers a financial asset to the buyer, it evaluates the extent to which it retains the risks and rewards of ownership of the financial asset and if:
  - i. substantially all the risks and rewards of ownership are transferred to the buyer, the entity shall derecognize the financial asset from its balance sheet and shall recognize as financial assets or liabilities all retained or new rights and obligations arising from the transfer (involvement);
  - ii. substantially all the risks and rewards of ownership of the transferred financial asset are retained by the entity, the entity shall not derecognize the financial asset from its balance sheet;
  - iii. substantially all the risks and rewards of ownership of the financial asset are not retained by the entity, the entity shall determine whether it has retained control over the financial asset.
- e. In the event referred to in paragraph 4 point 3, if the entity:
  - i. has retained control over the financial asset, the entity shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset;
  - ii. has not retained control over the financial asset, the entity shall derecognize the financial asset from its balance sheet and shall recognize as financial assets or liabilities all retained or new rights and obligations arising from the transfer.
- f. The entity retains control over the transferred financial asset if it has the right to dispose of the transferred financial asset, whereas it does not retain control if the buyer has the right to dispose of this financial asset.

An alternative solution could be to base new regulations on paragraphs 11.33-11.35 of IFRS for SMEs, which appear to be more transparent for users who are not familiar with this issue:

1. An entity shall derecognize a financial asset only when:
  - a. the contractual rights to the cash flows from the financial asset expire or are settled, or
  - b. the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset, or
  - c. the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third

party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall:

- i. derecognize the asset, and
  - ii. recognize separately any rights and obligations retained or created in the transfer.
2. If a transfer does not result in derecognition because the entity has retained significant risks and rewards of ownership of the transferred asset, the entity shall continue to recognize the transferred asset in its entirety and shall recognize a financial liability for the consideration received. The asset and liability shall not be offset. In subsequent periods, the entity shall recognize any income on the transferred asset and any expense incurred on the financial liability.
3. If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:
  - a. If the transferee has the right by contract or custom to sell or repledge the collateral, the transferor shall reclassify that asset in its statement of financial position separately from other assets.
  - b. If the transferee sells collateral pledged to it, it shall recognize the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
  - c. If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the transferee shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.
  - d. Except as provided in point 3, the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognize the collateral as an asset.

In the event of transferring the principles of financial assets derecognition to the Accounting Act, paragraph 11 of Financial Instruments Regulation may be deleted. However, if these principles are to be left in Financial Instruments Regulation, it is suggested to replace paragraph 11 with one of the above proposals. Its current wording was drafted on the basis of the previous version of IAS 39, therefore it is recommended to update it according to the new solutions in this regard.

#### 4.4.4. Financial assets impairment

Although the issue of financial assets impairment concerns all entities, it is particularly relevant to financial institutions as financial risk management is a part of their core activity. As it was described in Section 1 of this report, the issues pertaining to the creation of specific provisions for banks are regulated by separate Regulation on the Establishment of General Banking Risk Provisions. Certain regulations in this regard are also contained in the Regulation on Specific Accounting Principles for Credit Unions. Additionally, Polish Accounting Standards Committee published in 2007 the National Accounting Standard no. 4 – Assets impairment. The Standard was updated in 2012 and it also includes examples concerning financial instruments. Therefore, the general provisions on impairment, which will pertain mostly to entities for which financial instruments do not constitute main balance sheet items, may be to a greater degree simplified and less detailed.

Representatives of the Polish Financial Supervision Authority pointed out at a working meeting that Article 28 paragraph 7 of the Accounting Act concerning permanent impairment of assets, is too general and does not define objective criteria obliging entities to recognize write-downs of assets, nor the methodology of determining impairment loss. This Article concerns generally impairment of all assets, whereas in case of financial instrument it could be more detailed, e.g. similarly as in paragraphs 11.21-11.24 of IFRS for SME:

1. At the end of each reporting period, an entity shall assess whether there is objective evidence of impairment of any financial assets. If there is objective evidence of impairment, the entity shall recognize an impairment loss in profit or loss immediately.
2. Objective evidence that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:
  - significant financial difficulty of the issuer or obligor,
  - a breach of contract, such as a default or delinquency in interest or principal payments,
  - the creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider,
  - it has become probable that the debtor will enter bankruptcy or other financial reorganisation,
  - observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions,



- other factors may also be evidence of impairment, including significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates.

Whereas the issue of methodology used to determine impairment loss seems too individual to be regulated at the general level of the Accounting Act. It could be defined according to the type of entity in separate detailed provisions (as it is currently for banks) or in the National Accounting Standard.

Additionally, Article 35b of the Accounting Act regulates the issue of receivables revaluation. It is puzzling, why this type of financial instruments was singled out in the Accounting Act and whether it should not be replaced by more general principles of determining permanent impairment of financial instruments, as for instance in paragraph 24 of Financial Instruments regulation.

1. Impairment loss of a financial asset or a portfolio of similar financial assets is determined:
  - a. in the case of financial assets measured at amortized cost - as the difference between the carrying value as at the valuation date and the realizable amount. Realizable amount is determined as the present value of cash flows expected by the entity, discounted at the effective interest rate applied to date while revaluating a financial asset or a portfolio of similar financial assets,
  - b. in the case of financial assets available for sale - as the difference between the cost of acquisition of the asset and its fair value as at the valuation date, with the provision that the fair value of debt instruments as at the valuation date is defined as the present value of future cash flows expected by the entity, discounted at the current market interest rate applicable to similar financial instruments. The cumulative loss recognized until that day in the revaluation reserve in equity is reflected as expense in the amount not smaller than the impairment loss net of the part reflected directly as expense,
  - c. in case of other financial assets - as the difference between the carrying amount and the present value of future cash flows expected by the entity, discounted at the current market interest rate applicable to similar financial instruments.
2. Since the date on which permanent impairment loss of a financial asset or a portfolio of similar financial assets is incurred, the interest income is no longer accrued according to the previous rate. Starting from this date, the interest income is accrued using the rate discounting future cash flows used to determine the recoverable amount in accordance with paragraph 1.
3. If the reason for recognizing a write-down due to permanent impairment has ceased to exist, provisions of Article 35c apply, with the reservation that the reduction of the previously recognized write-down and the increase of the value of assets measured by

the entity at amortized cost must be limited to an amount which will not result in an increase of asset value in excess of the amount of amortized cost which would have been determined as at that date had the permanent impairment not been incurred.

Although the National Accounting Standard no. 4 includes several examples of permanent impairment calculation for financial instruments, at working meetings representatives of professional circles suggested additional areas which could be discussed in greater detail, e.g. principles of measurement of the hedges applied, methods of estimating credit risk, methodology of determining impairment loss. A good solution would be to discuss these issues within the scope of the suggested new National Accounting Standard pertaining to financial instruments.

#### 4.4.5. Embedded derivatives

The subject of embedded derivatives aroused serious controversies from the very beginning. The need to solve the problem of derivatives embedded in lease agreements was one of the reasons for amending Financial Instruments Regulation in 2004. It seems that the question of embedded derivatives should basically concern financial institutions and thus should be regulated, according to needs, in detailed provisions, e.g. for banks or insurance companies, where such agreements may constitute a significant part of the portfolio (e.g. structured deposits). Separation of embedded derivatives from agreements which do not constitute financial instruments does not appear to bring any particular added value for non-financial entities. For that reason it is recommended not include paragraph 10 of Financial Instruments Regulation in the general provisions.

The deletion of paragraph 10 does not mean that entities will not be able to apply the principles relating to the separation of embedded derivatives if they consider such separation necessary to assure accuracy and clarity of the financial statement, as in the event of lack of Polish regulations in this regard, pursuant to Article 10 paragraph 3, they will be allowed to apply solution provided for in IAS.

#### 4.4.6. Hedge accounting

Hedge accounting is one of the issues related to financial instruments which are the main source of problems for entities. There is a general tendency to simplify principles governing hedge accounting, especially those related to the measurement of hedge effectiveness. Neither IFRS 9 nor IFRS for SMEs do any longer require such a restrictive approach to retrospective evaluation of effectiveness. Particularly the hedge accounting principles provided for in Chapter 12 of IFRS for SMEs seem to have been simplified in such a way that they should be much easier to apply by entities.

One possible solution could be to replace the current Chapter 4 of Financial Instruments Regulation with new provisions based on those presented in paragraphs 12.15-12.25 of IFRS for SMEs. It should be noted however, that in principle IFRS for SMEs were not developed for public interest entities and some of the simplifications, e.g. concerning restrictions of the types of risks that may be hedged or transactions which can be regarded as hedging instruments, may go too far if applied to financial institutions. Therefore, in their case, it should be considered, whether hedge accounting principles should not stay as they are (e.g. in the Regulation on Specific Accounting Principles for Banks hedge accounting principles are already separately regulated in Chapter 7). Whereas in case of non-financial institutions, the adoption of principles based on IFRS for SMEs could offer considerable simplifications.

An alternative approach could be to leave the regulations of Chapter 4 in their present form, only simplifying certain provisions on effectiveness assessment, e.g. instead of complying with the requirement under paragraph 28.4 to determine effectiveness taking into account the time value of money which must be in the range of 80% to 125%, entities could confirm effectiveness through an analysis of transaction conditions, without quantitative measurements.

It is recommended to introduce the following changes in paragraph 28:

- paragraph 28.1, point 5 – justification of economic relationship between the hedged item and the hedging instrument and of expected high effectiveness of the hedge in accordance with documented risk management strategy,
- paragraph 28.2, point 2 – to be deleted,
- paragraph 28.2, point 3 – in the reporting period, the effectiveness of the hedge is measured on a continuous basis and maintained at a high level in accordance with assumptions made in a documented risk management strategy,
- paragraph 28.4 – hedge effectiveness level shows to what extent the impact on the entity's profit or loss caused by changes in the fair value of the hedged item or related cash flows is offset by the changes in the fair value or cash flows of the hedging instrument. In order to demonstrate high level of hedge effectiveness, the entity carries out appropriate analyses in accordance with assumptions made in a documented risk management strategy.

Additionally, it is suggested to amend paragraph 30.5. According to its current wording, entities may hedge non-financial items only against foreign currency risk or against all the risks altogether. A change in this regard could allow entities to hedge separated price risk and to use for example commodity derivatives as hedging instruments. Such a modification was also introduced to IFRS 9 and IFRS for SMEs. The following changes are recommended:

- paragraph 30.3 – a hedge may apply to one or more risk factors prone to change fair value or cash flows, provided that the entity is able to prove high effectiveness of the hedge for this (these) risk factor(s),

- paragraph 30.5 – to be deleted.

Irrespective of the adopted solutions, examples of applying and accounting for different models of hedge accounting could be presented in the suggested new National Accounting Standard pertaining to financial instruments.

#### 4.4.7. Disclosures

Considering that for all public interest institutions such as banks, insurance companies, credit unions, mutual funds or pension funds, the scope of disclosures is separately regulated in appropriate regulations on specific accounting principles, the extension of the current scope of disclosures to include additional information on financial instruments would not be justified. Definitely the scope of disclosures required under IFRS 7 would constitute an excessive burden for these entities.

It seems however, that the content of Chapter 5 of Financial Instruments Regulation should be transferred to Annex 1 to the Accounting Act which presents the scope of information to be disclosed in the financial statement by entities other than banks, insurance and reinsurance companies. The separation of disclosures concerning financial instruments and placing them in a separate regulation caused that companies often omitted this information in their financial statements as they focused only on information required under the Accounting Act. Gathering all the disclosures in one place would not only be more convenient but might also improve the perception of disclosures concerning financial instruments, which potentially could raise their quality in financial statements.

#### 4.4.8. Financial instruments accounting principles for small enterprises

As it was described at the beginning of this Section, it seems legitimate to divide entities into two groups, one of which would be made of small entities allowed to apply much simpler principles of accounting for financial instruments.

Small entities should be exempted from the obligation to classify financial instruments to categories, as it is in case of other entities. Financial instruments should be measured according to their types. The following principles of measurement are recommended:

- cash – at par value
- stocks and shares held – at cost less accumulated impairment, or – in case of shares quoted in an active market – at fair value determined as market price
- purchased debt securities – at cost less accumulated impairment, or – in case of debt securities quoted in an active market – at fair value determined as market price

- derivatives – at fair value determined on the basis of market quotations, generally accepted measurement models for which there is data available from the active market or other reliable method
- receivables and loans – at the amount due, in keeping with the prudence principle
- liabilities, including loans taken – at the amount due

Methods of derivatives measurement based on mathematical models can be too complicated for many small entities, therefore it is suggested to accept as reliable the measurement provided by the financial institution with which the agreement for the derivative instrument in question was concluded. Actually, this method is already used by many small companies which at the end of the year receive from banks confirmations and valuations of derivatives. A measurement of transactions performed by the other party is often assessed by auditors of financial statements as less reliable. However, as these principles are to concern only small entities, which are in majority not subject to audit, this approach seems acceptable, all the more so because even if institutions presented a valuation overstated to their benefit, its recognition in financial statement would mean that it is accepted by the company. Indeed, it would be disadvantageous for the company but in keeping with the prudence principle, especially as companies which are not able to verify the measurement, anyway treat valuation presented by the bank as the amount due. Additionally due to the fact that banks are considered public trust institutions, and their valuation models are verified by statutory auditors, the acceptance of such simplified approach for small entities seems to be justified. Also inclusion in the law on accounting the method of derivatives measurement for small entities based on valuation by a bank being a transaction party, will result in lack of doubts whether such solution can be applied.

An alternative solution could be to recognize derivatives on the cash basis, which is already quite common among small companies. However, in the context of problems that many entities had with currency options in the years 2008-2009, it seems that risk related to derivative instruments should be recognized in financial statements as at the balance sheet date, and not at the time of payment, all the more so because in 2009 banks often terminated currency options agreements prior to their settlement date.

Additional principles of recognizing financial instruments valuation:

- gains or losses from fair value valuation of financial instruments are recognized as financial income or expense, respectively, of the period in which the revaluation occurred
- interest is accrued proportionally to the period concerned and is recognized as financial income or expense
- interest accrued but not received increase value of the financial instrument

- in case of purchasing a financial instrument with a discount it is recognized as financial income from the date of purchase to maturity. The recognized value of the discount increases the value of the financial instrument
- if the amount of received financial assets is lower than the amount of the related liability, the difference represents prepaid expense and is recognized as financial costs proportionally over the related liability period
- in case of permanent impairment of an asset, including the interest accrued or the discounts, impairment loss is incurred to the realizable net sale price and recognized as financial costs for this period
- interest on financial assets subject to previously incurred impairment losses is not accrued until it is received
- if the reason for recognizing a write-down due to permanent impairment ceased to exist, the reduction of the previously recognized write-down is recognized as financial income
- profit or loss on disposal of financial assets is recognized as financial income or expense
- in case of release from or expiry of a financial liability without its settlement, the reduction is recognized as financial income. In case of replacing previous financial liability with a new one, the entity derecognizes the previous liability and recognizes the new one. A potential difference in value is recognized as financial income or expense

Disclosures of financial instruments pertaining to small entities should be reduced to the absolute minimum. It is suggested that they cover exclusively information on financial instruments required by Article 16 of Directive 2013/34/EU. It was presented in Section 2.1 of this report.





