

NEW ACCOUNTING RULES FOR THE RECOGNITION AND MEASUREMENT OF FINANCIAL INSTRUMENTS – SOME ISSUES IMPLIED BY THE IFRS 9¹

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Abstract: *Up until now accounting standards regarding financial instruments were changed several times. The latest change was the issuance of the IFRS 9 Financial instruments published for the purpose of simplifying the rules in its predecessor IAS 39 Financial instruments: recognition and measurement. From the above mentioned changes of accounting regulatory regime for financial instruments we may conclude that accounting bodies, so far, have not found the adequate approach and treatment for the financial instruments. They considered that fair value would be a revolutionary measure for the financial instruments and that this measure would provide more relevant, transparent and comparable information. But the standard setters did not predict that this measurement attribute might have an effect on earnings power and financial position of a company. In this paper we observe critically the main differences between IFRS 9 and IAS 39 regarding the recognition and measurement of financial instruments and with an emphasis on of some problems of early adoption of IFRS 9 by companies.*

Key words: *IFRS 9, IAS 9, financial instruments, fair value, recognition, measurement*

Rezime: *Računovodstveni standardi vezani za finansijske instrumente menjani su nekoliko puta do sada. Najskorija promena ove vrste bila je publikovanje standarda pod nazivom MSFI 9 Finansijski instrumenti čija je svrha bila da zameni prethodni standard MRS 39 i da pojednostavi računovodstveni tretman finansijskih instrumenata. Ove česte promene navode na razmišljanje da je problematika finansijskih instrumenata veoma složena, te da donosioci standarda i regulatorna tela još uvek nisu pronašla odgovarajući tretman za finansijske instrumente. Iako su računovodstvena tela smatrala da je primena fer vrednosti za finansijske instrumente dovela do revolucije u računovodstvu, zato što produkuje transparentnu, relevantnu i uporedivu računovodstvenu informaciju, ipak nisu mogli da predvide kakve će promene fer vrednost imati na zarađivačku moć i finansijsku poziciju kompanije. U ovom članku dali smo kritički osvrt na glavne razlike između MSFI 9 i MRS 39 vezano za vrednovanje i priznavanje finansijskih instrumenata sa posebnim akcentom na neke probleme rane primene ovog standarda koji očekuju kompanije.*

Ključne reči: *MSFI 9, MRS 39, finansijski instrumenti, fer vrednost, priznavanje, vrednovanje*

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INTRODUCTION

The issuance of the accounting standards usually follows the “best practice” and the role of the academic accountants is of a paramount importance. The academicians knowledge and expertise is needed in the process of standard preparation where they emphasize the theories as a source of the accounting concepts and variables, but also in the process of the implementation of a standard where the academic accountants do various research and formulate conclusions regarding the attainment of the financial reporting goals. The problems of measuring the financial instruments is not new in accounting and in the history all assets (as well as financial instruments) were measured at the historical costs. But the savings and loan crisis in the 80-ties and 90-ties in the US made this measurement attribute quite irrelevant because it produced the overestimated financial assets in the balance sheet of financial institutions during the period of the so called “bear market”. After many years of using the historical cost as the most objective financial measure for all the assets in a balance sheet, the standard setters in 1998 launched IAS 39 where fair value was promoted for the financial instruments. IAS 39 classifies all financial instruments into four categories based on the management intent to use these assets for trading purposes (trading category or fair value through profit and loss), to hold assets until maturity (held to maturity category), or to use assets as loans and receivables. The rest of the assets with no intent to hold or to sell in the near term are classified into the available for sale category. According to this standard all financial instruments are measured using the fair value, except the instruments into the held to maturity and loans and receivables category. This standard emphasize the derivative instruments as well and treat them as instruments measured at fair value. With the emerge of the financial crisis it was obvious that new measurement rules for the financial instruments did not hit the target. Crisis revealed that many assets were written down to the lower fair values when crisis effects were evident. That is why many banks recognized losses and asked standard setters to amend the IAS 39 in order to give them the financial relief from the crisis effects. After the amendments of IAS 39 were accepted, standard setters started with the project regarding the financial instruments with the goal of making the rules for the financial instruments more simple, transparent and useful for the adopters. As the final result the IFRS 9 Financial instruments was introduced. In this paper we are emphasizing the rules for recognition and measurement of the financial instruments after the financial crisis giving the critique overview of all concepts and issues mentioned in the new standards especially the

classification rules and impairment rules. The paper has been divided into the following sections: the role of the accountants in the process of the IFRS 9 implementation, IAS 39 and its problems during the financial crisis, difference between IAS 39 and IFRS 9 in the area of recognition and measurement of financial instruments and some problems of the early adoption of IFRS 9.

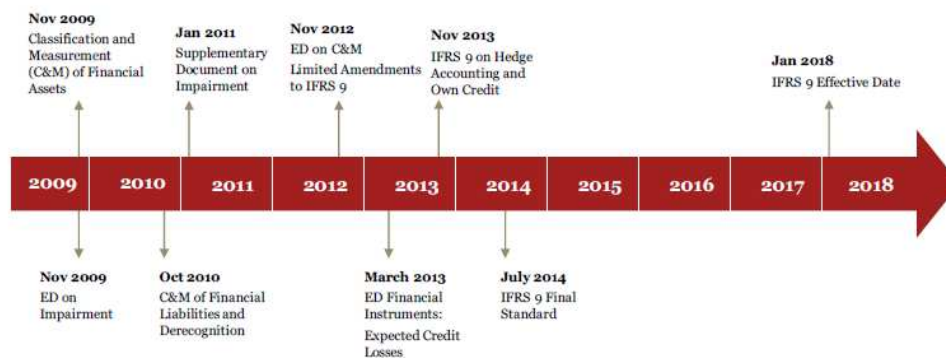
1. THE ROLE OF THE ACCOUNTANTS IN THE PROCESS OF IFRS 9 IMPLEMENTATION

The accounting standard setters in order to comply with the ever changing economic environment pass new regulations in form of the accounting standards. In this process there is the necessity to use the knowledge and expertise of academic accountants, not only when standard is set but in the process of discussion and preparation of the exposure draft. This role of academicians is to do “more academic research that provides insight into questions of interest to accounting standard setters...research is particularly valuable to standard setters because it is unbiased, rigorously crafted and grounded in economic theory...” (Barth, 2000). Academic accountants and their research make a foundation for the standards and after the implementation of the standard, their research results show whether the standard needs to be improved or not. But this role is not only limited to academic accountants but in some cases specialist are recruited such as corporate finance academicians, investment theory and portfolio theory academicians, because of specific nature of some accounting item (for example, financial instruments).

Since 2008, *IAS 39 Financial instruments: recognition and measurement*, was strongly emphasized by practitioners as a standard that directly led to the financial crisis. One of the most important critiques was that the measurement of financial instruments grouped into the category *available for sale* using fair value model leads to the losses recognized in the equity section of a balance sheet and in that case those losses do not influence income statement and are quite invisible for the investors. After the crisis it was obvious that this standard needs revision and improvement in the following areas; classification of financial instruments, recognition and measurement. At the following picture we are able to see the history of IFRS 9 and the transition of *IAS 39* to *IFRS 9*:

Picture 1.: History of IFRS 9

Brief history and timeline of IFRS 9



Source: PWC(2014) A look at the current financial reporting issues – In depth IFRS 9 classification and measurement, Delaware, CFO direct network.

Required changes of *IAS 39* started in 2009 when the classification and measurement of financial assets was pointed as the issue of a paramount importance and on November 2009 Exposure Draft about impairment of assets was issued. In October 2010 the standard setters pointed out the measurement problem of financial liabilities and on March 2013 expected credit loss model was introduced. The changes finished in November 2013 with the smallest one made in the area of hedge accounting using derivative instruments. In July 2014 final version of *IFRS 9* was introduced as a final response of the accounting bodies to the financial crisis requirements. IASB makes *IFRS 9* effective on 2018. So, the standard setters find 4 years of early implementation long enough to reveal some possible problems of the implementation. This is very long transition period because the effective implementation needs more preparation efforts of the companies as final adopters of this standard.

The role of the accountants is to do the research on the basis of the problems of implementation of *IAS 39*, and to propose changes to the measurement, recognition and impairment when needed and those changes were triggered with the severe changes in the economic environment after the financial crisis in 2008. According to the previous picture, after the crisis, academic accountants did the great job in trying to reformulate the theoretical framework for the financial instruments. This was done within the financial instruments project with three phases in

which the necessity of theoretical and academic accounting knowledge was needed:

- a) Stage 1- classification of financial assets and liabilities,
- b) Stage 2- impairment and
- c) Stage 3- hedge accounting.

In the first stage, academicians and professionals tried to find the best practice that determines the characteristic of financial instruments and the proper criteria is chosen to be the *cash flow and business model accounting*. In the second stage a new impairment model for loans is introduced which best suites the recognition of expected credit losses. The third stage was involved with the hedge accounting issues and in this area it was necessary to extend the disclosures about risk management of a company. The theoretical basis rests on modern portfolio theory and capital market theory.

The theoretical background about the classification is based on the theoretical characteristics of a cash flow and it also has a basis in the portfolio theory and capital market theory. (Fabozzi, 2002) In theory the reasons is that investor compare all investment opportunities when committing their capital. Thus the principles of investing must be based on capital market theory and it is stated in the following sentence “financial assets the typical benefit or value is a claim to future cash” (Fabozzi, 2002, pp. 1). Namely, the cash flow represents the characteristics of each financial instrument. For example, investors in shares have a cash flow which is the result of dividend payments and the terminal value received when the instrument is sold. The bonds cash flow is more predictable because it consists of interest payments made to the bondholders and payment of the nominal amount at the end of the maturity date of that instrument. For derivative instruments, the respective cash flow can be established. In this area academic accountants help standard setters to formulate new classification rules based on the corporate finance and financial management theory that describes the cash flow of financial instruments.

In the area of impairment accounting rules are quite rigid because the item will be impaired if the net book value is higher than the market (fair) value of the assets, and at the balance sheet date the entity needs to write off the value of the assets to its market (fair) value. This is supported by the prudence principle (ACCA, 2014), which means “the inclusion of a degree of caution in the exercise of the judgment needed in making the estimates required under conditions of uncertainty, such that assets and income are not overstated and liabilities or expenses are not understated.” In this context in order not overstate the assets entity needs to write down the value of the asset in line with its fair or market value at

the balance sheet date. Impairment in the context of IAS 39 is related to the loan losses to which banks and financial institutions were exposed to during the financial crisis after 2008. The new IFRS 9 propose the expected credit loss model as the one that best suites the impairment procedure.

Hedge accounting rules in the IFRS 9 are based on the hedge principles established in the corporate finance and investment theory. In this theory it is pointed out that one of the best ways to minimize the risk is to use derivative instruments, because “it is well known that derivative instruments are the tools which are used by enterprises in order to reduce or cut the financial risks, which affect the financial structure of enterprise in a negative way” (Hacioglu, Dincer, 2014, pp.VII). In this paper we will emphasize the rules for measurement and classification of financial instruments but not the sophisticated accounting to treat derivatives and hedging.

2. IAS 39 ISSUES DURING AND AFTER THE FINANCIAL CRISIS IN 2008

Based on the necessity for the new model for financial instruments, IASC (International Accounting Standards Committee) passed the *IAS 39 Financial instruments: recognition and measurement* in December 1998. The *IAS 39* applies to all contracts that meet the definition of financial instruments, although the definition is given in *IAS 32 Financial instruments: presentation*. According to this standard “financial instrument is any contract that gives rise to financial assets of one entity and a financial liability or equity instrument of another entity”(IAS 32, par. 11). In this standard the definition of a derivative instrument is given emphasizing three characteristic of that instrument: “value changes in response to the change in specific interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index... it requires no initial investment and it will be settled at a future date”(IAS 39, par. 9).

The measurement issues in this standard depend on the classification of the financial assets or liability. According to the *IAS 39* all financial assets that meet the definition of a financial asset is classified into 4 categories:

- Fair value through profit and loss,
- Loans and receivables,
- Held to maturity and
- Available for sale.

In the first category all instruments purchased by the entity for the purpose of trading and making profit on a short term basis are considered to be fair value instruments through profit and loss. The fair value is applied to all instruments in this category with the changes in fair value reported in the income statement (that is why the sintagma “through profit or loss” is used to describe this category). Loans and receivables are financial instruments with fixed payments whose value is not determined in active market. They are measured at amortized cost method. Held to maturity is asset with fixed payments and investing in those assets is to hold them until maturity and to receive contractual amounts such as interest. These assets are measured using amortized cost method after the initial recognition. Equity instrument cannot be reported under this section. Available for sale category is a residual category where the rest of financial assets are placed. Assets in the category available for sale are measured using fair value in all cases, with the changes reported in special section of equity and then reported in other comprehensive income statement.

Financial liabilities are classified in two categories:

- Financial liability through profit and loss,
- Other financial liability.

In the first section all liabilities that are designed as derivative instruments used for speculative purposes are put in this category. Derivatives used for hedging purpose follow the rules for hedging in this standard. Fair value measurement principle is applied in the first category, while all other liabilities are measured at amortized cost method. The main criteria under the IAS 39 used for classification of financial instruments into these categories are the following:

- a) Management intention to hold financial instrument till maturity,
- b) Management intention to trade for short term profit reasons,
- c) Loans and receivables and
- d) All other instruments (no intention to hold or to trade).

The above mentioned criteria are quite flexible allowing managers to use their judgment and subjective elements for classification of financial instruments. Taking into consideration the fact that the classification affects the measurement, than the subjectivity is transferred to the measurement process as well. This was one of the main weaknesses of this standard. Available for sale category draws lots of attention of academic accountants and they find it very subjective. In this residual category debt and equity instruments can be placed, but there is significant difference in measurement.

Debt instruments placed in available for sale category impairment test is needed when there is objective evidence of loss, with the possibility

of reversal entry. If equity instruments are placed under this category impairment test is used only if there is significant or prolong decline in the value of shares. Reversal entry is only through other comprehensive income category.

IAS 39 establishes the impairment model or impairment test. These tests are used for the assets carried at amortized costs and on assets placed in the available for sale category. All of these losses on impairment are recognized in the income statement. IAS 39 proposes “incurred loss” model for the impairment. In this model incurred loss means loss event the existence of which is related with the deterioration of the financial instrument cash flow.

In the mid 2008 world was hit by the severe financial crisis and banks suffered much of a crisis effect. IAS 39 (par. 50) prohibited reclassification from trading category. The political pressure on IASB was so high that the Board reconsidered the idea of reclassifying the assets from the categories not previously been allowed for reclassification (IASB, 2008). Reclassification was motivated by the rare circumstances and the IASB believes that the market conditions in Europe in the end of 2008 were an example of rare circumstances. The motivation for the reclassification lies in the fact that by reclassifying the assets banks in Europe can get some short term relief from the crisis effect and can be competitive with the US banks where the reclassification was permitted during the crisis. IASB permit new amendment in IAS 39 (par. 50).

New amendments on IAS 39 allows financial institutions, mainly banks, to move some financial instruments from the trading category into the held to maturity, available for sale or loans and receivables. The reclassification allows these institutions to have a short term profitability relief from the crisis. If it was not published then banks would have to recognize losses in the income statement which will have made them more sensitive to the capital adequacy criteria and central bank intervention. Banks heavily use the reclassification criteria allowed by the amendments, especially large banks with more financial instruments in the asset side. This would mean in some cases a change from fair value to historical cost (amortized cost) and unrealized gains and losses are not recognized in the income statement. The amendments permit that the instruments from the available for sale category can be moved into the loans and receivables category without having a rare circumstances criteria met. This last reclassification would have an influence on equity, not on the profit.

Academic accountants find the reclassification interesting and many researchers try to find whether the reclassification meets its goals. Linner (2011) found that in 2008 only 30% of banks that use

reclassification would have reported losses if no reclassification had been made. This finding supports the idea that bank uses reclassification to boost their profit or not to report losses, so the purpose of having short term relief was not satisfied. Instead the new purpose was obvious and that is earnings management. The other study in this area shows that the pre tax net income was 182 mil Eur or 43% higher for banks after reclassification, while the effect on equity was 287 mil Eur. (Brischoff, Brüggenmann, Daske, 2012) The results of a market reaction of investors to the firms that reclassify the assets shows that the reaction of investors was negative (Paananen, Renders, 2009). Brüggermann (2011) states that the banks use reclassification because of regulatory capital restrictions imposed on them. Regulatory costs (closure of a bank, loss of shareholders value) can be very high for banks if restrictions were violated and if regulatory methods are applied. In all of the above mentioned cases it seems that banks use the reclassification option because of motives and incentives described in positive accounting theory (Watts, Zimmermann, 1986). The main motive was to increase profit and to avoid regulatory requirements regarding the adequacy of capital for banks.

3. MAIN DIFFERENCES BETWEEN IAS 39 AND IFRS 9 IN THE AREA OF CLASSIFICATION AND MEASUREMENT OF FINANCIAL INSTRUMENTS

IAS 39 was considered as one of the most controversial accounting standards. The main controversies are in the following areas:

- a) Classification and measurement of financial assets,
- b) Impairment.

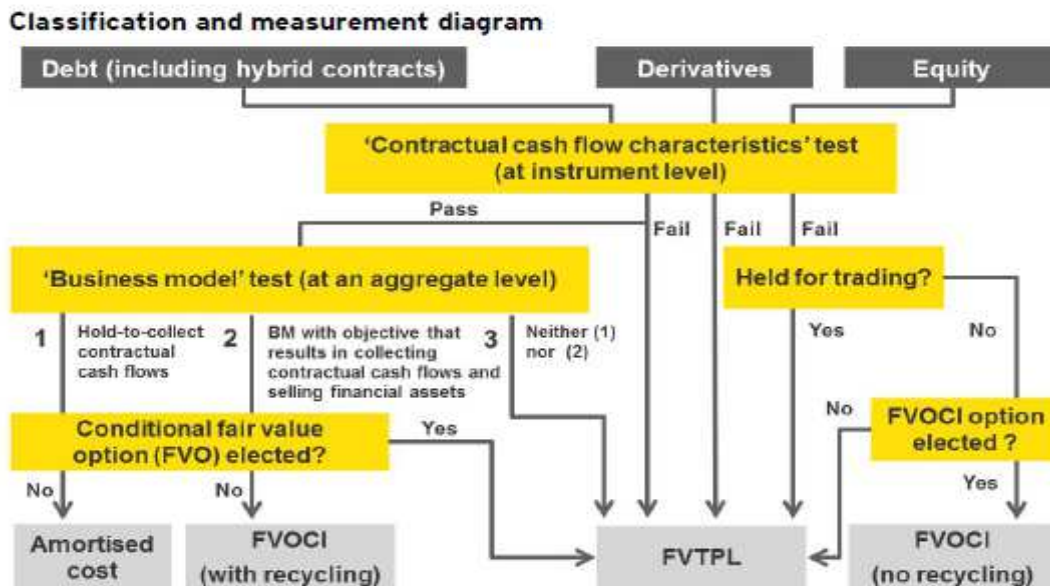
In terms of asset classification this standard focuses on the “management intent” model for the classification. On an individual basis all instruments are classified whether the intent is to hold the assets, or to sell the assets or neither. Management by intent model for classification is used on each asset and reclassification is used when the intent changes. This model was criticized as having no specific criteria for measuring the intent of a manager for the specific financial instrument (Schipper, 2012). Intent model is management plan regarding the instrument, and if plans change than the group in which instruments is placed will be different and the whole treatment of the instrument follows different rules than before. Intent based accounting for classification used in the IAS 39 is vague, unclear and gives a room for the earnings management. Schipper (2012) correctly states that “fungible and exchangeable financial assets are particularly suitable to approaches to value realization based on

management intent, and management intent are particularly easy to implement”. That is why this principle was widely used by management of a company.

IFRS 9 promotes “business model” for classification and eliminates the intent based accounting. Business model is preferred by the standard setters because “an entity business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity intent for an individual instrument” (Schipper, 2012, according to FASB, 2009). Business model is a matter of fact that can be observed and it is supported by the document, so it is more relevant for the users than the previous intent based model in IAS 39. IFRS 9 carries forward the rules for measurement of the basic IAS 39 model, but it reduces the possibility to apply historical cost method only to the category named amortized cost. By introducing only three main categories makes the issue of classification and measurement less sophisticated and more useful.

The next picture shows us the various rules used for classification by the IFRS 9:

Picture 2.: Classification of Financial instruments in accordance with the IFRS 9



Source: Ernst Young (2014) IASB Issues IFRS 9 Financial instruments – classification and measurement, EYGM limited, pp. 2

According to the above presented picture all instruments are divided into Debt instruments, Derivatives and Equity. All derivatives and

the most of the Equity will be classified into the Fair value through profit and loss group. Equity instruments that are held for trading can be presented into the Fair value through other comprehensive income group without the recycling option. Debt instruments can be presented into the Fair value through profit and loss if these instruments do not pass the contractual cash flow test at the instrument level. It means that these instruments are not solely the principal and interest cash flow. Other debt instruments that pass the “cash flow test” are included into the amortized cost model where historical cost is used and if fair value is used then instruments are grouped into the Fair value through other comprehensive income group. In comparison with the IAS 39 it was not obvious in which category to place the debt instrument and it gives managers the ability to manage the profit and to choose the most favorable category from the standpoint of gains and losses recognized. IFRS 9, however, takes into account the business model and cash flow of the instrument in order to evaluate the group and the accounting measurement. Standard setters believe that in this specific case with the business model the possibility to manage earnings is less than with the IAS 39 “intent” model.

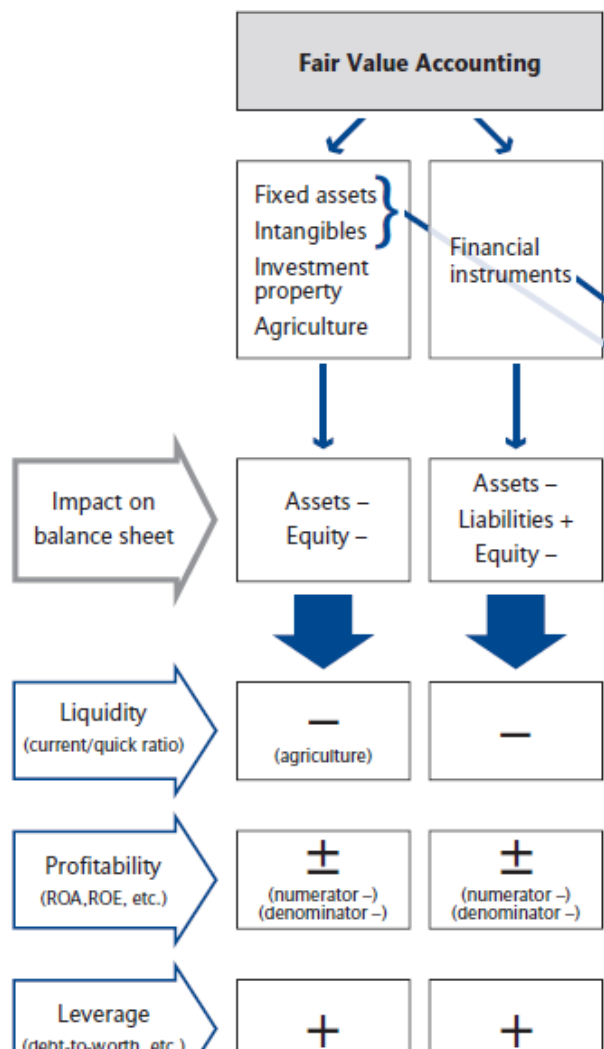
The second area of difference between IAS 39 and IFRS 9 is the *impairment* transaction. Regarding the impairment the criteria assessed by the IAS 39 is based on the “incurred loss” model for the instruments recognized as loans and receivables and amortized cost instruments whose measurement attribute is historical cost. For the fair value instruments, the impairment is not explicitly published because the fair value itself takes into consideration the loss in the value of the specific asset at the balance sheet date. Incurred loss model does not recognize the loss in the value of the assets if it is not considered permanent. In that case many banks during the crisis in 2008 found that the loss on loans is determined to be a result of market conditions during the crisis and not the permanent loss in the value of the assets. These guidance does not require the timely recognition of expected credit losses and where heavily criticized (Byrne, 2014. According to: Focus, 2010). The IFRS 9 model for the impairment uses the “expected credit loss” model and it is applied to loans, lease, receivable, debt securities, financial guarantees and loan commitments issued. More evidence is used in the expected credit loss model and the entity needs to evaluate the 12 month expected losses or lifetime expected losses. This model looks into the future in order to evaluate the credit losses and it comprise of future information regarding the probability of the loss in the specific financial instrument. In that case the new impairment rules make the reported information more relevant for the investors. The investors with the credit loss model are able to

assess the credit risk of a financial instrument and to use this information when making business decisions.

4. IFRS 9 FINANCIAL INSTRUMENTS AND SOME ISSUES OF ITS EARLY ADOPTION BY COMPANIES

In this section of the paper we try to research are there some effects of IFRS 9 adoption and what kind of effects are expected. The main question is whether the new rules for the classification of assets make profit more volatile in the income statement and will it in turn affect the market value of a company. It is obvious that under IFRS 9 regime some assets valued at amortized costs will be revaluated at the fair value with the changes recognized in the income statement and some of them will be reclassified into fair value through other comprehensive income only if the business model suggests that the financial instrument is used because of twofold purposes (to collect cash flow and to sell the assets). Because the business model is set by managers they have more incentive to classify the assets into the category that has the favourable effect (in this case this is the category of fair value through other comprehensive income). Banks are mostly affected by the classification criteria imposed in the IFRS 9 because of the Basle III framework regarding the capital adequacy or regulatory capital requirements. If banks classify some loans from the amortized cost to the fair value through profit and loss it will affect the regulatory capital and ratios. So, banks need to adopt the model that best suits their interests. Other comprehensive income can be used “as a buffer that allows the use of fair value accounting without the direct impact of the income statement“ (CGA, 2011). In the following section the negative scenario (bear market and decrease in the value of financial instruments) was taken into consideration by the Canadian accountants and we may see from the picture 3 that the liquidity will be deteriorated and leverage as well. The effects on ROE are quite vague. Although, the profit will not be affected and that is why the numerator increases while at the same time total equity decrease because the denominator or equity is negatively affected by the unrealized losses on these financial instruments.

Picture 3.: The pessimistic scenario of fair value effects on ratios



Source: Certified General Accountants Association of Canada (2011) The effects of IFRS on financial ratios. Canada, pp. 27

Early adopters of IFRS 9 need to take into consideration the above mentioned effects on the ratios because the investors in the efficient markets will process all of the information and incorporate them into the stock prices. In turn it will affect corporate managers to seek the most adequate treatment of the financial instruments using the freedom given by the IFRS 9 rules.

CONCLUSION

IFRS 9 has several distinguishing features in comparison with its predecessor IAS 39 and these distinctions are in the following areas: firstly, the IFRS 9 introduces only three categories for asset classification which makes the rules for the measurement more transparent and simple to be used by the early adopter of this standard; secondly, classification is based upon the business model and cash flow model for the financial instruments and this makes the classification criteria more detailed, more informative and reliable. The reclassification is allowed only if the business model changes so this standard does not allow the earnings management. Early adopters of the IFRS 9 may expect that many reclassifications will be done in terms of reducing the number of instruments in the amortized cost category and classify them as fair value through other comprehensive income (which affects the financial position of an entity) or fair value through profit and loss which affects the profitability. For banks this decision for reclassification is not an easy one because of the regulatory capital requirements imposed on banks. Many banks may expect that the new IFRS 9 rules will trigger the adequacy capital criteria. Besides that it is expected that the profitability and leverage ratios will be affected as well as liquidity ratios. Taking into consideration all of these effects we expect that the lower number of financial institutions would use the early adoption feature of the IFRS 9. Nevertheless, the IFRS 9 should be seen as more practical and useful standard than its predecessor IAS 39.

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