NO. 215-A | DECEMBER 22, 2000

Financial Accounting Series

SPECIAL REPORT

Financial Instruments
JWG
Joint Working Group of standard setters

JOINT WORKING GROUP OF STANDARD SETTERS

Recommendations on accounting for

Financial Instruments and Similar Items

Published by

Financial Accounting Standards Board
of the Financial Accounting Foundation

WRITTEN COMMENT REQUIREMENTS

Any individual or organization may send written comments to the attention of the director of research and technical activities at the address listed below. To be timely, comments should be postmarked by June 30, 2001. Comments can also be submitted by electronic mail to director@fasb.org. Respondents submitting comments by electronic mail should clearly identify themselves and the organization they represent.

Copies of all written submissions on the project will be available for inspection in the FASB's Public Reference Room. Copies are available for a duplication fee. All comments received will be shared with all Joint Working Group member organizations unless respondents specify otherwise.

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This Special Report also will be available on the FASB web site at www.fasb.org until June 30, 2001.

SUMMARY

The Financial Accounting Standards Board has issued this Special Report prepared by the Financial Instruments Joint Working Group of standard setters (JWG) to solicit views on financial reporting for financial instruments. The Special Report has not been edited using the FASB's guidelines for publication. It has been published in exactly the form in which it was received from the JWG and is identical to similar reports published in other countries with representatives on the JWG. Although it is not a formal part of the due process in an FASB project, this Special Report is related to the Board's current project on reporting financial instruments at fair value.

The JWG was formed in 1997 for the sole purpose of developing a coherent framework for reporting financial instruments at fair value. That framework was to be based on the principles discussed in the March 1997 Discussion Paper, *Accounting for Financial Assets and Financial Liabilities*, issued by the International Accounting Standards Committee (IASC) and the Canadian Institute of Chartered Accountants, as further developed or amended as a result of the deliberations of the JWG.

The JWG consists of nominees of accounting standard setters or other professional organizations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, and the United States, as well as the IASC. The positions taken in the Draft Standard reflect the views of a majority of the members of the JWG. They do not necessarily represent the view of the organizations that nominated the members of the JWG.

Comments Invited

The FASB is soliciting comments on the issues discussed in the Request for Comments in the Draft Standard (page 7). Unlike its procedures when issuing an Exposure Draft or Preliminary Views, the Board has not deliberated the conclusions contained in this Special Report. Standard setters in the jurisdictions represented by each of the JWG members are publishing the JWG's recommendations at approximately the same time. The comments received will be shared among all of those organizations unless respondents specify otherwise.

The Draft Standard of the JWG

Although it is not an Exposure Draft, the document including the recommendations of the JWG is titled a *Draft Standard* and is in a form similar to an Exposure Draft with a standards section, an application (implementation) section, and a basis for conclusions. The JWG's charge was to develop a comprehensive set of principles for reporting financial instruments at fair value, and, consequently, its recommendations were designed to be applied in that context. In contrast, US standards for financial instruments are designed to be applied in a system in which some financial instruments are measured at fair value and others are not. Thus, the two are very different and difficult to compare, and no detailed analysis of differences between the Draft Standard and existing US standards has been attempted.

The Draft Standard is formatted in IASC style, which includes paragraphs set in ***bold italic*** text and other paragraphs set in plain text. The introductory paragraph to each International Accounting Standard indicates that differences in type of text indicate differences in status or level of emphasis. The FASB does not use that style and considers all paragraphs in the standards section (or incorporated by reference into the standards section) to have equal status and emphasis. In addition, certain terms are different from terms used under the FASB style. For example, the Draft Standard uses the terms *enterprise* and *should* when the FASB would use *entity* and *shall*.

The Draft Standard addresses issues in five general areas: (a) scope and definitions, (b) recognition and derecognition, (c) measurement, (d) balance sheet and income statement presentation, and (e) disclosures. The Request for Comments includes questions related to all aspects of reporting financial instruments. The Board expects comments on many of the issues to be useful in its current project on reporting financial instruments at fair value.

Reconsideration of the requirements in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is not on the Board's agenda at this time. However, comments on Questions Q8–Q12 in the Request for Comments and any other questions related to derecognition are important to standard setters in other countries that nominated members of the JWG and will be forwarded to them for use in their own separate projects on financial instruments.

Responses to questions related to issues other than derecognition generally will relate to the Board's current project on reporting financial instruments at fair value. The Board has already received comments on its own proposals for defining financial instruments and measuring them at fair value, which were published in December 1999 in the FASB Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and*

Liabilities at Fair Value.[1] The recommendations in the Draft Standard for fair value measurement and for the population of items to which the requirements should be applied are similar in broad terms to those in the Preliminary Views, but the details differ. Thus, the Board believes that relevant comments on the Draft Standard will be useful during the next phase of its fair value project, especially comments on those issues on which the Draft Standard and Preliminary Views differ.

Respondents who also responded to the Preliminary Views need not repeat comments on that document and need not send a copy of the previous letter. Those responses are available to Board members, and respondents may incorporate them by reference. The Board is most interested in comments on the recommendations in the Draft Standard that are different or that appear to be different from the proposals in the Preliminary Views or that were not addressed in the Preliminary Views.

Differences between the JWG Draft Standard and the FASB Preliminary Views

There are a number of apparent differences in details between the Draft Standard and the Preliminary Views, and some of them could have significant effects in some circumstances. The Board has not identified all differences, nor has it analyzed the likely effects of the differences. Some examples of differences that the FASB staff has identified are discussed in the following paragraphs. The list is illustrative and is not intended to be complete. In addition, the effects of some differences in wording between the Preliminary Views and the Draft Standard may be interpreted differently by other readers.

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[1]A copy of the Preliminary Views can be obtained from the FASB's order department at the address on the inside cover of this Special Report. Ask for Product Code No. ITC17. A copy can be downloaded without charge from the FASB web site at http://www.fasb.org.

Scope—The JWG agreed to exclude insurance contracts from the scope of the Draft Standard because another body designated by the IASC is currently considering insurance accounting. The Preliminary Views includes insurance contracts that meet the definition of financial instruments. The Draft Standard also includes other exceptions to its requirements that are not exceptions in the Preliminary Views. Some examples are forward contracts that represent "normal purchases and sales"[2] and equity securities for which no quoted prices are available. The Draft Standard also specifically excludes from its scope assets related to demand deposit agreements and credit card contracts that are discussed as unresolved issues in the Preliminary Views.

Measurement—Unlike the Preliminary Views, the Draft Standard would not require (or permit) consideration of costs of exit transactions in determining fair value. The Draft Standard also would prohibit reporting a freestanding written option as an asset even if market participants are willing to pay the writer of the option to assume its rights and obligations under the option contract. (The option of a credit card holder to borrow from the card issuer is an example of such an option.) Finally, some of the recommendations in the Draft Standard about how to determine fair value that are otherwise similar to the proposals in the Preliminary Views are described in more detail in the Draft Standard. One example is how to decide which market exit price should be used to determine fair value if there is more than one observable price for an instrument.

Presentation and disclosure—The Draft Standard recommends specific requirements for presenting financial instruments in the balance sheet and changes in fair value of financial

[2]That exception is similar, but not identical, to the exception in paragraph 10(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

instruments in the income statement. It also recommends specific disclosures. Neither presentation nor disclosure was addressed in the Preliminary Views.

Hedge accounting—The Draft Standard and the Preliminary Views would affect hedge accounting similarly. Both would preclude any form of hedge accounting that affects accounting and reporting for a financial instrument, and neither would change existing hedge accounting that does not involve the accounting and reporting for a financial instrument. That means that if the Draft Standard were applied in the United States, hedge accounting as described in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* would be permitted only for hedging relationships that do not involve financial instruments and for fair value hedging relationships in which the hedged item is not a financial instrument.

Financial Instruments

JWG

Joint Working Group
of standard setters

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

SUMMARY

This Draft Standard proposes far-reaching changes to accounting for financial instruments and similar items. These include:

(a) measurement of virtually all financial instruments at fair value;

(b) recognition of virtually all gains and losses resulting from changes in fair value in the income statement in the periods in which they arise;

(c) preclusion of special accounting for financial instruments used in hedging relationships;

(d) adoption of a components approach for accounting for transfers of financial assets; and

(e) some expansion of disclosures about financial instruments, financial risk positions and income statement effects.

Background

Advances in financial risk management and information technology, globalisation of capital markets, and accelerated use of sophisticated derivatives and other complex financial instruments have combined to change fundamentally the business and investment environment. It has become apparent that traditional accounting concepts for the recognition and cost-based measurement of financial instruments need to be rethought.

Accounting standard setting bodies around the world are at different stages in considering and addressing the issues. Many standard setters have required disclosures about financial instruments, and a few have issued standards for recognition and measurement of financial instruments that adopt mixed cost—fair value approaches. Those recognition and measurement standards are highly complex, and those issuing them have indicated that they are intended to be interim standards pending further study. Studies by several major accounting standard setting bodies and others have recommended the adoption of a comprehensive fair value measurement model for financial instruments that would be consistent with accepted capital markets practices and finance concepts for pricing financial instruments.

Recognising the world-wide importance of the issues, the Financial Instruments Joint Working Group of standard setters (JWG) was established to develop a proposed comprehensive standard on accounting for financial instruments based on fair value measurement principles. The JWG's charge was to propose a standard that would implement the fair-value-based principles set out in the Discussion Paper, Accounting for Financial Assets and Financial Liabilities, issued by the International Accounting Standards Committee (IASC) and Canadian Institute of Chartered

Accountants (CICA) in 1997, with such further development or amendment as the JWG considered appropriate based on its work and deliberations.

The JWG comprises representatives or members of accounting standard setters or professional organisations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, the United States, and the IASC. The views expressed by JWG members in preparing the Draft Standard were their own and in most cases the standard setters and professional organisations themselves have not fully deliberated or developed official views on the positions taken in the Draft Standard.

Scope

The Draft Standard would apply to all enterprises.

The Draft Standard would apply to all financial instruments except for certain financial instruments that have unique aspects:

(a) for which there are accounting standards (for example, investments in subsidiaries and associates, and equity instruments issued by the reporting enterprise); or

(b) that are the subject of separate study (in particular, most insurance contracts).

The scope of the Draft Standard includes certain non-financial contracts that are considered to be very similar to financial instruments (including certain commodity contracts that can be settled net by financial instruments and separate assets and liabilities resulting from contracts to service financial assets).

Financial instrument components of contracts that also have components falling outside the scope of the Draft Standard ("hybrid contracts") would generally be separately accounted for as free-standing financial instruments.

The Principal Provisions

The Draft Standard is founded on four basic principles.

1. Fair Value Measurement Principle

The JWG accepted the Discussion Paper conclusion that fair value is the most relevant measurement attribute for all financial instruments, and has concluded that sufficiently reliable estimates of the fair value of financial instruments are obtainable for financial reporting purposes, with the exception of certain private equity investments. [The basic case for fair value measurement of financial instruments is set out in the Basis for Conclusions paragraphs 1.6-1.26]

Draft Standard and Basis for Conclusions – Summary

The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies. Such a valuation technique should incorporate estimates and assumptions that are consistent with available information that market participants would use in setting an exit price for the instrument.

The estimated market exit price for a financial liability is to reflect the effects of the same market factors as for a financial asset, including the credit risk inherent in the liability.

The Draft Standard addresses circumstances requiring special consideration in using observed market prices to determine fair value. These include:

(a) situations in which observable market prices may not be determined by normal market interactions (for example, where the observed market price would have been different if not for other transactions or contracts between the transacting parties);

(b) where observable market transactions are only infrequently available;

(c) where there are prices in more than one market for a financial instrument;

(d) where an enterprise holds a large block of a financial instrument and observable market exit prices are only available for small blocks; and

(e) where the observable market exit price includes value that is not directly attributable to the financial instrument. A prominent example is demand deposit liabilities. Observable market exit prices for these liabilities include the value of benefits expected to result from future deposits and from other services that can be expected to arise from the customer relationship. The Draft Standard would require that such value not be included in the fair value of deposit liabilities because the objective is to estimate the value of the existing financial instrument.

The Draft Standard sets out basic standards for selecting valuation techniques and for the use of estimates and assumptions. Present value concepts are central to the development of valuation techniques.

The JWG believes that an important underpinning for ensuring that fair value estimates and assumptions are made on a reliable and internally consistent basis lies in an enterprise establishing fair value measurement policies and procedures that are appropriate to its financial activities.

2. Income Recognition Principle

All gains and losses resulting from measuring financial instruments at fair value are to be recognised in the income statement in the reporting periods in which they arise, with one exception. The exception is that, in accordance with existing foreign currency translation standards, exchange translation gains and losses relating to certain foreign operations are to be separately presented outside the income statement.

The Draft Standard would require the presentation of interest revenue and interest expense calculated on a fair value basis, and information about gains and losses by general classes of financial risks. The JWG concluded that the traditional historical cost "effective interest" method is not appropriate for the analysis of income determined on a fair value basis for interest-bearing financial instruments.

3. Recognition and Derecognition Principle

An enterprise would be required to recognise a financial instrument when it has the contractual rights or obligations that result in an asset or a liability and to derecognise a financial instrument or a component thereof when it no longer has the pertinent rights or obligations.

The Draft Standard would require a components approach to transfers involving financial assets. Difficult issues arise in applying this approach to complex transfer transactions (such as securitisations, sale and repurchase and stock lending arrangements, and certain factoring situations) where the transferor has a continuing involvement in the transferred assets. The Draft Standard would require that a transferor, generally, continue to recognise a transferred financial asset, or part thereof, to the extent that the transferor has a conditional or unconditional obligation to repay the consideration received or a call option over a transferred component, unless the transferee has the ability to transfer that asset to a third party.

4. Disclosure Principle

The JWG believes that financial statement presentation and disclosure should be sufficient to enable evaluation of risk positions and performance in respect of each of an enterprise's significant financial risks. To accomplish this objective the Draft Standard would require:

(a) a description of each of the financial risks that was significant to an enterprise in the reporting period and the enterprise's objectives and policies for managing those risks;

(b) information about the balance sheet risk positions and financial performance effects for each of these significant risks; and

(c) information about the methods and key assumptions used to estimate the fair value of financial instruments.

A number of the Draft Standard disclosures are already required by accounting standards in many jurisdictions. The adoption of a comprehensive fair value measurement system provides a richer and more consistent foundation for disclosures that facilitate the predictive and accountability purposes of financial reporting.

Hedges

Following from the first three principles above, the Draft Standard does not permit special accounting for financial instruments that are entered into as part of risk management activities. In other words, financial instruments that are used for hedging purposes (for example, used as hedges of risks expected to arise from anticipated future transactions) are to be recognised and measured at fair value, with gains and losses recognised immediately in the income statement, just as for all other financial instruments.

Implementation and Transition

The JWG recognises that it is a very serious step to put in place accounting standards that fully embrace these four principles and, in particular, to let go of the historical cost basis of accounting for financial instruments. The JWG's conclusion that this step should be taken now reflects its belief that:

(a) existing mixed cost–fair value accounting has very significant deficiencies and is not sustainable in the longer term;

(b) an accounting system based on the four principles is superior in relevance and, therefore, in the usefulness of the information that can be derived from it; and

(c) the Draft Standard is capable of reasonable and reliable implementation.

In the JWG's view, it is the last of these reasons (the capability of reasonable and reliable implementation) that presents the most difficult challenge. The development of a fully effective standard requires addressing a number of issues that have not been subject to accounting consideration to date, and it will require application experience and field testing to fully resolve and perfect. The Basis for Conclusions discusses the more significant issues identified by the JWG and the reasons for the positions taken in the Draft Standard. The JWG believes that these issues can be reasonably accommodated within the Draft Standard and that they are no more serious than many difficult issues that are presently accommodated within existing standards in other areas of financial reporting. In a number of areas the Draft Standard would require only basic levels of presentation and disclosure that can be further built upon as experience is gained. The Draft Standard places much importance on enterprises establishing policies and procedures appropriate to ensuring reliable and consistent fair value estimations.

The effective implementation of the Draft Standard requires integrating knowledge of certain finance and capital markets concepts and practices with financial accounting objectives and framework concepts. This requires a somewhat different "mind-set" and expertise base from that appropriate to traditional recognition and historical-cost-based accounting for financial instruments. The JWG believes that it is of utmost importance to put in place a well planned and internationally co-ordinated implementation process, including education and field testing, and that there should be a sufficient transition period to enable this.

The Next Steps

The Draft Standard, Application Supplement, and Basis for Conclusions are being issued for comment by each of the participating standard setters. Each participating standard setting body intends to take into account this document's proposals, and comments received, in developing standards that will be applicable in its jurisdiction. It is expected that the participating standard setters will make their best efforts to work together towards achieving the same accounting for financial instruments in each jurisdiction.

Financial Instruments JWG Joint Working Group of standard setters

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

Contents

Paragraphs

PREFACE **P1-P8**

REQUEST FOR COMMENTS **Q1-Q36**

DRAFT STANDARD **1-195**

Objective

Scope **1-6**

Enterprises and Financial Instruments Included in Scope 1

Additional Items Included in Scope 2-3

Hybrid Contracts 4-6

Definitions **7-30**

Definitions relating to Financial Instruments 7-13

Definitions of Financial Risks 14-16

Definition of an Insurance Contract 17-19

Definitions relating to Servicing Assets and Servicing Liabilities 20-24

Definition of a Hybrid Contract 25

Definitions relating to Recognition and Derecognition 26-27

Definition of Fair Value 28

Definitions relating to Foreign Currency Items 29

Definitions relating to Income Statement Presentation 30

Recognition and Derecognition **31-68**

Recognition 31-36

Derecognition 37-48

Basic Requirements 37-40

Arrangements to Pass Cash Flows Through One Enterprise to Another 41-48

Transfers involving Financial Assets 49-68

Introduction 49-50

Transfers Where the Transferor Has No Continuing Involvement in the Asset .. 51-54

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party 55-62

Transfers Where the Transferor Has an Obligation to Repay Consideration Received or a Call Option over a Transferred Component 63-67

Other Transfer Transactions 68

Measurement 69-130

Basic Requirements 69-73

Hybrid Contracts 74-76

Market Exit Prices of Identical or Similar Instruments 77-86

Sources of Market Exit Price Information 77-83

Using Price Information about Similar Financial Instruments 84-86

Identifying Appropriate Prices in Special Situations 87-103

Introduction 87

Prices Not Determined by Normal Market Interactions 88-90

Infrequent Transactions 91

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument 92-94

Prices from More than One Market for the Same Instrument 95-99

Effect of an Embedded Option on the Enterprise Holding the Option 100-101

Large Blocks of Instruments 102-103

Estimating Fair Value without Observable Market Exit Prices 104-117

Selecting a Valuation Technique 104-110

Inputs to Valuation Techniques 111-117

Financial Liabilities 118-121

Exception for Certain Private Equity Investments 122-125

Foreign Currency Denominated Financial Instruments 126-128

Establishing Fair Value Estimation Policies and Procedures 129-130

Balance Sheet Presentation 131-135

Income Statement Presentation **136-152**

Basic Requirement 136

Income Statement Disclosures 137-152

Interest Revenue and Expense 139-140

Information about Net Gains and Losses 141-147

Foreign Currency Denominated Financial Instruments 148-151

Further Disaggregation 152

Hedges **153**

Disclosure **154-189**

Significant Financial Risks 154-155

Financial Risk Management Objectives and Policies 156-163

Terms and Conditions of Financial Instruments 164-169

Financial Risk Position at the Reporting Date 170-180

Basic Interest Rate Risk 170

Currency Risk 171

Credit Risk 172-174

Other Significant Financial Risks 175-176

Financial Risk Position at the Reporting Date Compared with that During the Reporting Period 177-178

Potential Effects of Changes in Risk Conditions on Financial Risk Position . 179-180

Financial Instruments Used to Manage Risks Associated with Transactions Expected to Occur in Future Reporting Periods 181-182

Methods Used to Estimate Fair Value 183-186

Derecognition Disclosures 187-189

Sale and Repurchase Transactions and Stock Lending Transactions 187

Retained Interests in Transferred Assets 188-189

Effective Date and Transition **190-195**

APPLICATION SUPPLEMENT **196-412**

BASIS FOR CONCLUSIONS **1.1-9.21**

APPENDIX A: Dissenting Views **A.1-A.23**

APPENDIX B: Consequential Amendments B.1-B.12

APPENDIX C: Glossary of Terms C

APPENDIX D: Members of the Financial Instruments Joint Working Group of standard setters .... D

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

PREFACE

P1. Advances in financial risk management and information technology, globalisation of capital markets, and accelerated use of sophisticated derivatives and other complex financial instruments, have combined to change fundamentally the business and investment environment. It has become apparent that traditional accounting concepts for the recognition and cost-based measurement of financial instruments need to be rethought.

P2. Accounting standard setting bodies around the world are at different stages in considering and addressing the issues. Many standard setters have required disclosures about financial instruments, and a few have issued standards for recognition and measurement that adopt mixed measurement cost—fair value approaches. Those recognition and measurement standards are highly complex, and those issuing them have indicated that they are intended to be interim standards pending further study. Studies by several major accounting standard setting bodies and others have recommended the adoption of a comprehensive fair value measurement model for financial instruments that would be consistent with accepted capital markets practices and finance concepts for pricing financial instruments.

P3. Recognising the world-wide importance of the issues, in October 1997, a number of standard setters agreed to establish the Financial Instruments Joint Working Group of standard setters (JWG), with the following objectives:

(a) to develop a proposed comprehensive standard on accounting for financial assets and financial liabilities, supported by a basis for conclusions and appropriate guidance material and examples;

(b) to put in place a coherent framework of principles for the recognition and fair value measurement of financial assets and liabilities, and for the presentation and disclosure of gains and losses and hedging activities; and

(c) to base the principles of the standard on those set out in the International Accounting Standards Committee's (IASC) and Canadian Institute of Chartered Accountants' (CICA) Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997, as further developed or amended as a result of the work programme and deliberations of the JWG.

P4. The JWG comprises representatives or members of accounting standard setters or professional organisations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, the United States, and the IASC (see Appendix D for a list of members). The views expressed by JWG members in preparing the Draft Standard were their own and in most cases the standard setters and professional organisations themselves have not fully deliberated or developed official views on the positions taken in the Draft Standard.

P5. On a number of topics, some members hold views different from the proposals made in the Draft Standard. References in the Basis for Conclusions to the JWG's conclusions on individual issues reflect the majority view. Arguments and issues underlying minority views are also discussed in the Basis for Conclusions, together with the reasons why the majority does not accept them.

P6. All members of the JWG agree that the document should be issued for comment. The French and German delegations dissent from the conclusions of the Draft Standard (see Appendix A).

P7. The JWG has carried out an extensive work programme, with input from participating standard setting bodies and other organisations. The proposals are presented in the form of:

(a) a Draft Standard, which is prepared in the style of, and within the context of, existing International Accounting Standards;

(b) an Application Supplement, which provides additional material that explains how certain aspects of the Draft Standard apply. The Application Supplement is an integral part of the Draft Standard; and

(c) a Basis for Conclusions, which summarises considerations that members of the JWG deemed significant in reaching the conclusions in the Draft Standard.

P8. The JWG's proposals are being issued in each participating jurisdiction for comment. All comments received will be shared between JWG members unless confidentiality is requested. Each participating standard setting body intends to take into account the JWG document, and comments received, in developing standards that would be applicable in its jurisdiction. It is expected that the participating standard setting bodies will make best efforts to work towards achieving the same accounting for financial instruments in each jurisdiction.

Request for Comments

Comments are sought on any aspect of this Draft Standard and Basis for Conclusions. Commentators are requested to indicate:

(a) whether they support the proposals in the Draft Standard and, if not, why not and what changes they would propose, together with the reasons for those changes; and

(b) any additional principles and guidance that they consider necessary, together with reasons.

Answers to the following questions and the reasons for those answers would be particularly helpful.

Scope and Definitions

Q1. The Draft Standard would apply to all enterprises (see Draft Standard paragraph 1 and Basis for Conclusions paragraphs 2.1-2.12). Do you agree? If not, please specify which enterprises you believe should be excluded from the scope (and why), and the basis on which you would distinguish those enterprises that should apply the Draft Standard from those that need or should not.

Q2. The definition of a financial instrument would differ somewhat from the present IASC definition (see Draft Standard paragraph 7 and Basis for Conclusions paragraphs 2.13 and 2.14). Do you agree with the definition in the Draft Standard? If not, what changes would you make, and why?

Q3. The Draft Standard would apply to all financial instruments except for those referred to in paragraph 1 (see also Basis for Conclusions paragraphs 2.20-2.36).

(a) Do you agree with the proposed scope exclusions and the manner in which they are defined? If not, why not?

(b) Are there other items that should be excluded from the scope of the Draft Standard? If so, why, and how should those items be defined?

Q4. The definition of an insurance contract used in the IASC Insurance Steering Committee's, Issues Paper: Insurance, November 1999, is used as the basis to exclude insurance contracts from the scope of the Draft Standard. However, financial guarantees and certain contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events would not be excluded (see Draft Standard paragraphs

1(d), 17-19 and Basis for Conclusions paragraphs 2.23-2.30)? Do you agree with this approach and definition? If not, what approach and definition would you propose?

Q5. The scope of the Draft Standard would include certain additional items, including certain contracts to buy or sell a non-financial item and servicing assets and servicing liabilities (see Draft Standard paragraphs 2 and 3, Application Supplement paragraphs 197-210, and Basis for Conclusions paragraphs 2.37-2.47).

(a) Do you agree that these additional items should be included in the scope? If not, why not?

(b) Are the additional items included defined in a manner that can be clearly applied? If not, how would you amend the requirements?

(c) Are there other items that should be included in the scope of the Draft Standard and, if there are, how should they be defined?

Q6. The Draft Standard would require an enterprise, with certain exceptions, to separately account for sets of contractual rights and contractual obligations in a hybrid contract that, if they were separated, would fall within the scope of the Draft Standard (see Draft Standard paragraphs 4-6 and 25 and Basis for Conclusions paragraphs 2.48-2.52). Do you agree with this proposal? Is the definition of a hybrid contract clear and operational? If you disagree with either of these two questions, what alternative would you suggest?

Recognition and Derecognition

Q7. The basic recognition principle is that an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in an asset or liability (see Draft Standard paragraphs 31-34, Application Supplement paragraphs 214-220, and Basis for Conclusions paragraphs 3.1-3.8). Do you agree? If not, why not? How would you amend the principle?

Q8. The Draft Standard would require that a transfer that does not have substance not affect the assets and liabilities recognised. It proposes that a transfer has substance only if either the transferee conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor, or the components transferred have been isolated from the transferor (see Draft Standard paragraphs 35 and 36, Application Supplement paragraphs 222 and 223, and Basis for Conclusions paragraphs 3.72-3.80). Do you agree? If not, how would you propose to limit the potential for non-substantive transactions that might occur without such a test?

Q9. The basic derecognition principle is that an enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component (see Draft Standard paragraphs 37-40, Application Supplement paragraphs 224-231, and Basis for Conclusions paragraphs 3.1-3.8 and 3.15-3.30). Do you agree? If not, why not? How would you amend the principle?

Q10. The Draft Standard would require that, in certain circumstances, when cash flows are passed through one enterprise to another, the assumption of a contractual obligation to make payments that fully reflect the amount of the cash flows being received from another enterprise would qualify as a transfer of the contractual right to receive the cash flows (see Draft Standard paragraphs 41-48, Application Supplement paragraphs 309-314, and Basis for Conclusions paragraphs 3.32-3.37).

(a) Do you agree? If not, why not? How would you amend the requirement?

(b) Is the requirement and implementation material workable? If not, what changes do you believe are necessary to make them workable?

Q11. The JWG has developed criteria to be used to determine whether a financial asset (or a component thereof) should be derecognised by the transferor when a transfer of substance involving a financial asset takes place. In particular, the Draft Standard would require the whole of the financial asset previously recognised by the transferor to be derecognised if either the transferor no longer has a continuing involvement in that asset or the transferee has the practical ability, which it can exercise unilaterally and without imposing additional restrictions, to transfer the whole of that asset to a third party (see Draft Standard paragraphs 51-62, Application Supplement paragraphs 236, 237 and 242-250, and Basis for Conclusions paragraphs 3.50 and 3.81-3.92).

(a) Do you agree? If not why not? How would you amend the requirement?

(b) The JWG has developed some material to determine whether the transferee has the practical ability described above (see paragraphs 56-61 and 244-249). Is this material appropriate, clear and operational? If not, how would you amend it?

Q12. The Draft Standard also would require, in the case of a transfer that does not result in the transferee having the practical ability described in Q11, if the transferor is left with either (a) an obligation that could or will involve the repayment of consideration received or (b) a call option over a transferred component that the transferee does not have the practical ability to transfer to a third party, some or all of the transaction to be treated as a loan secured by the transferred component (see Draft Standard paragraphs 63-67, Application Supplement paragraphs 251-258, and Basis for Conclusions paragraphs 3.38-3.71 and 3.93-3.102).

(a) Do you agree? If not, why not? How would you amend the requirement? In particular, if you believe that some transfers involving financial assets are loans secured by the transferred asset, how would you differentiate between those transfers and transfers that are, in effect, sales of the transferred asset? If you do not believe that some transfers involving financial assets are loans secured by the transferred asset, or do not believe that some transfers are sales of the transferred asset, please explain your reasoning.

(b) The Draft Standard would require the liability to be recognised in such circumstances to be measured initially at the maximum amount that might need to be repaid under the obligation or the amount of the consideration received in respect of the transferred component over which the transferor has the call option. To the extent that the obligation and call option overlap, only the larger of the two liabilities would be recognised (see Draft Standard paragraph 64 and Basis for Conclusions paragraphs 3.93-3.98). Do you agree with this approach to determining the amount of the liability? If not, how would you change the approach?

(c) The Draft Standard would require, in the case of transfers that the Draft Standard would require the transferor to treat in part or entirely as loans secured on the transferred asset, the transferee not to adopt accounting that is the mirror-image of the transferor's (see Application Supplement paragraphs 238-241 and Basis for Conclusions paragraphs 3.64-3.68). Do you agree with this approach? If not, why not? How would you amend the Draft Standard?

Q13. The Draft Standard would require the basic recognition and derecognition principles set out in paragraphs 31 and 37 to be applied to all transfers not falling within paragraphs 51-67 (see Draft Standard paragraph 68 and Basis for Conclusions paragraph 3.62). Do you agree with this proposal? If not, why not? How would you amend the Draft Standard?

Measurement

Q14. The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognised initially and to re-measure them at fair value at each subsequent measurement date, with one exception (see Draft Standard paragraph 69, Application Supplement paragraphs 315-317, and Basis for Conclusions paragraphs 1.6-1.26). Do you agree? If not, what other approach would you suggest and why?

Q15. The Draft Standard would require the fair value of a financial instrument to be an estimate of its market exit price determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction (see Draft Standard paragraphs 28, 70 and 71 and Basis for Conclusions paragraphs 4.1-4.10). The JWG also proposes that any expected costs that would be incurred to exit a financial instrument at that market exit price should not be taken into account in arriving at fair value (see Draft Standard paragraphs 72 and 73 and Basis for Conclusions paragraph 4.11).

(a) Do you agree with the market exit price objective? If not, how would you amend it and why?

(b) Do you agree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument? If not, how would you amend it?

Q16. The Draft Standard would require an enterprise to measure a part of a hybrid contract that is to be separately accounted for as if it were a free-standing financial instrument, except if the enterprise determines that it cannot reliably identify and measure the separate sets of financial instrument rights and obligations in the hybrid contract. In the latter case the enterprise would account for the entire contract in the same manner as a financial instrument falling within the scope of the Draft Standard (see Draft Standard paragraphs 74-76 and Basis for Conclusions paragraphs 4.12-4.16). Do you agree with this proposal? If not, what alternative would you suggest?

Q17. The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies (see Draft Standard paragraphs 77-86 and 104-117, Application Supplement paragraphs 320-327 and 344-369, and Basis for Conclusions paragraphs 4.17 and 4.36-4.47). Do you agree with this hierarchy? If not, how would you amend the proposals, and why?

Q18. The Draft Standard addresses a number of circumstances requiring special consideration in using observed market prices to determine fair value (see Draft Standard paragraphs 87-103, Application Supplement paragraphs 328-343, and Basis for Conclusions paragraphs 4.18-4.35).

(a) Do you agree with the Draft Standard's conclusions in these circumstances? Are there additional circumstances that should be addressed (please specify)?

(b) Is the conclusion that value that is not directly attributable to a financial instrument should not enter into the determination of the fair value of a financial instrument (see Draft Standard paragraphs 92-94, Application Supplement paragraphs 331-339, and Basis for Conclusions paragraphs 4.18-4.32) appropriate and operational, in particular as it applies to demand deposit and credit card relationships? If not, why not?

(c) Do you agree with the conclusion that, if an enterprise holds a large block of financial instruments and market exit prices are available only for individual instruments or small blocks, the available price should not be adjusted for the potential effect of selling the large block (see Draft Standard paragraphs 102 and 103 and Basis for Conclusions paragraphs 4.34 and 4.35)? If not, in what circumstances would you require adjustment, and how would you ensure consistency of the amount of adjustments that would be made?

Q19. The Draft Standard would require an enterprise that cannot estimate fair value using observable market exit prices of identical or similar financial instruments to estimate fair value by using a valuation technique. The Application Supplement includes material explaining how valuation techniques would be used in a number of situations (see Draft Standard paragraphs 104-117, Application Supplement paragraphs 344-369, and Basis for Conclusions paragraphs 4.36-4.47).

(a) Is this material clear and operational? If not, how would you modify it?

(b) Is this material sufficient, or do you believe that more detailed material is necessary? Please specify what additional material you believe to be necessary.

(c) Are there other significant circumstances (please specify) on which guidance should be provided?

(d) Is the proposed material consistent with market pricing practices? If not, how should it be modified?

Q20. The JWG believes that fair values are, generally, reliably determinable, at reasonable cost, for all financial instruments except certain investments in private equity instruments (see Draft Standard paragraphs 122-125 and Basis for Conclusions paragraphs 1.14-1.21 and 4.64-4.67). Do you agree? If not, why not? If you believe that other items are not capable of reliable fair valuation, what are they, what factors cause their fair values not to be reliably determinable, and how should these items be measured?

Q21. The Draft Standard would require the reported value of an enterprise's financial liabilities to reflect the enterprise's own creditworthiness and changes in it (see Draft Standard paragraphs 118-121, Application Supplement paragraphs 370-372, and Basis for Conclusions paragraphs 4.50-4.62).

(a) Do you agree? If not, why not? How do you propose that the effect of changes in the enterprise's own credit worthiness could be excluded without giving rise to the difficulties noted in Basis for Conclusions paragraph 4.59?

(b) Is the material in paragraph 370 of the Application Supplement, explaining how an enterprise can establish whether there has been a change in its own creditworthiness affecting its financial liabilities when there is no observable market exit price, appropriate and operational? If not, why not? How could it be improved?

Q22. The Draft Standard would require an enterprise to establish appropriate policies and procedures for estimating fair value of financial instruments (see Draft Standard paragraphs 129 and 130, Application Supplement paragraphs 376-379, and Basis for Conclusions paragraphs 4.68 and 4.69). Do you agree with this proposal? If not, how would you change it in a manner that provides reasonable assurance of reliable and consistent fair value estimates?

Balance Sheet Presentation

Q23. The Draft Standard would require that minimum categories of financial assets and financial liabilities be distinguished on the face of the balance sheet and in the notes to the financial statements (see Draft Standard paragraphs 131-135 and Basis for Conclusions paragraphs 5.1-5.5). Do you agree with the categories proposed? Are the categories clear and useful? If not, how would you amend them and why?

Income Statement Presentation

Q24. The Draft Standard would require an enterprise to recognise all changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise, with one exception (see Draft Standard paragraph 136, Application Supplement paragraphs 380 and 381, and Basis for Conclusions paragraphs 6.1-6.29) Do you agree? If not, how should such gains and losses be treated, and why?

Q25. The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value (see Draft Standard paragraphs 137-152, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.30-6.84).

(a) Do you agree with the proposed disaggregation? If not, why not? What other basis of disaggregation would you propose to provide information about the components of changes in fair value of financial instruments?

(b) Do you believe that any other gains and losses arising on fair value measurement of financial assets and financial liabilities should be separately presented in the income statement or notes thereto? If so, which gains and losses, and why do you believe that they should be shown separately? On what basis should such gains and losses be distinguished?

Q26. The Draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis, except that an enterprise may use the current market expectations basis if the chief operating decision maker relies primarily on that basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk (see Draft Standard paragraphs 139 and 140, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.46-6.77).

(a) Do you agree that interest income and expense should be separately presented?

(b) Do you agree with the proposed method of determination? If not, how would you propose that interest revenue and interest expense be determined in a fair value model?

(c) Is the guidance clear and operational? If not, what additional guidance is necessary?

Hedges

Q27. The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities (see Draft Standard paragraph 153 and Basis for Conclusions paragraphs 7.1-7.22). Do you agree? If not, why not? How would you address the issues raised in paragraphs 7.1-7.22 of the Basis for Conclusions?

Disclosure

Q28. The Draft Standard would require disclosure of an enterprise's significant financial risks and of the enterprise's financial risk management objectives and policies (see Draft Standard paragraphs 154-163, Application Supplement paragraphs 393 and 394, and Basis for Conclusions paragraphs 8.5-8.12). Do you agree that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments? If not, how would you change these disclosures?

Q29. The Draft Standard would require disclosures about financial instruments used to manage risks associated with transactions expected to occur in future reporting periods only when an enterprise separately discloses gains or losses on those financial instruments (see Draft Standard paragraphs 181 and 182 and Basis for Conclusions paragraphs 8.36-8.43). Do you agree with this approach? If not, how would you change it?

Q30. The Draft Standard encourages, but does not require, disclosures about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions (see Draft Standard paragraphs 179 and 180, Application Supplement paragraphs 409-411, and Basis for Conclusions paragraphs

8.30-8.35). Do you agree that these disclosures should be encouraged? If not, why not, and what alternative would you propose?

Q31. Do you agree with the other disclosures proposed in Draft Standard paragraphs 164-178 and 183-189 (see also Application Supplement paragraphs 391 and 392 and 395-408 and Basis for Conclusions paragraphs 8.13-8.29 and 8.44-8.56)? If not, how should the disclosures be amended, while maintaining a balance between the need to inform users about an enterprise's financial risk position and the concern of causing competitive harm to the enterprise or unnecessary burden for preparers?

Implementation Recommendations

Q32. The JWG proposes that about two years is a suitable period of time between issuance of a final standard and the effective date to balance preparation time with the need for standards (see Basis for Conclusions 9.1-9.4). Do you agree? Do you believe that certain enterprises need additional time to prepare for implementation? If so, please specify which enterprises and how they should be differentiated from those that apply a final standard initially. Also, please specify why these enterprises may need more time and the length of time that may be required.

Q33. Some suggest that a comprehensive fair value model for financial instruments should be first introduced in supplemental financial statements, presented in parallel with financial statements prepared in accordance with existing practices. Only after a period of time would such financial statements replace financial statements prepared in accordance with existing practices (see Basis for Conclusions paragraphs 9.5-9.7). Do you believe that supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices? If so, how would you overcome the disadvantages of such an approach, which are identified in Basis for Conclusions paragraph 9.6?

Q34. The Draft Standard includes a number of transitional provisions to be taken into account in adopting it (see Draft Standard paragraphs 192-195 and Basis for Conclusions paragraphs 9.8-9.21). Do you agree with these provisions? If not, why not? How would you amend them?

Q35. What steps need to be taken to assist in implementing a comprehensive fair value model for financial instruments? Please comment on any significant legal or other obstacles to implementing a final standard based on this Draft Standard and on how they might be best addressed.

Q36. Are there other issues that must be resolved before the Draft Standard could be implemented? If so, what are they and what steps should be taken to resolve them?

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FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

DRAFT STANDARD

The principles, which have been set in bold italic type, should be read in the context of the supporting paragraphs and the accompanying Application Supplement. This Draft Standard does not apply to immaterial items. Terms or phrases defined in paragraphs 7-30 of this Draft Standard are underlined the first time they appear and where their significance is particularly important.

Objective

This Draft Standard establishes principles for recognition, derecognition, measurement, presentation and disclosure of financial instruments and similar items in the financial statements of all enterprises. The primary objective is to prescribe accounting that reflects, in an enterprise's balance sheet and income statement, the effects of events on the fair value of an enterprise's financial instruments and certain similar items, in the periods in which those events occur.

Scope

Enterprises and Financial Instruments Included in Scope

1. ***This Draft Standard applies to all enterprises in accounting for all <u>financial instruments</u>, except for those financial instruments that are:***

   (a) ***equity interests in subsidiaries, associates or joint ventures that are accounted for in accordance with other accounting standards;***[1]

   (b) ***employers' assets and liabilities under employee benefit plans;***[2]

[1] The IASC requires most equity interests in subsidiaries, associates or joint ventures to be accounted for in accordance with IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries; IAS 28, Accounting for Investments in Associates; or IAS 31, Financial Reporting of Interests in Joint Ventures. However, equity interests in subsidiaries, associates and joint ventures that are acquired and held exclusively with a view to their disposal in the near future or that operate under severe long-term restrictions that significantly impair the ability to transfer funds to the parent, investor or venturer are not accounted for in accordance with those standards. Therefore, in accordance with International Accounting Standards (IASs), such equity interests would fall within the scope of this Draft Standard. These IASs also permit a parent or investor to present separate (rather than consolidated) financial statements and to carry investments in subsidiaries, associates or joint ventures at cost in those separate financial statements. Although the requirements of this Draft Standard do not apply to such investments, they do apply to all other financial instruments presented in separate financial statements.

(c) ***retirement benefit obligations of defined benefit plans;***[3]

(d) ***rights and obligations with insurance risk, resulting from <u>insurance contracts</u>,***[4] ***except for:***

(i) ***<u>financial guarantees</u>; and***

(ii) ***contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events, if that payment is made regardless of any effect of the event on the contract holder;***

(e) ***<u>equity instruments</u> issued and classified as equity by the reporting enterprise;***

(f) ***business combination contracts involving contingent consideration;***[5]***or***

(g) ***contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, certain licence fees, royalties and similar items)***[6] [see Application Supplement paragraphs 196 and 213]**.**

Additional Items Included in Scope

2. ***This Draft Standard applies to the following, which should be accounted for in the same manner as financial instruments that fall within the scope of this Draft Standard:***

(a) ***contracts to buy or sell a non-financial item that can be settled net by a financial instrument, except for contracts that were entered into and continue to be for the purpose of delivery of a non-financial item in accordance with the enterprise's normal purchase or sale requirements*** [see Application Supplement paragraphs 197-207]***; and***

(b) ***<u>servicing assets</u> and <u>servicing liabilities</u>*** [see Application Supplement paragraphs 208-210].

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[2] The IASC requires employer's assets and liabilities under employee benefit plans to be accounted for in accordance with IAS 19, Employee Benefits.

[3] The IASC requires retirement benefit obligations of defined benefit plans to be accounted for in accordance with IAS 26, Accounting and Reporting by Retirement Benefit Plans.

[4] An IASC Steering Committee is developing proposals for accounting for insurance contracts. See IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999.

[5] The IASC requires business combination contracts involving contingent consideration to be accounted for in accordance with paragraphs 65-76 of IAS 22, Business Combinations.

[6] The IASC requires revenue on licence fees and royalties to be recognised in accordance with paragraph 20 of IAS 18, Revenue.

3. Servicing assets and servicing liabilities are accounted for as separate assets and liabilities only if they are (a) retained when serviced financial assets are derecognised or (b) acquired in a separate purchase or assumption of servicing rights. Servicing assets and servicing liabilities that are not separated from the financial instrument being serviced are accounted for as part of that financial instrument.

Hybrid Contracts

4. ***This Draft Standard applies to sets of contractual rights and obligations in a hybrid contract that, if they were separated from the contract, would fall within the scope of this Draft Standard.***[7]

5. ***If the sets of rights and obligations in a hybrid contract that, if they were separated from the contract would not fall within the scope of this Draft Standard would be measured at fair value in accordance with other accounting standards, then an enterprise should account for the entire contract in the same manner as financial instruments that fall within the scope of this Draft Standard.***

6. Examples of hybrid contracts include:

   (a) a contract, such as a convertible debt instrument, that comprises both a financial liability that falls within the scope of this Draft Standard and equity of the issuer (which is excluded from the scope of this Draft Standard by paragraph 1(e));

   (b) a contract that comprises an equity instrument of another enterprise that falls within the scope of this Draft Standard and a right to non-financial benefits, such as a right to purchase goods or services from the investee at a discount from market prices (which is excluded from the scope of this Draft Standard because it does not meet the definition of a financial instrument); and

   (c) a contract that comprises rights or obligations with insurance risk resulting from insurance contracts that is excluded from the scope of this Draft Standard by paragraph 1(d), and an equity instrument of another enterprise that falls within the scope of this Draft Standard.

[7] See paragraphs 74-76 regarding measurement of contractual rights and obligations in a hybrid contract.

Definitions

Definitions relating to Financial Instruments

7. ***The following terms relating to financial instruments are used in this Draft Standard, with the meanings specified.***

A financial instrument is one of the following:

(a) cash;

(b) an equity instrument;

(c) a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to receive that financial instrument in exchange for no consideration other than release from the obligation; or

(d) a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party.

A financial asset is a financial instrument that is an asset.

A financial liability is a financial instrument that is a liability.

An equity instrument is a financial instrument that represents a residual interest in the assets of an enterprise after deducting all its liabilities.

A conditional financial instrument is a financial instrument that requires delivery of another financial instrument or exchange of financial instruments only if specified future events occur.

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

A financial guarantee is a contract that requires payments to be made to a creditor if a debtor fails to make payment when due.

A loan asset is a contractual right, that is not traded on an exchange or in dealer markets, to receive cash or other financial instruments of fixed or determinable amounts

and timing in exchange for no consideration other than releasing the borrowing party from its obligations to the enterprise.

An <u>impaired loan asset</u> is a loan asset whose credit quality has deteriorated to the extent that it is more likely than not that the lender will fail to receive the full amounts owing on or before the scheduled payment dates in accordance with the terms of the loan contract.

8. Parts of the definition of a financial instrument include the term financial instrument, but the definition is not circular. If there is a contractual right to receive and an obligation to deliver, or to exchange financial instruments, the instruments to be received and delivered or exchanged give rise to other financial instruments. A chain of contractual rights or obligations may be established, but it ultimately leads to receipt or payment of cash or to acquisition, disposition or issuance of an equity instrument.

9. Rights or obligations that make up financial instruments are derived from the contractual provisions that underlie them. The term "contractual" refers to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, because the agreement is enforceable at law. Contractual rights and obligations, and thus financial instruments, are created by contracts that may take a variety of forms including written or oral agreements and contracts implied by an enterprise's actions or by virtue of custom or practice.

10. An asset or liability that is not contractual in nature, such as an income tax asset or liability that is created as a result of statutory requirements imposed by governments, or a legal liability arising from breach of a duty (such as a duty of due consideration to others), does not meet the definition of a financial instrument and is not included within the scope of this Draft Standard. Even after such an asset or liability has been reduced to a fixed payment schedule, it is not a financial instrument.

11. A minority interest in a consolidated subsidiary is not a financial instrument.

12. Some related party balances might take the form of receivables or payables but have the basic attributes of equity instruments. If so, they are accounted for as equity instruments. Balances arising from capital transactions with owners and distributions to owners that are classified as equity or that represent equity investments in a subsidiary, associate or joint venture fall outside the scope of this Draft Standard[8]. Other financial instruments of related parties would be accounted for in accordance with the requirements of this Draft Standard.

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[8] In accordance with IASs, certain equity investments in a subsidiary, associate or joint venture would fall within the scope of this Draft Standard. See the footnote to paragraph 1(a).

13. A financial instrument is conditional on a specified event if the occurrence or non-occurrence of that event determines whether the delivery or exchange of financial instruments will be required, rather than determining only the timing and amounts of financial instruments to be delivered or exchanged. Financial guarantees payable in the event of default by a borrower and weather derivatives payable in the event that certain weather conditions occur are examples of <u>conditional financial instruments</u>. A loan that has a prepayment option is not conditional because the prepayment option simply defines the timing and amounts to be paid, not whether the borrower has an obligation to repay the loan.

Definitions of Financial Risks

14. ***The following terms dealing with financial risks are used in this Draft Standard, with the meanings specified.***

A <u>financial risk</u> of an enterprise is any risk to which a financial instrument held or issued by that enterprise is subject.

<u>Basic (or "risk free") interest rate risk</u> is the risk of changes in the fair value or cash flows of an asset or liability due to changes in the basic interest rate.

<u>Currency risk</u> is the risk of changes in the value of an asset or liability due to changes in exchange rates.

<u>Credit risk</u> is the risk that one party will fail to discharge its contractual obligation and thereby cause another party to incur a loss.

<u>Liquidity risk</u> is the risk that a loss may be incurred because a position cannot be eliminated quickly.

15. In general usage, risk is the possibility of adverse consequences. In this context, exposure to risk is the condition of being unprotected against adverse consequences. In economic terms, risk is the possibility of economic loss. Risk exists where there is variability of financial outcomes, since variability contains the possibility of economic loss. In efficient financial markets there will normally be a direct relationship between risk and the potential for gain—the greater the risk taken the greater the potential for gain. Risk-averse investors require a higher rate of return to accept higher risk. Thus, this Draft Standard uses the term "risk" in the context of the relationship of risk and return.

16. Financial risks include basic interest rate risk, currency risk, credit risk, liquidity risk, and other price risks, such as commodity price risks and equity price risk, where a financial instrument held or issued by an enterprise is subject to that risk. Financial risks do not include operational risks, such as the risk that a share certificate might be lost or the risk

that cash flows might be misappropriated. Risks affecting the activities of an enterprise are considered to be financial risks of that enterprise only to the extent that the enterprise holds or issues financial instruments that are subject to those risks. For example, an enterprise that manufactures goods using a particular commodity may be affected by price changes in that commodity. If the enterprise does not have financial instruments that are subject to that commodity price risk, it is not considered to have any financial risk related to the commodity's price. Rather, any commodity price risk is considered to be one of the broader business risks of the enterprise. Financial instruments are commonly used in managing certain types of business risks (for example, certain commodity price risks). In this case, the price risks to which these financial instruments are subject are considered to be financial risks of the enterprise.

Definition of an Insurance Contract

17. ***The following definition of an insurance contract is used in this Draft Standard, with the meaning specified.***

    An <u>insurance contract</u> is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).[9]

18. Insurance risk includes the risk that the number of insured events will differ from that expected (occurrence risk), the risk that the cost of events will differ from expected cost (severity risk) and the risk of changes in the amount of an insurer's obligation after the end of a contract period (development risk). A contract that exposes the insurer to <u>financial risk</u> without insurance risk is not an insurance contract.

19. All warranty contracts, whether required to be settled with products or services, or with cash or another financial instrument, are considered to meet the definition of an insurance contract.

Definitions relating to Servicing Assets and Servicing Liabilities

20. ***The following terms dealing with servicing assets and servicing liabilities are used in this Draft Standard, with the meanings specified.***

    A <u>servicing asset</u> results from a contract to service financial assets if the <u>benefits of servicing</u> are more than <u>adequate compensation</u>.

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9 This definition, and the elaboration in paragraph 18, is the same as that used in the IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999. Further elaboration is contained in that Issues Paper.

A servicing liability results from a contract to service financial assets if the benefits of servicing are less than adequate compensation.

Benefits of servicing are revenues from contractually specified servicing fees, late charges and other ancillary sources, including any float, that the servicer is entitled to receive only if it performs the servicing of the financial assets.

Float is the amount of funds available to an enterprise between the time that money is received and the time that the enterprise is required to make payment using those funds.

Adequate compensation is the amount of benefits of servicing that the market believes would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.

Contractually specified servicing fees are all amounts that, according to the contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to exercise their actual or potential authority under the contract to have the financial assets serviced by another servicer.

21. Benefits of servicing arise from the servicing contract. The contractual terms may, or may not, be based on conditions in the current market for servicing.

22. Adequate compensation, on the other hand, is generally observable in the market for servicing. It depends largely on the nature of the underlying assets being serviced and the amount of effort required to service the assets. Adequate compensation does not depend on the servicing costs of a specific servicer. As a result, for example, an inefficient servicer might initially record a servicing asset when serviced financial assets are derecognised, even though it anticipates incurring a loss from carrying out the servicing itself over the term of the contract because its enterprise-specific costs are greater than the benefits of servicing. That inefficient servicer does not have a liability because it could avoid that loss by selling the servicing to an efficient servicer.

23. Contractually specified servicing fees may include some or all of the difference between the amounts collectible on the asset being serviced and the amounts to be paid to the beneficial owners of the assets, depending on the servicing contract.

24. An interest-only strip, or similar retained interest, arises if the servicer is entitled to cash flows from the serviced assets that are expected to exceed the contractually specified servicing fees, and the servicer has the right to that excess income, even if it ceases to perform the servicing. An interest-only strip or similar retained interest is a financial asset, rather than a servicing asset.

Definition of a Hybrid Contract

25. ***The following definition of a hybrid contract is used in this Draft Standard, with the meaning specified.***

    A <u>hybrid contract</u> is a contract that has one or more sets of rights and obligations that, if they were separated from the contract, would be accounted for as financial instruments that fall within the scope of this Draft Standard, and one or more sets of rights and obligations that do not fall within the scope of this Draft Standard.

Definitions relating to Recognition and Derecognition

26. ***The following terms dealing with recognition and derecognition are used in this Draft Standard, with the meanings specified.***

    <u>Derecognition</u> of an asset or liability or <u>component</u> thereof is ceasing to recognise that asset, liability or component on an enterprise's balance sheet.

    The <u>components</u> of a financial instrument are the contractual rights to future economic benefits and the contractual obligations to transfer economic benefits that make up the financial instrument [see Application Supplement paragraphs 224-226]**.**

    A <u>transfer</u> occurs when one party passes to another party or parties the whole, or some component, of one or more of its assets.

    A <u>clean-up call option</u> is a call option (or similar right) held by a servicer of transferred components, or its affiliate, to purchase the remaining transferred components if the amount of those remaining components falls to a level at which the cost of servicing them becomes burdensome in relation to the benefits of servicing. The servicer of transferred components or its affiliate may be the transferor.

27. The term "transfer" is used broadly in this Draft Standard to include all forms of sale, assignment, provision of collateral, sacrifice, distribution and other exchange. It does not include origination, issuance or expiry.

Definition of Fair Value

28. ***The following definition of fair value is used in this Draft Standard, with the meaning specified.***

    <u>Fair value</u> is an estimate of the price an enterprise would have received if it had sold an asset or paid if it had been relieved of a liability on the measurement date in an arm's-length exchange motivated by normal business considerations.

Definitions relating to Foreign Currency Items

29. ***The following terms dealing with foreign currency items are used in this Draft Standard, with the meanings specified.***

Foreign currency—according to the context a currency may be foreign with respect to either:

(a) the functional currency of a foreign entity; or

(b) the reporting currency of the reporting enterprise.

A foreign currency denominated financial instrument is one for which the settlement amount at any given time is determined in terms of a foreign currency.

A foreign entity is an operation (for example, a subsidiary, division, branch, joint venture, etc.) whose financial statements (a) are prepared in a currency other than the reporting currency of the reporting enterprise and (b) are consolidated with or accounted for under the equity method in the financial statements of the reporting enterprise.

The functional currency of an entity is the currency of the primary economic environment in which the entity operates. Normally, that is the currency of the environment in which that entity primarily generates and expends cash. A reporting enterprise may have multiple functional currencies, one of which is normally the same as the reporting currency.

The reporting currency is the currency in which the reporting enterprise presents its financial statements.

The reporting enterprise is the enterprise whose financial statements are addressed in this Draft Standard.

Definitions relating to Income Statement Presentation

30. ***The following terms dealing with income statement presentation are used in this Draft Standard, with the meanings specified.***

Interest revenue (expense) is the return to the lender (cost to the borrower) for the temporary use of money. Within the context of measuring financial instruments at fair value, it is the market return (cost) on the fair value of an enterprise's interest-bearing financial assets (liabilities) for a reporting period. It includes (a) basic interest; (b) credit risk premium; (c) liquidity risk premium; and (d) any premium to the lender for bearing

risks of adverse variability of expected cash flows apart from credit risk and liquidity risk.

Interest-bearing financial assets (liabilities) comprise all financial instruments except cash on hand, equity instruments, and forward contracts (including swaps), options and similar derivative financial instruments.

Basic (or "risk-free") interest is the amount of interest that compensates the lender for the time value of money.

Credit risk premium is the premium over the basic interest rate that the market requires to cover (a) the effects of expected defaults due to the failure of the borrowing party to discharge its contractual obligation and (b) compensation for assuming the risk of default. The credit risk premium includes any interest rate spread over the basic interest rate for risks relating to industry or geographic sectors.

Current yield to maturity is the average per period rate of interest that equates the fixed or determinable cash flows of an interest-bearing financial asset or liability with its fair value [see Application Supplement paragraph 382].

Current market expectations rate of interest is the current per period rate of interest reflected in current interest forward rates implicit in observable market interest yield curves [see Application Supplement paragraphs 383-385].

Recognition and Derecognition

Recognition

31. ***An enterprise should recognise:***

    (a) ***a financial asset when, and only when, it has contractual rights under a financial instrument that result in an asset; or***

    (b) ***a financial liability when, and only when, it has contractual obligations under a financial instrument that result in a liability.***

32. ***If a contractual right under a financial instrument has arisen from, or been affected by, a transfer that has substance (as set out in paragraph 36), the transferor should follow paragraphs 49-68 in applying paragraph 31 to determine whether and in what form to recognise any retained components of that asset and any new contractual rights acquired and obligations assumed in connection with that asset.***

33. After a transfer involving financial assets, determining what the transferor would derecognise will sometimes help in understanding the character of the transfer consideration received and, as a result, in determining what would be recognised. Accordingly, paragraph 32 requires the transferor to apply the more detailed principles on transfers to determine whether and in what form to recognise any retained components and any new rights acquired and obligations assumed.

34. An enterprise has the contractual rights and/or contractual obligations that make up a financial instrument from the time that it becomes a party to the relevant contractual provisions of the instrument. This means that:

    (a) an enterprise that becomes a party to a *new* financial instrument recognises any resulting assets and liabilities at the inception of the instrument; and

    (b) an enterprise that becomes a party to an *existing* financial instrument recognises any resulting assets and liabilities when it obtains—receives—the contractual rights and obtains—assumes—the contractual obligations that comprise the financial instrument.

35. ***A transfer that does not have substance should not affect the recognised financial assets and liabilities of the transferor or transferee*** [see Application Supplement paragraphs 222 and 223].

36. ***A transfer has substance only if either:***

    (a) the transferee is an enterprise that conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor; or

    (b) the components transferred have been isolated from the transferor, i.e., have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

    [See Application Supplement paragraphs 214-220 for application of the recognition principles to forward contracts and other executory contracts, regular way security transactions, security interests and hybrid contracts.]

Derecognition

Basic Requirements

37. ***An enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component*** [see Application Supplement paragraphs 224-231].

38. ***If contractual rights under a financial instrument have been transferred in a transfer that has substance (as set out in paragraph 36), the transferor should follow paragraphs 49-68 in applying paragraph 37 to determine whether some or all of that asset should be derecognised.***

39. An enterprise ceases to have a contractual right when the right expires or is fulfilled in accordance with the terms of the contract, or when control of the right is transferred to another party, i.e., when the right is transferred and relinquished.

40. An enterprise ceases to have a contractual obligation when the obligation expires or is fulfilled. An obligation is fulfilled only if the enterprise that had the obligation has obtained release from primary responsibility for that obligation by settlement, by accommodation with the creditor, or by process of law [see Application Supplement paragraphs 227-230].

Arrangements to Pass Cash Flows Through One Enterprise to Another

41. Sometimes an enterprise acting as a principal that has a contractual right to receive the cash flows that arise from a financial asset also has a contractual obligation to pay to another enterprise cash flows that reflect the collections from that asset. Examples include back-to-back loan arrangements and sub-participations in which the payments an enterprise makes reflect the payments it receives on a specific loan asset. It will usually be appropriate for

the enterprise to recognise such contractual rights and contractual obligations separately. However, in certain limited circumstances, instead of assuming a new free-standing obligation, the enterprise has transferred and relinquished part or all of the contractual rights related to an asset. In those circumstances, the enterprise would derecognise the part or all of the asset related to the contractual rights relinquished.

42. If an enterprise with a contractual right to receive cash flows from a financial asset assumes a contractual obligation to pay cash flows to a second enterprise, it would apply paragraphs 43-48 to determine whether a transfer has occurred. If it is determined that a transfer has occurred, the enterprise would apply paragraphs 49-68 to determine whether control of the transferred contractual right to receive cash flows has been relinquished and, therefore, whether the contractual right would be derecognised. On the other hand, if it is determined that either:

(a) no transfer has occurred, or

(b) although there has been a transfer, control has not been relinquished,

the contractual right to receive cash flows and the contractual obligation to pay cash flows to another enterprise would be recognised separately (assuming that they meet the criteria for recognition set out in paragraph 31).

43. ***An enterprise (the collector) with a contractual right to receive cash flows from a financial asset (the original asset) that assumes a contractual obligation to pay cash flows to a second enterprise (the eventual recipient) should treat the transaction as the transfer of the contractual right (or a proportion of that contractual right) if, and only if, the cash flows to be paid to the eventual recipient are required to reflect in full, or on a pro rata basis, the collections from the original asset.***

44. ***The cash flows to be paid to the eventual recipient will not reflect in full, or on a pro rata basis, the collections from the original asset if:***

(a) the collector has the right to retain, for its own benefit, cash flows from the contractual rights involved in excess of its fees for collection services;

(b) the collector has the right to temporarily use, outside the normal settlement period, some or all of the cash flows from the contractual rights involved for its own benefit;

(c) the collector is obliged to pay amounts to the eventual recipient even if equivalent amounts have not been collected from the original asset, other than short-term advances with full right of recovery; or

(d) ***the collector has a right to renegotiate the contractual terms of the original asset and the right does not arise from an interest in the original asset that is unrelated to its role as collector, and the collector is not obliged to reflect the wishes of the eventual recipient in exercising that right.***

45. The collector is not prevented from treating a transaction as the transfer of contractual rights solely because it has one or more of the following rights or obligations.

(a) A right to retain reasonable and customary fees for collection services from the cash it collects.

(b) A right to retain some or all of the future cash collections in the event of its own bankruptcy or other receivership.

(c) A right to deposit the cash collected in a commingled deposit account and to use funds drawn from that account for its own benefit. However, if the collector has—and exercises—such a right, it will be necessary to ensure that, from the end of the normal settlement period (which is a period defined by the market rather than, for example, the terms of the transfer) steps are taken to ensure that cash equal in amount to the amount collected is no longer being used for the collector's benefit. Such steps will usually include either paying the amount to the eventual recipient or moving the amount to a segregated deposit account where it is not commingled with the collector's other assets.

(d) An obligation to make short-term advances against future collections from the assets on terms that require the recovery in full from the eventual recipient of any amounts not subsequently collected from the original asset.

46. Some enterprises act as collectors of original assets in which they also hold a beneficial interest and, therefore, have renegotiation rights as beneficial interest holders. Such renegotiation rights do not prevent a collector from treating a transaction as the transfer of contractual rights if the powers of the collector in a renegotiation are proportionate to its beneficial interest holdings in the original assets.

47. For similar reasons, a right of veto over renegotiations of the original assets also would not preclude treating a transaction as the transfer of contractual rights if the collector has that right only because it retains a beneficial interest in the original assets and each beneficial interest holder in the original assets has a similar right of veto.

48. The requirements of paragraphs 43 and 44 for treating a transaction as the transfer of contractual rights will usually be met if either:

    (a) the cash that is paid to the eventual recipient comes only from a segregated fund comprising the original asset and cash collections from those assets and that fund is not commingled with the collector's other assets; or

    (b) the eventual recipient has the ability to insist that cash collections from the original asset are not commingled with those of the collector or are to be paid directly to itself or another party rather than the collector.

Transfers involving Financial Assets

Introduction

49. When accounting for a transfer that has substance and involves a financial asset, the transferor of the financial asset (or component thereof) involved would apply paragraphs 51-68; the transferee would apply paragraph 31.

50. For the purposes of paragraphs 51-68:

    (a) retention by the transferor of the right to service a transferred financial asset will not in itself represent a continuing involvement of the type referred to in paragraph 51, nor will it prevent the transferee from having the practical ability referred to in paragraph 55; and

    (b) retention by the transferor of a clean-up call option over some or all of the transferred components will not in itself represent a continuing involvement of the type referred to in paragraph 51. Furthermore, references in these paragraphs to "call options" are to call options other than clean-up call options.

    [See Application Supplement paragraphs 234-241 for a summary of the accounting]

Transfers Where the Transferor Has No Continuing Involvement in the Asset

51. ***An enterprise (the transferor) that is a party to a transfer that involves one of its financial assets should derecognise that asset in its entirety if it has no continuing involvement in the asset.***

52. A transferor will have no continuing involvement in a financial asset if it neither retains any of the contractual rights that resulted in that asset nor obtains any new contractual rights or contractual obligations relating to the asset, i.e., if it has no interest in the future performance of that asset and no responsibility to make payments in the future in respect of the asset under any circumstance.

53. New contractual rights or contractual obligations relating to a previously recognised financial asset that are sometimes received or assumed as part of a transfer include recourse provisions and other guarantees against the unfavourable performance of the asset, agreements to reacquire the asset, and options written or held relating to the asset.

54. Paragraphs 55-68 do not apply to a transfer that results in the transferor having no continuing involvement in its previously recognised financial asset.

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party

55. ***An enterprise (the transferor) that is a party to a transfer involving one of its financial assets should derecognise that asset in its entirety if the transferee:***

    (a) has the practical ability to transfer that asset in its entirety to a third party; and

    (b) is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer.

    The transferor should apply paragraph 31 to recognise assets and liabilities relating to any continuing involvement it has in its previously recognised financial asset.

56. Paragraph 55 addresses practical ability and the practical effect of any restrictions. Restrictions on the transferee's right to transfer a financial asset to a third party will not necessarily prevent the transferee from having the practical ability to make such a transfer. For example:

    (a) a prohibition on transfers to third parties may have no practical effect (and may therefore not prevent the transferee from having the practical ability to transfer the asset to a third party) if replacement assets are readily available, because the transferee may be able to transfer the asset and still satisfy the prohibition by obtaining a replacement asset. For similar reasons, a limitation imposed by the transferor on the specific parties to whom the transferee can transfer the asset may have no practical effect if replacement assets are readily available. For this purpose, replacement assets are deemed to be readily available only if the asset is actively traded on an accessible market;

    (b) a restriction or limitation, that is effective, on the number or identity of the parties to whom the transferee can transfer the asset also will have no practical effect if sufficient *other* potential buyers exist to create a market for the transfer of the asset; and

(c) the retention by the transferor of a right to match a bona fide offer received by the transferee from a third party will also not prevent the transferee from having the practical ability to transfer the asset to a third party.

57. If the transferee is not in a position immediately after the transfer to complete a second transfer to a third party, it will not have the practical ability referred to in sub-paragraph 55(a). It will not be in a position to complete the transfer if, for example, it has to exercise a call option to obtain additional rights to be able to transfer the asset or if it has to obtain additional rights before it can insist on the third party paying an amount equal to the fair value of the entire asset.

58. Sub-paragraph 55(b) requires the transferee to be able to exercise its practical ability to transfer the asset to a third party unilaterally. The transferee will not be able to exercise its ability unilaterally if, for example, the terms of the transfer require the transferee to obtain the consent of the transferor to the transfer of the asset, which consent can be withheld without reason, and that restriction is effective in practice. On the other hand, if the transferor's consent is needed but it cannot reasonably be withheld, the transferee may still have the ability to transfer the components unilaterally.

59. The transferee needs also to be able to exercise its ability to transfer the asset to a third party without having to impose additional restrictions on that transfer. It will need to impose additional restrictions on a transfer to a third party if, for example:

(a) the transferor has a call option over the asset, or over a component of the asset, and a replacement for that asset or component is not readily available, unless it is virtually certain that the transferor will not exercise the option. In such circumstances, the transferee is likely to be able to transfer the asset (or component) to a third party without fear of defaulting on the call option only by encumbering the transfer with a similar call option;

(b) the transferee retains a put option over the asset, or over a component of the asset, that it is virtually certain to exercise and a replacement for that asset or component is not readily available. In this case the transferee is likely to be economically impeded from transferring the asset (or component) unencumbered by an option or right to reacquire, since the transferee would not then be able to exercise its retained put option; or

(c) the transferor has imposed obligations on the transferee concerning the servicing of the asset, which the transferee would have to impose on any enterprise to which it transferred the asset. For example, if the transferor stipulates special procedures for collecting the asset, the transferee would need to attach a similar provision to any transfer that it makes to a third party.

60. For the purposes of sub-paragraphs 59(a), 59(b), 64(b) and 64(c):

(a) an enterprise has a call option (or a put option) over a component or asset if it has a contract that gives it the unilateral right to reacquire (or to insist that another party reacquire) that component or asset;

(b) an enterprise has a call option (or a put option) over a group or pool of components or assets if, through a contract that gives it the unilateral right to reacquire (or to insist that another party reacquire) some but not all of the components in that group or pool, it has the right to select which components or assets are to be reacquired; and

(c) an enterprise does *not* have a call option (or put option) over a component or asset or group or pool thereof if, although having a right to reacquire (or to insist that another party reacquire) some but not all of the components or assets in a group or pool of components or assets, it does *not* have the right to select which components or assets are to be reacquired.

61. In the circumstances described in sub-paragraphs 59(a) and (b), the assessment of whether it is virtually certain that a call option will not be exercised or that a put option will be exercised would be made at the time the option is written. Subsequent events that change the probability of the option being exercised generally would not result in any change to the assets and liabilities recognised and derecognised. The only exceptions are:

(a) if an option previously considered to be constraining the transferee's ability to transfer the asset expires unexercised and, as a result, the transferee is no longer constrained, the transferred asset would be derecognised in its entirety on that date; and

(b) if an option previously considered not to be constraining the transferee's ability to transfer the asset is exercised, paragraphs 31 and 37 would be applied.

62. Paragraphs 63-68 do not apply if the transferee has the practical ability to transfer the asset in its entirety to a third party, unilaterally and without needing to impose additional restrictions on the transfer.

[See Application Supplement paragraphs 242-250]

Transfers Where the Transferor Has an Obligation to Repay Consideration Received or a Call Option over a Transferred Component

63. Paragraphs 51-62 describe transfers that result in the transferor derecognising a previously recognised asset in its entirety and, possibly recognising new components. Paragraph 64 identifies transfers that are to be accounted for in whole or in part as loans secured by the

transferred asset. In such transfers, the transferred asset will not be derecognised entirely or at all, and paragraph 65 establishes the extent to which it would be derecognised.

64. ***If an enterprise (the transferor) is a party to a transfer involving one of its financial assets and as a result:***

    (a) the transferor has a conditional or unconditional obligation to repay some or all of the consideration it received in the transfer, it should recognise a liability for the maximum amount of the consideration it could be required to repay;

    (b) the transferor has a call option (or similar right) over a transferred component that the transferee does not have the practical ability to transfer (unilaterally and without imposing additional restrictions) to a third party, the transferor should recognise a liability for the amount of the consideration it received in the transfer of that component; or

    (c) the transferor has both an obligation of the kind described in sub-paragraph (a) and a call option (or similar right) of the kind described in sub-paragraph (b), it should recognise a liability for which the initial measure:

        (i) should not exceed the total amount of consideration received in the transfer; and

        (ii) to the extent that the obligation and call option (or similar right) relate to the same transferred component, should be the larger of the amounts that would be recognised under sub-paragraph (a) or (b).

65. ***Any consideration received in excess of the liability recognised under paragraph 64 is sales proceeds. The transferor should derecognise the asset or components thereof transferred to the extent of those proceeds and should continue to recognise the remainder of the asset.***

66. A conditional or unconditional obligation to repay some or all of the consideration received in the transfer could take a variety of forms. For example:

    (a) it could be an unconditional obligation to pay a specified amount on a specified future date in exchange for being released from the obligation;

    (b) it could be an obligation to pay a specified amount in exchange for return of the transferred asset arising from a forward purchase agreement or a put option; or

    (c) it could be an obligation to make good the losses of another enterprise arising from recourse arrangements and guarantees.

67. Paragraph 68 does not apply if, after a transfer involving financial assets, the transferor has an obligation to repay some or all of the consideration it received in the transfer, as described in sub-paragraph 64(a), and/or a call option (or similar right) over a transferred component that the transferee does not have the practical ability to transfer to a third party, unilaterally and without needing to impose additional restrictions on the transfer, as described in sub-paragraph 64(b).

[See, also, Application Supplement paragraphs 251-258]

Other Transfer Transactions

68. ***In the case of a transfer that has substance (as set out in paragraph 36) but is not subject to paragraphs 51-67, the transferor should apply:***

- ***(a) paragraph 31 to determine whether to recognise any retained components of that asset and any newly acquired contractual rights relating to the asset; and***
- ***(b) paragraph 37 to determine whether some or all of the asset should be derecognised.***

[Application Supplement paragraphs 259-314 consider the implications of the recognition and derecognition requirements for various common types of transfer.]

Measurement

Basic Requirements

69. ***An enterprise should measure financial instruments at fair value when recognised initially and, except for certain private equity investments described in paragraph 122, should re-measure financial instruments at fair value at each subsequent measurement date***.

70. For the purposes of measuring a financial instrument, fair value is an estimate of the price an enterprise would have received if it had sold the asset or paid if it had been relieved of the liability on the measurement date in an arm's-length exchange motivated by normal business considerations.

71. The fair value of a financial instrument is, therefore, an estimate of its market exit price, which is determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction. That is, fair value is the price that arm's-length market participants would pay or receive in a routine transaction under the market conditions at the date at which it is to be measured for accounting purposes (the measurement date).

72. ***An enterprise should not adjust the estimated market exit price to reflect expected costs it would incur to sell a financial asset or obtain relief from a financial liability.***

73. Such costs would include, for example, fees and commissions paid to agents, advisors, brokers and dealers, duties, and transfer taxes.

[See Application Supplement paragraphs 315-317 regarding initial measurement]

Hybrid Contracts

74. ***Except when paragraph 76 applies, an enterprise should measure a part of a <u>hybrid contract</u> that is to be separately accounted for in accordance with paragraph 4 as if it were a free-standing financial instrument at initial recognition and subsequently.***

75. The result is that at initial recognition, the reported amount of the part of the hybrid contract that does not fall within the scope of this Draft Standard would be equal to the fair value of the consideration paid or received for the entire hybrid contract less the fair value of the part of the contract determined as if it were a free-standing financial instrument.

76. ***If an enterprise cannot reliably identify and measure the separate sets of financial instrument rights and obligations in a hybrid contract, it should account for the entire***

hybrid contract throughout the remaining period of the contract in accordance with the requirements of this Draft Standard as if it were a financial instrument falling within the scope of the Draft Standard.

[See Application Supplement paragraphs 318 and 319]

Market Exit Prices of Identical or Similar Instruments

Sources of Market Exit Price Information

77. ***Except as provided in paragraphs 88-94, 100 and 101, if market exit price information in the following list is available, an enterprise should base the fair value of a financial instrument on that information. If information on more than one of the market exit prices in the following list is available, an enterprise should use the price information nearest the top of the list.***

 (a) **A** ***market exit price for an identical instrument on the measurement date. An identical instrument is exactly the same in denomination and description except for its identifying number or other unique identifier.***

 (b) A market exit price for an identical instrument near enough to the measurement date that the effect on fair value of the passage of time and changes in market conditions between the market date and the measurement date can be practicably estimated.

 (c) A market exit price for a similar instrument on the measurement date. Two instruments are similar if they have similar patterns of cash flows that are expected to vary in similar fashion in response to changes in market conditions and other risk factors. In addition, estimation of the effects on fair value of differences between the instruments should be practicable.

 (d) A market exit price for a similar instrument near enough to the measurement date that the effect on fair value of the passage of time and changes in market conditions between the market date and the measurement date can be practicably estimated.

78. ***An enterprise should adjust a price other than a market exit price for the identical instrument on the measurement date to reflect any differences between the instruments and for the passage of time and changes in market conditions*** [see Application Supplement paragraphs 320-322].

79. Financial instruments may be traded on exchanges, in dealer markets, and in brokered or principal-to-principal transactions. The market exit price of a financial instrument traded on

an exchange or other public market on which last traded prices are quoted daily is the daily closing price.

80. Prices of financial instruments traded in dealer markets are sometimes quoted as bid and asked prices, and actual transaction or closing prices are not reported. The objective in using bid and asked prices as evidence of fair value is to determine the price at which a transaction would occur on the measurement date. That price may differ depending on whether the instrument is an asset or liability to the enterprise, whether the enterprise is a dealer, and other factors specific to the individual market or instrument. The appropriate price on which to base fair value may be the bid price (what the dealer is willing to pay for the instrument), the asked price (the price for which the dealer will sell the instrument), or somewhere between. For instruments that are actively traded and for which the difference between bid and asked prices is small, the price at the mid-point of the range will be acceptable.

81. If the difference between bid and asked prices is large enough that the range is significant to the fair value of a financial instrument, the mid-point price will not be acceptable unless that is the price at which a transaction would occur on the measurement date. If the enterprise cannot determine the price within the range at which a transaction would occur on the measurement date by observing market transactions, the enterprise would base fair value on prices of similar instruments or valuation techniques. The quoted bid and asked prices for a financial instrument would be considered the maximum and minimum limits of the estimated market exit price for that instrument.

82. The bid and asked prices discussed in the preceding paragraphs refer to quotes that are actual offers to buy or sell. Quotes from pricing services may come from observed transactions in identical or similar instruments, or they may depend on internally developed valuation techniques or assumptions [see Application Supplement paragraphs 378 and 379 for considerations relating to quotes from pricing services].

83. The available information about prices in principal-to-principal and brokered transactions varies. For example, some industry groups or pricing services publish price information about certain instruments, while little or no information may be available about prices of other instruments. An enterprise is not required to perform an exhaustive search for price information but would consider any information that is publicly available or that can be obtained reasonably from brokers, industry groups, publications of regulatory agencies, or similar sources.

Using Price Information about Similar Financial Instruments

84. Instruments are considered to be similar if they have contractually specified cash flows that are similar in timing and amounts, are of similar credit risk with similar industry and geographical dependencies, and have similar prepayment expectations. Another factor to

consider is marketability. For example, one instrument might be traded readily at an observable market price and a second, otherwise similar instrument might be rarely traded. If it is not reasonable to assume that the effect of a difference in marketability is immaterial, an enterprise would apply a valuation policy that is consistent with available information that market participants would use.

85. Value enhancements, such as guarantees or securitisations, that an enterprise plans to obtain in the future, would not enter into the estimation of the market exit price. An observed price of an instrument that is similar to the measured instrument except for value enhancements would be used to estimate the fair value of the measured instrument provided that the effect of the enhancements can be estimated and the price can be adjusted accordingly. For example, the observed price of securitised loans receivable could be used as a basis for estimating the market exit price of non-securitised loans of the same type if the enterprise can determine the effect on fair value of the liquidity, security and other benefits added by the securitisation. The effect of the securitisation on the price of the securitised assets must be removed.

86. The market exit price of a similar instrument would not be the primary basis for estimation of a market exit price if recent prices for an identical instrument are available. However, if a market exit price is available nearer the measurement date for a similar instrument than for an identical instrument, the similar instrument's price would be considered in determining how to adjust the less timely price of the identical instrument for changes in market conditions.

[See Application Supplement paragraphs 323-327]

Identifying Appropriate Prices in Special Situations

Introduction

87. The following circumstances require special consideration in using observed exit prices to determine fair value.

    (a) Prices not determined by normal market interactions.

    (b) Infrequent transactions.

    (c) Prices that include value that is not directly attributable to the financial instrument.

    (d) Prices from more than one market for the same instrument.

    (e) Effect of an embedded option on the enterprise holding the option.

    (f) Large blocks of instruments.

Prices Not Determined by Normal Market Interactions

88. ***If available information indicates that an observed exit price is not determined by normal market interactions, an enterprise should not use that observed exit price as the primary basis for determining fair value. The following list identifies the only circumstances in which observed exit prices should be presumed not to have been determined by normal market interactions. If an observed exit price is not suitable as the primary basis for determining fair value, it may be useful in providing corroborative evidence to support an estimation of fair value developed from other sources.***

    (a) The observed exit price reflected transaction(s) between enterprises, one or more of which were experiencing severe financial difficulties, such as bankruptcy, orders from courts or regulators or other extreme legal or financial pressures.

    (b) The observed exit price would have been different if not for other transactions, contracts or agreements between the transacting parties.

    (c) The observed exit price would have been different if it had not occurred in a transaction between related parties.

    (d) Publicly acknowledged pricing errors or illegal pricing acts affected the observed exit price for a particular instrument.

89. In accordance with sub-paragraph 88(a), urgency of one or both parties may have caused the price to be different from the price the reporting enterprise could have obtained in a more orderly transaction executed under the same market conditions. This sub-paragraph applies only to individual transactions and not when an entire market is affected by similar difficulties.

90. The following are three examples of situations in which the condition in sub-paragraph 88(b) is likely to exist.

    (a) The observed exit price reflected a transaction that was previously specified in a contract such as a forward contract or option. Such prices generally are affected by market conditions when the original contract was signed.

    (b) The observed exit price reflected a transaction that involved extinguishment of an existing obligation before its contractually specified settlement date. An example is a debtor settling a non-prepayable loan with the creditor. If a debtor is settling with a creditor and the contract does not provide for assumption of the liability by another debtor, the negotiations are not made on an equal footing. The creditor has a superior bargaining position and may be able to demand more than a market price if the debtor needs to get out of the contract and cannot do it any other way.

(c) The transacting parties have entered into other recent or simultaneous transactions or have agreed to enter into future transactions that affected the observed exit price of the instrument being measured. For example, a seller may discount the price of one item if it can recoup its loss on other transactions with the same counter-party.

[See Application Supplement paragraphs 328-330]

Infrequent Transactions

91. ***If a market exit price for an identical or similar financial instrument is seldom available on a measurement date, an enterprise may determine that it should use a valuation technique (see paragraphs 104-117). If a valuation technique is used, an enterprise should carefully evaluate any significant difference between the estimated fair value resulting from the valuation technique and an observed market exit price to determine whether the valuation technique requires adjustment (see paragraph 108).***

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument

92. ***Values that are included in a market exit price that are not directly attributable to the rights and obligations that constitute a financial instrument should not enter into the determination of the fair value of that financial instrument.***

93. Certain financial instruments establish relationships with customers that are expected to result in future cash flows that are not directly attributable to the existing financial instruments themselves. An enterprise can sometimes realise the value of those expected future cash flows (or a portion of that value) when the financial instrument is sold to or assumed by another enterprise. That is, the price received on sale may be greater than (or paid on assumption may be less than) the value that is directly attributable to the rights and obligations that constitute the financial instrument. The portion of an observable market exit price that is not directly attributable to the financial instrument would not be included in determining a market exit price for the financial instrument.

94. Some examples of values included in market exit prices that are not directly attributable to financial instruments include the value of:

(a) expected cash flows from expected renewals or extensions of an existing financial instrument that the enterprise does not have a contractual right or obligation to renew or extend;

(b) expected cash flows from future transactions with the customer that do not result directly from the financial instrument contract but are expected to occur because of a relationship established by the existence of the financial instrument contract; and

(c) any net cash flow benefits expected by the writer of free-standing options to result from holders' future decisions to exercise or not exercise the options. (However, the fair value of an existing financial instrument, such as a loan asset, that contains an embedded written option, such as a prepayment option, would reflect market expectations of the holder's future decisions to exercise or not exercise that option.)

[See Application Supplement paragraphs 331-339 on credit card contracts and demand deposit liabilities.]

Prices from More than One Market for the Same Instrument

95. ***If an enterprise has access to more than one exit market for a financial instrument and prices in those markets are different, the instrument's fair value should be based on the most advantageous market exit price. "Most advantageous" means the optimum market exit price obtainable for that financial instrument in a market to which the enterprise has access. A market exit price is not a more advantageous price for the same instrument if the price advantage results from enhancements that are not present in the enterprise's financial instrument.***

96. The most advantageous price would be the highest market exit price for an asset and the lowest market exit price for a liability, after taking into account any significant differences in costs that would have to be incurred to sell a financial asset or obtain relief from a financial liability.

97. "Most advantageous" does not refer to an enterprise's goals or expectations that differ from market expectations. As an example, an enterprise might determine that its best course of action is to withdraw from a particular area of activity quickly, even though it will not realise the most advantageous price for its assets and liabilities. If the enterprise were to sell an asset for less than the most advantageous price or settle a liability for more than the most advantageous price, the enterprise would report a loss only when the sale or settlement occurs.

98. ***An enterprise has access to a market if there is no legal impediment to its participation in that market. If only portfolios of instruments (as opposed to individual instruments) are traded in a particular market, the enterprise has access to that portfolio market only if it holds a portfolio that could be traded in that market.***

99. No two portfolios are exactly alike. Therefore, if the most advantageous market exit price is for a portfolio, the enterprise would adjust for the effects on fair value of any dissimilarity between its portfolio and those observed to have been traded.

[See Application Supplement paragraphs 340 and 341]

Effect of an Embedded Option on the Enterprise Holding the Option

100. ***If a financial instrument contains a contractual provision (an embedded option) that gives the enterprise the right to settle or require settlement at a price that is more advantageous than the price in observed arm's-length transactions, the enterprise should measure the instrument at that contractual settlement price (the exercise price of the embedded option) adjusted for the effect of any time period to the exercise date.***

101. This requirement applies only to the enterprise that holds the option. The writer of the option would report the instrument at fair value based on observed transactions or, if necessary, at an estimate of that value determined by a valuation technique.

    [See Application Supplement paragraphs 342 and 343]

Large Blocks of Instruments

102. ***In some circumstances, an enterprise might expect the market exit price of a single transaction involving a large number of units of identical instruments (a large block) to be different from the market exit price of a single identical instrument or a small block of identical instruments. However, if market exit prices are available, the enterprise should use them without adjustment for difference between the size of the enterprise's holdings and the quantity exchanged in the observable transaction(s).***

103. In other words, if an enterprise holds a large block of a particular instrument and the only available market exit prices come from transactions involving individual instruments or small blocks, the enterprise would not adjust for the expected effect of selling the large block. That prohibition applies whether the effect is expected to be a discount or a premium. Similarly, if the enterprise holds only a small number of instruments and the available market exit prices come from transactions involving large blocks, the enterprise would not adjust the available price for the potential effect of selling individual instruments.

Estimating Fair Value without Observable Market Exit Prices

Selecting a Valuation Technique

104. ***If an enterprise cannot estimate fair value using the observable market exit prices of identical or similar financial instruments, it should estimate fair value by using a valuation technique that incorporates the factors that market participants would consider in setting a price.***

105. The objective of measuring a financial instrument at fair value using a valuation technique is to estimate the market exit price of the instrument. A technique for measuring a financial

asset would estimate what the enterprise would have received if it had sold a financial asset in an orderly transaction priced under the market conditions that existed on the measurement date. A technique for measuring a financial liability would estimate what the enterprise would have had to pay a third party with the same credit rating to assume the enterprise's financial liability,[10] or what the enterprise would have had to pay to repurchase its liability in an arm’s-length exchange motivated by normal business considerations (for example, as if the instrument were traded regularly on an exchange or in a dealer market, with appropriate adjustment for any significant difference in marketability).

106. ***If there is a valuation technique that is commonly used by market participants to price the instrument being measured and that has been demonstrated to provide reliable estimates of market exit prices, the enterprise should use that technique.***

107. For example, there are well-established models for pricing many types of financial options. An enterprise that holds or writes one of those options would use the model best suited for the type of option held or written. It would consistently apply that model, except if a new model or a change in the method of application of the existing model has been demonstrated to result in a more accurate estimate (see paragraphs 129 and 130 on estimation policies and procedures).

108. ***If no technique for pricing an instrument is in common use by market participants, an enterprise should develop its own technique. All valuation techniques should be consistent with accepted economic methodologies for pricing financial instruments of the type being measured and should be tested for validity using prices from actual transactions.***

109. As indicated in paragraph 108, an enterprise is required to test its valuation techniques by comparison to market exit prices in occasional transactions that it can observe or in which it participates. An enterprise would make reasonable efforts to become aware of such transactions between other parties on which information is publicly available.

110. Present value concepts are central to the development of techniques for estimating the fair value of financial instruments because the market exit price of a financial instrument represents market participants' collective estimate of the present value of its expected cash flows. That estimate reflects the amounts, timing, and uncertainty of future cash flows and the price that market participants are able to charge for bearing the uncertainty. Although financial options have certain unique characteristics, present value concepts are also applicable for estimating their fair value. The fair value of a financial option reflects the

[10] The description of this technique is not intended to imply that the creditor would consent to assumption by a party with the same credit risk. Stipulating that the assuming enterprise has the same credit risk is necessary to achieve the objective of measurement based on the enterprise’s own credit standing. It avoids including the value of any credit enhancement that would occur if any enterprise with a superior credit standing assumed the liability.

market's estimation of the current present value of its expected cash flows as with any financial instrument, but within the context of the expected effects of the price and volatility of the variable underlying the option.

[See Application Supplement paragraphs 344 and 345]

Inputs to Valuation Techniques

111. ***When using a valuation technique to estimate fair value, an enterprise should use estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument.***

112. Available market information would be supplemented, as necessary, with the enterprise's estimates and assumptions about other information that market participants would be expected to consider in setting a price for the instrument. Some examples of market information that would be used are market interest rates, foreign currency exchange rates, and commodity prices, as well as prepayment and bankruptcy or delinquency statistics and similar government or industry statistics. The enterprise's own assumptions may be the only source of information about some factors that affect fair value, but they would be consistent with the available information about the estimates and assumptions that market participants would use.

[See Application Supplement paragraph 346]

113. ***A present value technique for estimating fair value starts with a set of projected cash flows, expectations about possible variations in the amounts or timing of those cash flows, and the time value of money. An enterprise should incorporate expectations about possible variations in cash flows into either the projected cash flows or the discount rate or some combination of the two. In determining discount rates, an enterprise should use assumptions consistent with those used in estimating the projected cash flows, to avoid the effect of some assumptions being double-counted or ignored.***

114. ***Projected cash flows and discount rates should be free from bias and should not reflect factors unrelated to the assets or liabilities in question. In addition, a present value technique for estimating the fair value of a financial instrument should be based on projected cash flows that are directly attributable to the contractual rights and obligations that constitute the financial instrument, as described in paragraphs 92-94.***

115. The following types of information may be required in estimating projected cash flows, possible variations in those cash flows, and possible adjustments to the discount rate used to determine their present value.

    (a) Contractual terms.

    (b) Expectations about counter-party behaviour.

    (c) Expectations of future market conditions implied by current market data such as yield curves and forward foreign currency prices.

    (d) Estimates of the values of other variables or probabilities of future events that affect the contractual cash flows.

    (e) Estimates of the net costs of servicing financial assets and financial liabilities that would be considered by market participants.

    [See Application Supplement paragraphs 347-354]

116. ***An enterprise should reflect the following information in the fair value estimate, either as a part of the present value computation or as an adjustment of the result:***

    (a) the price market participants are able to receive for bearing the uncertainty inherent in the financial instrument (the risk premium); and

    (b) other factors market participants would be expected to consider in setting prices, including marketability and profit margins expected by market participants.

117. As an example of sub-paragraph 116(b), a purchaser is not likely to be willing to pay as high a price for an asset that is not readily marketable as for an asset that could be resold

quickly for a determinable price. Similarly, the price that market participants would receive for assuming a liability may include a profit margin for providing this service to the original debtor.

[See Application Supplement paragraphs 355-369 regarding use of valuation techniques to determine fair values of non-traded options and other derivatives, non-traded equity instruments, loan assets and impaired loan assets.]

Financial Liabilities

118. ***The estimated market exit price of a financial liability should reflect the effects of the same market factors as the price of a financial asset, including the credit risk inherent in the liability.***

119. Differences between the fair value of a financial instrument as a liability and its fair value as an asset can arise from:

    (a) bid-asked spreads (see paragraphs 80-82);

    (b) use of the most advantageous market exit price, if there is more than one market (see paragraphs 95-99 and Application Supplement paragraphs 340 and 341); and

    (c) the differing effects of settlement options on the fair value of the same financial instrument as an asset or as a liability (see paragraphs 100 and 101 and Application Supplement paragraphs 342 and 343).

120. Observable market exit prices for financial liabilities (such as traded corporate bonds) reflect the effects of the credit risk inherent in the liabilities. If an enterprise finds it necessary to estimate a market exit price using a discounted cash flow computation, the effect of the enterprise's own credit risk would also be included in either the expected cash flows or the discount rate.

121. An enterprise may be aware of information that would affect its credit standing if that information became known to market participants. An enterprise would not use this information to adjust an observed market exit price of a financial liability. However, if it is necessary to use a valuation technique to estimate the market exit price of a financial liability, an enterprise may not be able to determine what market participants know or would know if they were setting a price to assume the liability. In that situation, an enterprise would make its estimate of fair value using all information that the enterprise would be legally obligated to disclose if the liability were traded, as well as that which market participants would reasonably be expected to discover for themselves.

[See Application Supplement paragraphs 370-375]

Exception for Certain Private Equity Investments

122. ***In rare circumstances, an enterprise may determine that it is not practicable to make a reliable estimate of the fair value of an equity investment in another enterprise for which there is no observable market exit price (private equity investment). In that situation, the enterprise should report the financial instrument at its carrying amount at the time the enterprise determined that it was not practicable to make a reliable estimate of its fair value, or at a lower amount determined under paragraph 125. This exception is not available to an enterprise or unit of an enterprise, such as a venture capital investment enterprise, for which investing in the equity of private enterprises is a significant business activity. The exception also is not available for any derivative that an enterprise holds or writes that is based on the value of a private equity investment, or for any investment that it holds that is the subject of a derivative that it holds or writes.***

123. Paragraphs 183-186 include requirements to disclose information about measurement uncertainties and about private equity investments that have not been measured at fair value.

124. If an enterprise determines that it has become practicable to estimate the fair value of an investment that had been reported under this exception, it would not be acceptable to adopt this exception again at a later date for that investment.

125. ***If there is evidence at a measurement date that the full carrying amount of a private equity investment that is not measured at fair value cannot be recovered, the enterprise should measure the investment at its estimate of the amount that could be recovered at that date. That new amount should not be adjusted unless there is evidence that the amount cannot be recovered or unless it becomes practicable to make a reliable estimate of the fair value.***

Foreign Currency Denominated Financial Instruments

126. ***An enterprise should re-measure the foreign currency fair value of a <u>foreign currency denominated financial instrument</u> to the functional currency using the currency spot rate at the reporting date.***

127. ***An enterprise should determine the fair value of a forward exchange contract on the basis of the forward exchange rate, discounted to reflect the fact that the exchange will not occur until a future date. If a forward exchange contract price is in a currency other than the functional currency, an enterprise should re-measure its foreign currency fair value to the functional currency in accordance with paragraph 126.***

128. In accordance with foreign currency translation standards of many jurisdictions, closing exchange rates for the period are used both for re-measuring foreign currency denominated

assets and liabilities into functional currencies and for translating them from functional currencies to the reporting currency. As a result, foreign currency denominated financial instruments are stated in the balance sheet of a reporting enterprise at the same amounts as if they had been translated to the reporting currency from the currencies of their denomination. The income statement effects, however, vary according to the functional currencies of the entities within the reporting enterprise where the financial instruments are held (see paragraphs 148-151).

Establishing Fair Value Estimation Policies and Procedures

129. ***An enterprise should establish appropriate policies and procedures for estimating the fair value of its financial instruments. An enterprise's fair value estimation policies should be consistent from period to period except when a change will result in more accurate estimates of fair value.***

130. An enterprise's policies and procedures would cover the significant types of financial instruments that it holds and issues. These policies and procedures would be sufficient to provide reasonable assurance of appropriate application of fair value measurement methods meeting the requirements of this Draft Standard. Paragraph 182 requires disclosures about the enterprise's methods for determining fair values.

[See Application Supplement paragraphs 376-379]

Balance Sheet Presentation

131. ***An enterprise should distinguish on the face of the balance sheet:***

   (a) cash and cash equivalents;

   (b) equity instruments held that are not accounted for under the equity method, except for those classified under sub-paragraph (d);

   (c) unconditional rights to receive financial instruments, except those classified under sub-paragraph (d);

   (d) other financial assets;

   (e) unconditional obligations to deliver financial instruments except those classified under sub-paragraph (f); and

   (f) other financial liabilities.

132. Unconditional rights to receive, or obligations to deliver, financial instruments make up those financial instruments that fall within part (c) of the definition of a financial instrument (see paragraph 7) and for which receipt or delivery does not depend on the occurrence of specified events.

133. Other financial assets and liabilities include conditional financial instruments (see paragraphs 7 and 13), as well as financial assets and financial liabilities that are forward contracts, options, financial guarantees, sets of rights or obligations in a hybrid contract that are accounted for as financial instruments that fall within the scope of the Draft Standard in accordance with paragraphs 4 and 5, compound financial instruments (i.e., financial instruments that combine two or more elements of equity instruments, unconditional rights and obligations, and conditional rights and obligations), and non-financial items that are accounted for as financial instruments that fall within the scope of the Draft Standard in accordance with paragraph 2.

134. ***An enterprise should distinguish, either on the face of the balance sheet or in notes to the financial statements referenced from the relevant items in the balance sheet, the following:***

   (a) significant classes of financial instruments that are unconditional rights to receive financial instruments, in sub-paragraph 131(c), including:

      (i) trade receivables;

(ii) <u>loan assets</u>;

(iii) <u>impaired loan assets</u>;

(iv) bonds and other debt securities held; and

(v) other significant financial assets in sub-paragraph 131(c), by type;

(b) significant classes of financial instruments that are unconditional obligations to deliver financial instruments, in sub-paragraph 131(e), including:

(i) trade payables;

(ii) demand loans payable;

(iii) debt issued; and

(iv) other significant financial liabilities in sub-paragraph 131(e), by type; and

(c) other significant financial assets and financial liabilities, by type.

135. The disclosure required by sub-paragraph 134(c) might include, for example:

(a) analysis of cash and cash equivalents between (i) reporting currency and (ii) foreign currency;

(b) analysis of equity instruments other than those accounted for under the equity method into (i) common stock; (ii) preferred stock; (iii) interests in partnerships; and (iv) shares in equity funds; and

(c) analysis of other financial assets (and, separately, other financial liabilities) into (i) forward contracts; (ii) swaps; (iii) options held (options written); (iv) financial guarantees; (v) hybrid contracts; (vi) servicing assets (servicing liabilities); and (vii) commodity contracts.

Income Statement Presentation

Basic Requirement

136. ***An enterprise should recognise changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise—with the exception of gains and losses arising in translating financial instruments from functional currencies to the reporting currency that are presented outside the income statement in accordance with standards of accounting for foreign entities***[11] [see Application Supplement paragraphs 380 and 381].

Income Statement Disclosures

137. ***An enterprise should disclose the following for the reporting period, either on the face of the income statement or in notes to the financial statements referenced from the relevant items in the income statement:***

(a) ***interest revenue on the fair value basis from interest-bearing financial assets, separately distinguishing the portion that is attributable to impaired loan assets;***

(b) ***interest expense on the fair value basis from interest-bearing financial liabilities;***

(c) ***net gain or loss on impaired loan assets after the determination of interest in sub-paragraph (a) above;***

(d) ***net gain or loss resulting from changes in the credit risk premiums of interest-bearing financial liabilities;***

(e) ***net gain or loss comprising (i) the net gain or loss arising on interest-bearing financial assets and financial liabilities after the determinations of sub-paragraphs (a)-(d) above and after any foreign currency gain or loss and (ii) the change in fair value, after adjustment for receipts and payments, arising on forward contracts (including swaps), options and similar derivative financial instruments that is attributable to underlying variables that are based on interest rates or credit risk;***

(f) ***net gain or loss on equity instruments, including dividends; and***

(g) ***net gain or loss on other financial instruments.***

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[11] The IASC requires such gains and losses to be classified as equity in accordance with paragraph 30 of IAS 21, The Effects of Changes in Foreign Exchange Rates.

138. ***An enterprise should also disclose the cumulative net gain or loss resulting from changes in the credit risk premiums of interest-bearing financial liabilities outstanding at the reporting date for the period from their dates of issue to the end of the reporting period.***

Interest Revenue and Expense

139. ***<u>Interest revenue</u> and <u>interest expense</u> on the fair value basis should be determined using the <u>current yield to maturity</u> basis, except that an enterprise may use the <u>current market expectations basis</u> if the chief operating decision maker relies primarily on that basis for assessing the performance of the enterprise's significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk.***

140. An enterprise that meets the conditions of paragraph 139 and elects to use the current market expectations basis would apply it consistently to all its significant interest-bearing financial instruments.

[See Application Supplement paragraphs 382-390]

Information about Net Gains and Losses

141. ***An enterprise should provide information about the primary sources of the net gain or loss amounts reported under sub-paragraph 137(d) and paragraph 138.***

142. The information required to be disclosed by paragraph 141 would indicate whether the amounts reported have been significantly affected by debt repayments or re-financings, changes in the nature or value of collateral provided as security, changes in the credit standing of the enterprise, changes in market credit risk spreads for financial liabilities of equivalent credit risk, or other factors.

143. ***An enterprise should provide information about the significant factors that contributed to the net gain or loss disclosed under sub-paragraph 137(e).***

144. The information required to be disclosed by paragraph 143 would identify at least each of the following factors that had a significant effect on the reported gain or loss and the direction of that effect:

(a) changes in basic interest rates;

(b) changes in credit risk premiums of financial assets, distinguishing effects of changes in credit interest rate spreads and in credit risk; and

(c) changes in other financial risks.

145. ***An enterprise should provide information about the primary sources of the gains or losses disclosed under sub-paragraphs 137(f) and 137(g).***

146. Examples of information required to be disclosed by paragraph 145 would be the significant classes of equity investments and the specific commodities whose price change effects were the primary sources of the reported gains or losses.

147. The information that is required to be disclosed by paragraphs 141-146 would be sufficient to inform users about an enterprise's financial performance in relation to its financial risk management objectives and policies disclosed in accordance with paragraphs 156-163.

Foreign Currency Denominated Financial Instruments

148. ***An enterprise should disclose the net gain or loss recognised in the income statement that arises from re-measuring foreign currency denominated financial instruments into their functional currencies. An enterprise should also disclose the net gain or loss resulting from translating financial instruments from functional currencies to the reporting currency.***

149. For consistency with the foreign currency translation standards of many jurisdictions, the Draft Standard adopts similar definitions and reflects the same two-stage approach found in those standards. Under that approach, assets and liabilities are measured in terms of the functional currency of the entity by which they are held. Gains and losses resulting from re-measuring assets and liabilities denominated in foreign currencies into their functional currencies are recognised in the income statement. As a second stage, the financial statements of all the foreign entities that are part of the reporting enterprise are translated into the reporting currency in order to prepare the financial statements of the reporting enterprise. Gains and losses arising from this second stage are presented outside the income statement.

150. An enterprise would indicate the primary currencies contributing to the two types of net exchange gain or loss disclosed under paragraph 148.

151. The income statement effects of foreign currency denominated financial instruments included in the amounts required to be disclosed by paragraph 137 would have arisen from re-measurements into functional currencies and subsequent translation into the reporting currency at exchange rates prevailing at the times the underlying transactions and events took place. For practical reasons, rates that approximate actual exchange rates at the times transactions and events occurred may be used, and the average rates for a reporting period may be used where rates have not undergone a major change in the period. However, if exchange rates fluctuate significantly, the use of average rates might not be appropriate.

Further Disaggregation

152. An enterprise may choose to disaggregate net gain or loss amounts by sources or types of financial risk, in which case it would disclose the basis on which the disaggregated amounts have been determined. Such risk-based disclosures would be consistent with the financial risks identified in the enterprise's disclosure of significant financial risks and its risk management objectives and policies (see paragraphs 154-163).

Hedges

153. The Draft Standard does not permit special accounting for financial instruments entered into as part of risk management activities. That is, financial instruments that are used for risk management purposes would be measured at fair value and the changes in fair value would be recognised in the income statement in the reporting periods in which they arise (except for certain foreign currency translation gains and losses, see paragraph 136).

Disclosure

Significant Financial Risks

154. ***An enterprise should describe each of the <u>financial risks</u> that was significant to it during the reporting period*** [see Application Supplement paragraphs 393 and 394].

155. An enterprise would evaluate whether a financial risk is significant for disclosure in accordance with paragraph 154 on the basis of its financial asset and financial liability positions related to that risk. This would be assessed taking into account asset and liability risk positions during the reporting period as well as positions at the end of the reporting period. It is not acceptable to view a financial risk as not significant to an enterprise because it has reduced its net risk exposure by having or arranging reciprocal asset and liability positions.

Financial Risk Management Objectives and Policies

156. ***An enterprise should explain the role that financial instruments have had during the period in creating or changing the risks that the enterprise faced in its activities. This should include a description of its objectives and policies for managing each of the significant financial risks identified in paragraph 154.***

157. An enterprise's explanation of the role that financial instruments have had during the period in creating or changing the risks that the enterprise faced in its activities would include (a) identification of the principal groups of financial assets and financial liabilities involved and (b) sufficient information about the primary financial and business activities of the enterprise to provide the context needed to enable users to understand the enterprise's disclosed financial risk management objectives and policies, information about its financial risk positions, and its financial performance.

158. The activities of some enterprises may be such that there are reciprocal asset and liability positions in respect of certain risks. For example, an enterprise may have loan assets financed by debt with similar maturities and contracted cash flows, with the effect of reducing the enterprise's net exposure to basic fair value interest rate risk and basic cash flow interest rate risk. In this case, the description required by paragraph 156 would include the enterprise's basic objectives and policies for matching, and for taking mis-matched positions, with respect to floating versus fixed rate terms and maturities of the asset and liability positions. In describing its objectives and policies for using financial instruments an enterprise would, for example, explain its use of forward contracts or swaps to mitigate its net balance sheet exposure to <u>basic interest rate risk</u> or certain commodity price risks, or its use of credit derivatives to manage certain credit risk exposures. An enterprise would

also explain any significant objectives and policies with respect to transfers of financial assets, such as securitisation transactions.

159. A description of financial risk management objectives and policies will typically include information about the enterprise's policies for:

(a) balancing fixed versus floating interest rate exposures;

(b) setting interest rate re-pricing and maturity dates;

(c) managing currency positions;

(d) setting acceptable risk exposure limits; and

(e) managing credit risk, including requiring collateral or other security to support financial instruments subject to credit risk, or for entering into arrangements (including master netting arrangements and credit guarantees) intended to achieve the same effect. Information about the enterprise's policy concerning access to collateral or other security would also be provided.

160. ***An enterprise should describe its objectives and policies for using financial instruments to manage significant risks associated with transactions expected to occur in future reporting periods.***

161. An enterprise's description of its objectives and policies for managing significant risks associated with transactions expected to occur in future reporting periods would include, for significant risks, identification of (a) the nature of the anticipated future transactions and the risks that are the subject of risk management, (b) the nature of the financial instruments permitted to be used, (c) any policies with respect to the extent of risk management activities and time periods, and (d) policies for monitoring and assessing effectiveness.

162. ***An enterprise should identify and explain any significant changes that it has made to its financial risk management objectives or policies during the reporting period.***

163. The explanation that is required by paragraph 162 would include both those changes that were in effect during the reporting period and those that will be in effect only for future reporting periods.

Terms and Conditions of Financial Instruments

164. ***An enterprise should disclose information about the significant terms and conditions of financial instruments held or issued at the reporting date that may have a significant***

effect on the amounts, timing and certainty of future cash flows to be received from or paid out in respect of those financial instruments.

165. Terms and conditions would be disclosed whenever financial instruments are important, either individually or as a class, in relation to the financial position of an enterprise or its results. If no single instrument is individually significant to the future cash flows of the enterprise, the essential characteristics of the instruments would be described by reference to appropriate groupings of like instruments.

166. Significant terms and conditions of financial instruments that would warrant disclosure, depending on the nature and significance of the financial instruments concerned, include:

(a) the principal, stated, face or other similar amount, which for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based;

(b) the date of maturity, expiry or execution;

(c) the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;

(d) the stated rate or amount of interest (which might be based on benchmarks, such as LIBOR), dividend or other periodic return on principal and the timing of payments;

(e) a description of early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices;

(f) a description of any collateral or other security interest held, in the case of a financial asset, or of any collateral pledged or other security interest given, in the case of a financial liability;

(g) any condition of the financial instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt-to-equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately);

(h) any features of the financial instrument that significantly concentrate or leverage risk (for example, a significant leverage factor in a derivative financial instrument, such as a requirement for payments based on a significant multiple of changes in fair value of an underlying price or index, that, if triggered, could be material to the enterprise's financial performance); and

(i) a description of options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised, the conversion or exchange ratio(s) and information described in items (a)-(h) for the instrument to be acquired in the exchange.

167. The terms and conditions of hybrid instruments would be explained in a manner that highlights not only the financial risks involved but also the fact that those risks are contained in a single instrument. For example, an enterprise that has issued convertible debt would explain that the financial liability and equity instrument components of that debt arise from the same financial instrument.

168. ***When the ability to dispose of or use financial assets is subject to external restrictions, through legal or contractual requirements outside the financial instrument contract, an enterprise should disclose the nature and extent of such restrictions at the reporting date.***

169. An example of the disclosure required by paragraph 168 would be disclosure of the fact that an enterprise is precluded from disposing of certain financial instruments as a result of regulations requiring that it maintain a certain proportion of liquid financial assets. Similarly, an enterprise might disclose that certain financial assets are subject to external stipulations that only the income on the assets be used by the enterprise, with the capital retained for further income generation.

Financial Risk Position at the Reporting Date

Basic Interest Rate Risk

170. ***When an enterprise has identified basic interest rate risk as a significant financial risk in accordance with paragraph 154, it should disclose, for each significant class of financial assets and financial liabilities affected by basic interest rate price risk at the reporting date, an analysis of their fair value, classified according to contractual interest re-pricing dates*** [see Application Supplement paragraphs 395-399].

Currency Risk

171. ***When an enterprise has identified currency risk as a significant financial risk in accordance with paragraph 154, it should disclose, separately for financial assets and for financial liabilities at the reporting date:***

(a) an analysis of their fair value, classified according to the main currencies of denomination involved; and

(b) ***the fair value of financial assets and financial liabilities of foreign entities, indicating the primary functional currencies involved.***

[See Application Supplement paragraphs 397 and 398]

Credit Risk

172. ***When an enterprise has identified <u>credit risk</u> as a significant financial risk in accordance with paragraph 154, it should disclose:***

(a) ***the amount of the maximum credit risk exposure at the reporting date in the event other parties fail to perform their obligations; and***

(b) ***for those financial instruments for which the maximum credit risk exposure differs from the fair value included on the balance sheet (including financial guarantees provided by the enterprise and similar financial instruments), the nature of the financial instruments giving rise to that exposure.***

173. ***When an enterprise has identified <u>credit risk</u> as a significant financial risk in accordance with paragraph 154, it should also disclose, for each significant concentration of credit risk arising from financial instruments at the reporting date:***

(a) ***a description of the activity, region or economic characteristic that is the basis of the concentration;***

(b) ***information about its maximum credit risk exposure, in accordance with sub-paragraph (a); and***

(c) ***information about collateral or other security held, or other arrangements (including master netting arrangements, set-off arrangements, credit guarantees and credit derivatives) entered into, to manage credit risk, including the extent to which such arrangements would mitigate the probability of loss due to credit risk.***

[See Application Supplement paragraphs 400 and 401]

174. Concentrations of credit risk may arise from exposures to a single counter-party or to a group of counter-parties having a similar characteristic such that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions. Characteristics that may give rise to a concentration of credit risk include the nature of the activities undertaken by counter-parties, such as the industry in which they operate, the geographic area in which activities are undertaken and the level of creditworthiness of groups of counter-parties. Concentrations of credit risk might also arise as a result of exposure of collateral or other security held, or other similar arrangements, to similar risk characteristics. For example, significant collateral amounts held might all be in the form of

similar property, or their values might all depend upon the same underlying variable (for example, oil prices).

Other Significant Financial Risks

175. ***For each significant financial risk identified in accordance with paragraph 154 that is not dealt with by the disclosures required by paragraphs 170-173, an enterprise should provide quantitative information about the extent to which the enterprise is affected by that risk at the reporting date*** [see Application Supplement paragraphs 402-408].

176. Other significant financial risks might include other price risks (including commodity price risks, equity price risk, etc.), prepayment risk and <u>liquidity risk</u>, as well as risks of volatility affecting the value of financial options and similar financial instruments.

Financial Risk Position at the Reporting Date Compared with that During the Reporting Period

177. ***If an enterprise's financial risk position at the reporting date is not representative of the position at other times during the reporting period, it should disclose information about the amount by which positions during the reporting period vary from the position at the end of the reporting period.***

178. Disclosing the highest and lowest, or average, positions during the reporting period might be appropriate means of providing this information.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

179. An enterprise is encouraged to provide information about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions. This information might be provided by measures such as sensitivity analysis, value-at-risk, or other established risk measurement techniques.

180. When an enterprise makes such disclosures it would explain:

(a) the methodology, main parameters and assumptions used to calculate each measure;

(b) the effects of any material differences between the methodology, parameters and assumptions used to calculate the measure for the reporting period and those used in the preceding reporting period; and

(c) an indication as to whether the measure disclosed at the reporting date is typical of similar measures during the reporting period.

[See Application Supplement paragraphs 409-411]

Financial Instruments Used to Manage Risks Associated with Transactions Expected to Occur in Future Reporting Periods

181. ***If an enterprise separately discloses amounts of gains or losses in the reporting period on financial instruments identified as managing risks associated with transactions expected to occur in future reporting periods, it should describe (a) the financial instruments involved; (b) the risk(s) that are being managed; and (c) the expected timing of the future transactions involved. An enterprise should continue to disclose this information, including the gains and losses in respect of that activity, until the future transactions occur or are no longer anticipated to occur.***

182. An enterprise may wish to provide additional disclosures of its financial risk management activities associated with transactions expected in future reporting periods. It might, for example, disclose the fair value at the reporting date of financial instruments identified as being used to manage future risks, or disclose information about the extent and effectiveness of its use of financial instruments during the reporting period to manage risks related to transactions that were expected to occur during the reporting period. Such disclosures would be explained in the context of the enterprise's financial risk management objectives and policies disclosed in accordance with paragraphs 156-163.

Methods Used to Estimate Fair Value

183. ***An enterprise should describe, for each significant class of financial asset and financial liability, the methods used to estimate fair values, including:***

   (a) ***identifying which financial instruments were valued using observable market exit prices (in accordance with paragraphs 77-103) and which were valued using valuation techniques (in accordance with paragraphs 104-117);***

   (b) ***for financial instruments valued using a valuation technique, describing the valuation technique used, including describing the methodology and significant assumptions used;***

   (c) ***describing significant changes made during the reporting period to methods and assumptions used to estimate fair value;***

   (d) ***identifying the factors taken into account in determining the effect of the enterprise's own credit risk on the fair value of its financial liabilities;***

   (e) ***if fair values of financial instruments are sensitive to key valuation assumptions, stating this fact, describing alternative assumptions, and indicating the most likely range of reasonably possible estimates; and***

(f) ***identifying any large blocks of financial assets that may not be capable of immediate realisation at their recorded fair value, their fair value and an explanation of this fact.***

184. In some instances, the choice of key valuation assumptions could result in a range of reasonably possible estimates for the fair value of a financial instrument or class of financial instruments. When that range is sufficiently great that it is reasonably possible that the choice of another appropriate valuation assumption could have a material effect on the financial statements, the disclosures required by sub-paragraph 183(e) would be made. An indication of the most likely range of reasonably possible amounts within which fair value could fall might be provided by indicating a range of amounts or by disclosing the effect of a change in the significant underlying assumptions used to estimate the fair value. Past experiences with regard to differences between estimated fair values and cash flows from the sale or settlement of financial instruments shortly after the measurement date might be indicative that measurement is sensitive to key valuation assumptions.

185. ***In the circumstances described in paragraph 122, when an enterprise determines that it is not practicable to make a reliable estimate of the fair value of a private equity investment, it should disclose the total carrying amount of the equity investment involved and the policy that it has adopted for determining the carrying amount of the equity investment. If the enterprise uses such a financial instrument in fulfilling its objectives and policies for managing significant financial risks, it should disclose that fact.***

186. ***If an enterprise sells, or determines that it becomes practicable to make a reliable fair value estimate for, equity investments for which it had previously determined it was not practicable to make a reliable fair value estimate in accordance with paragraph 122, the enterprise should disclose the carrying amount of such equity investments at the previous reporting date and either (a) the proceeds from sale of the investments or (b) the fair value at the date it determines a reliable estimate of fair value can be made.***

Derecognition Disclosures

Sale and Repurchase Transactions and Stock Lending Transactions

187. ***An enterprise (the transferor) should disclose the following information if it transfers and derecognises a financial asset in accordance with paragraphs 49-68 and concurrently enters into an agreement to repurchase substantially the same financial asset at a future date:***

(a) ***the nature of the transfer;***

(b) ***the fair value and class of the financial assets derecognised as a result of the transfer; and***

(c) ***the fair value and class of the financial assets and any liabilities recognised as a result of the transfer.***

The transferor should continue to provide this disclosure until it ceases to have the rights and obligations arising from its repurchase agreement.

Retained Interests in Transferred Assets

188. ***An enterprise (the transferor) that transfers some of a financial asset should disclose the following information if some components of the asset are derecognised and the components of the asset that the transferor continues to recognise have greater risk of variability in value than the derecognised components:***

(a) ***the fair value and balance sheet classification of the components that continue to be recognised; and***

(b) ***information about the risks inherent in those assets that will significantly affect the performance of the components that continue to be recognised.***

189. ***The enterprise should continue to provide the disclosure described in paragraph 188 until either the components referred to in sub-paragraph 188(a) are derecognised or the risk of variability in value of those components is no more than the risk of variability inherent in the components that were derecognised.***

Effective Date and Transition

190. ***This Draft Standard becomes operative for financial statements covering financial years beginning on or after _________, 200X. Earlier application is encouraged, but this Draft Standard should be applied only from the beginning of a financial year that begins after its issuance. If an enterprise applies this Draft Standard for periods beginning before ________, 200X, it should disclose that fact.***

191. An enterprise that chooses to adopt the Draft Standard before the effective date would be expected to apply all aspects of the Draft Standard at the same time, unless the parts of the Draft Standard adopted do not contravene accounting standards existing at the date of adoption.

192. ***An enterprise should adopt the following transitional requirements.***

(a) Except as required by sub-paragraph (d), at the beginning of the financial year in which this Draft Standard is initially applied, an enterprise should recognise in its balance sheet all financial instruments and should measure them at fair value in accordance with the provisions of this Draft Standard. Any difference between the previous carrying amount (which may have been zero) and fair value determined in accordance with this Draft Standard should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which this Draft Standard is initially applied.

(b) An enterprise should not adjust the carrying amount of non-financial items to exclude gains and losses arising from hedging arrangements that were included in that carrying amount before the beginning of the financial year in which this Draft Standard is initially applied.

(c) Except as required by sub-paragraph (b), an enterprise should recognise any gain or loss applicable to periods before the beginning of the reporting period in which this Draft Standard is initially applied, that this Draft Standard would require to be recognised in the income statement, as an adjustment of the balance of retained earnings at the beginning of the financial year in which this Draft Standard is initially applied. This adjustment should include those gains and losses first recognised as a result of applying this Draft Standard and those gains and losses previously excluded from the income statement but which this Draft Standard would require to be recognised in the income statement.

(d) On initial application of this Draft Standard, an enterprise should not recognise financial assets or financial liabilities that it had derecognised prior to

implementation of this Draft Standard, nor should it derecognise financial assets or financial liabilities that it had recognised prior to implementation of this Draft Standard. However:

(i) ***if application of the Draft Standard would have required recognition of an item that was derecognised under previous accounting, the enterprise should describe the financial asset or financial liability involved until such time as it would have been derecognised in accordance with the Draft Standard; and***

(ii) ***an enterprise should identify any contractual rights or contractual obligations that, although acquired, assumed or retained in connection with a transfer or settlement, were not recognised (either separately or as part of a financial asset or financial liability incorporating other rights or obligations) under the accounting previously applied. If those rights and obligations meet the criteria for recognition in paragraph 31, they should be recognised, measured at their fair value and accounted for in accordance with this Draft Standard. An enterprise need not change the manner in which those rights and obligations are presented in the financial statements.***

(e) ***An enterprise should classify components of a <u>hybrid contract</u> existing at the beginning of the financial year in which this Draft Standard is initially applied by applying the requirements of this Draft Standard at that date.***

193. As an example of the accounting in accordance with sub-paragraph 192(d), prior to the initial application of the Draft Standard an enterprise that transferred receivables but retained a subordinated interest in those receivables might, under previous accounting, have derecognised the receivables but not have recognised its retained interest. Sub-paragraph 192(d) requires the enterprise to recognise the retained interest as an asset and measure it at its fair value on initial application of the Draft Standard. Similarly, an enterprise might have transferred, prior to the date of initial application of the Draft Standard, receivables and assumed a liability by guaranteeing the collectability of a certain amount of those receivables. Under previous accounting, the enterprise might have derecognised the receivables, but not have recognised the financial guarantee. Sub-paragraph 192(d) requires the enterprise, on application of the Draft Standard, to recognise the financial guarantee as a liability if it meets the criteria for recognition in paragraph 31 and to measure it at its fair value. However, the enterprise would not change the previous accounting for the transfer of the receivables, even if the transfer would not have qualified for derecognition in accordance with the requirements of this Draft Standard.

194. Another example of sub-paragraph 192(d) would be where, prior to the initial application of the Draft Standard, an enterprise has transferred traded securities in exchange for cash

and at the same time agreed to repurchase those securities (on a date that is after the initial application of the Draft Standard) at a slightly higher fixed price. If the transfer had taken place after the implementation of the Draft Standard, the transferor would have derecognised the securities and recognised the forward agreement to repurchase them. However, under previous accounting the enterprise might have continued to recognise the securities and accounted for the cash it received in that "repo" agreement as the proceeds of a secured loan. Applying sub-paragraph 192(d) to this circumstance, the enterprise would not recognise the rights and obligations under the forward repurchase agreement because it has already recognised them, not separately but rather as part of a larger financial asset (the securities the enterprise continues to recognise). It would also not derecognise the securities.

195. ***When this Draft Standard is first adopted, an enterprise should not restate comparative information for recognition, derecognition and measurement and should disclose the fact that such information has not been restated. An enterprise need not present other information required by this Draft Standard for comparative periods.***

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

APPLICATION SUPPLEMENT

This section comprises additional material that explains how certain aspects of the Draft Standard apply. It is an integral part of the Draft Standard and should be applied in the same manner as the principles in the Draft Standard.

Contents

Paragraphs

Scope 196-213

Licence Fees, Royalties and Similar Items 196

Certain Contracts to Buy or Sell Non-financial Items That Can Be Settled Net by a Financial Instrument 197-207

Settled Net 197-203

Normal Purchase or Sale 204-207

Servicing Assets and Servicing Liabilities 208-210

Leases 211-213

Recognition and Derecognition 214-314

Recognition 214-223

Forward Contracts and Other Executory Contracts 214-216

Regular Way Security Transactions 217

Security Interests 218-219

Hybrid Contracts 220

Description Given to Assets and Liabilities on the Balance Sheet 221

Transfers That Have Substance 222-223

Derecognition 224-231

Components of Financial Assets and Financial Liabilities 224-226

Obtaining Release from Primary Responsibility for an Obligation 227-230

Derecognition and Consolidation 231

Transfers involving Financial Assets 232-258

Introduction 232-233

Application Supplement – Contents

Summary of the Transferor's Accounting 234-237

Summary of the Transferee's Accounting 238-241

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party 242-250

Transfers Where the Transferor Has an Obligation to Repay Consideration Received or a Call Option over a Transferred Component 251-258

Application of the Recognition and Derecognition Requirements to Various Transfers Involving Financial Assets 259-314

Sale and Repurchase Arrangements 260-275

Stock Lending (Sometimes Called Securities Lending) 276-277

Transfers Where the Transferor Retains a Call Option to Reacquire the Rights or the Transferee Retains a Put Option to Return the Rights 278-281

Transfers with Some or All Gains and Losses Passed Back to the Transferor 282-283

Income and Principal Strips 284-287

Loan Transfers 288-293

Factoring Arrangements 294-304

Securitisations 305-308

Sub-participations 309-312

Servicing Arrangements 313-314

Measurement 315-379

Initial Measurement 315-317

Hybrid Contracts 318-319

Adjustments for the Passage of Time and Changes in Market Conditions 320-322

Using Price Information about Similar Financial Instruments 323-327

Prices Not Determined by Normal Market Interactions 328-330

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument 331-339

Credit Card Contracts 332-335

Demand Deposit Liabilities 336-339

Prices from More than One Market for the Same Instrument 340-341

Application Supplement – Contents

Effect of an Embedded Option on the Enterprise Holding the Option 342-343
Estimating Fair Value without Observable Market Exit Prices 344-369
Inputs to Valuation Techniques 346
The Relationship between Discount Rates and Projected Cash Flows 347-354
Non-traded Options and Other Derivatives 355-356
Non-traded Equity Instruments 357-358
Loan Assets 359-363
Impaired Loan Assets 364-369
Financial Liabilities 370-375
Financial Guarantees of an Enterprise's Financial Liabilities 373-375
Establishing Fair Value Estimation Policies and Procedures 376-379
Use of Pricing Services 378-379
Income Statement Presentation 380-390
Change in Fair Value of Financial Instruments 380-381
Fair Value Interest Revenue and Expense 382-389
Current Yield to Maturity Basis 382
Current Market Expectations Basis 383-385
Interest Calculation 386-389
Compound Financial Instruments 390
Disclosure 391-412
General Presentation Matters 391-392
Significant Financial Risks 393-394
Financial Risk Position at the Reporting Date 395-411
Basic Interest Rate Risk and Currency Risk 395-399
Credit Risk 400-401
Other Significant Financial Risks 402-408
Potential Effects of Changes in Risk Conditions on Financial Risk Position . 409-411
Disclosure Example 412

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Scope

Licence Fees, Royalties and Similar Items

196. In accordance with paragraph 1(g), contractual rights or contractual obligations that are contingent on the future use of, or right to use, non-financial items are excluded from the scope of this Draft Standard. When an enterprise transfers the rights to cash flows from such contracts to another party in exchange for a residual interest in a securitisation trust, or similar enterprise, the residual interest is a financial instrument and is, therefore, subject to the requirements of this Draft Standard.

Certain Contracts to Buy or Sell Non-financial Items That Can Be Settled Net by a Financial Instrument [see Draft Standard, paragraph 2(a)]

Settled Net

197. "Settled net by a financial instrument" means settling a contract by delivering a financial instrument in an amount reflecting the difference between the fair value of a non-financial item and the fair value of the consideration to be exchanged for the non-financial item. A contract can be settled net by a financial instrument if any of the following circumstances exist:

   (a) the terms of the contract explicitly or implicitly permit either party to settle net by a financial instrument;

   (b) there is an established market mechanism, or side agreement, outside the contract that facilitates settlement net by a financial instrument; or

   (c) the non-financial item that is the subject of the contract has interchangeable (fungible) units, which are exactly the same as those for which an active market exists. (For example, natural gas deliverable at Sabine Pipe Line Co.'s Henry Hub in Louisiana, USA, is considered to be the same as Henry Hub natural gas traded on the New York Mercantile Exchange (NYMEX)).

198. An established market mechanism includes any pre-existing institutional arrangement that permits either party to eliminate its net position and, thereby, to be relieved of all rights and obligations under the contract without incurring a prohibitive penalty or other cost. For example, an enterprise entering into a contract to purchase a commodity on a futures exchange has the ability to enter into an offsetting contract on that exchange so that the enterprise is no longer obligated to receive a physical delivery of the commodity. Similarly, the existence of brokers who stand ready to buy and sell commodity contracts that relieve the enterprise of its rights and obligations under the contract for a non-prohibitive fee also constitutes an established market mechanism. In contrast, an off-exchange contract to sell

the purchased commodity to a third party would not result in settlement net since this does not relieve the enterprise of its rights and obligations under the original contract.

199. A side agreement for delivery to a third party, at which time the contracting parties settle payment, does not constitute settlement net of the original contract. The fact that delivery is to a third party does not affect the original contract between the purchaser and the supplier.

200. The existence of a clause stipulating that in the event of non-performance a penalty or other cost will be payable in an amount that is fixed at the inception of the contract does not constitute settlement net by a financial instrument. However, a payment that is directly based on changes in the price of the items that are the subject of the contract does constitute settlement net by a financial instrument, unless there is an additional penalty or other cost that is prohibitive. The presence of a nominal handling fee, in addition to the settlement payment, would not be considered to be a prohibitive penalty or cost.

201. A penalty or other cost is considered prohibitive if it is an amount that is expected to be significant enough throughout the remaining term of the contract to make the possibility that the non-financial item will not be delivered remote. The assessment of whether a penalty or other cost is prohibitive would be carried out only at the contract's inception.

202. A requirement that one or both parties to a contract may assign its rights or obligations to a third party only after obtaining permission from the counter-party does not, of itself, preclude the contract from meeting the criteria for settlement net. An assessment of the substance of the assignment clause is necessary. If the chance that the counter-party will withhold permission to assign the contract is remote, the mere existence of the clause would not preclude the contract from meeting the criteria for settlement net. However, if there is more than a remote chance that the counter-party will withhold permission to assign the contract, it is precluded from meeting the criteria for settlement net.

203. If parties to a contract agree to settle net subsequent to the contract's inception, the contract would be accounted for in accordance with this Draft Standard from the time such an agreement is made. An enterprise would also consider what effect this has on its policy for normal purchases or sales (see paragraph 206, below).

Normal Purchase or Sale

204. Except as noted in paragraph 205, a contract meets an enterprise's normal purchase or sale requirements if it provides for the purchase or sale of a non-financial item that will be delivered in quantities expected to be used or sold by the reporting enterprise over a reasonable period in the normal course of its business. In such circumstances, an enterprise would account for that contract in accordance with accounting standards applicable to the non-financial item. An enterprise would have a consistent policy in place for concluding that a contract meets these conditions. This policy need not specify each individual contract

to which it relates but would be stated in a manner such that it is clear at the inception of any contract whether that contract is for such purposes.

205. The following contracts are not considered to be for normal purchase or sale requirements:

(a) a contract that requires periodic cash settlement of changes in value or that is otherwise settled net periodically, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a non-financial item;

(b) a contract that will probably be settled net;

(c) a contract containing an option enabling the counterparty to force net cash settlement. In such circumstances, the enterprise would not have the ability to ensure delivery;

(d) a contract that has a price based on changes in the fair value of a variable that is unrelated to the item being sold or purchased (such as an equity index);

(e) a contract denominated in a foreign currency that is neither the currency of the primary economic environment in which any substantial party to the contract operates, nor the currency in which the price of the non-financial item that is acquired or delivered is routinely denominated in international commerce (for example, the US$ for crude oil transactions); and

(f) a contract for delivery of a non-financial item, with immediate repurchase or sale, and a contract settled by offsetting with the same counterparty (sometimes referred to as a "bookout"), unless the enterprise's business is that of buying or selling non-financial items (for example, a commodity trader).

206. Management's purpose in entering into a contract for physical delivery to meet the normal purchase or sale requirements of the enterprise would be evident from the nature of its business operations and its purchase and sale practices within current business conditions. If an enterprise settles net contracts that it has previously treated as being for normal purchases or sales, or settles net contracts with similar terms and conditions, this would call into question whether future contracts of a similar nature are for normal purchases or sales.

207. A contract that otherwise meets the characteristics of a normal purchase or sale but that requires delivery to a third party does not of itself preclude an enterprise from treating that contract as a normal purchase or sale.

Servicing Assets and Servicing Liabilities [see Draft Standard, paragraph 2(b)]

208. Servicing of financial assets includes collecting principal, interest, fees, expected late charges, escrow payments and ancillary charges from borrowers; paying taxes and insurance from funds held in escrow; monitoring delinquencies; executing foreclosures if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting payments to holders of beneficial interests in the financial assets.

209. Servicing assets or servicing liabilities arising on the origination of financial assets would be included on the balance sheet as part of the asset being serviced and would not be recognised separately until the financial asset is derecognised, in whole or in part. An enterprise that undertakes a contract to service financial assets that are not recognised in its financial statements would recognise a separate servicing asset or servicing liability.

210. Contractual rights of a servicer to receive an interest-only strip, or other cash flows from the serviced asset, in excess of contractually specified servicing fees need not be recognised and measured separately from the servicing asset or servicing liability, given that both will be measured at fair value. However, the servicer may wish to present them separately for a number of reasons. For example, there may be regulatory reasons for reporting those items separately.

Leases

211. To determine how the Draft Standard applies to contractual rights and obligations arising from leases, an enterprise considers whether there are sets of rights and obligations within the lease contract that need to be separated in accordance with the Draft Standard's requirements for hybrid contracts (see paragraphs 4-6). The enterprise applies standards for lease accounting[12] to determine whether it must recognise any financial assets or financial liabilities. The Draft Standard is applied only to financial assets and financial liabilities recognised in accordance with the requirements for hybrid contracts or those for lease accounting. Thus, when an enterprise accounts for a lease contract as a finance lease, the lessor's receivable from the lessee and the lessee's liability to the lessor are financial instruments and, therefore, are subject to the requirements of this Draft Standard.

212. An unguaranteed residual value taken into account in determining a lessor's finance lease receivable is not a financial instrument. It would, therefore, be accounted for separately from the finance lease receivable in accordance with the requirements for hybrid contracts in paragraphs 4-6 and 74-76. A guarantee by a lessee to a lessor of a specified residual value of a leased asset that arises from a lease accounted for as a finance lease would be

[12] The IASC requires leases to be accounted for in accordance with IAS 17, Leases.

recognised and measured as part of the financial instrument, in accordance with this Draft Standard.

213. Lease payments might be contingent on the future use of leased property. For example, the amount of lease payments on a retail store might depend on future sales volumes. Such rights and obligations are excluded from the scope of the Draft Standard by paragraph 1(g).

Recognition and Derecognition

Recognition

Forward Contracts and Other Executory Contracts

214. When an enterprise enters into an agreement to purchase a financial asset at a future date, it does not immediately have the asset that is the subject of the contract. Instead, it has a contractual right to obtain the asset that is conditional upon performance by the counterparty. Similarly, until it obtains the asset, it does not have a contractual obligation to pay for it, merely an obligation that is again conditional upon performance by the counterparty. In other words, it has a forward purchase contract—a contractual commitment to purchase a specified financial instrument on a future date at a specified price in exchange for a payment. Therefore, as the recognition principles set out in paragraph 31 require an enterprise to recognise contractual rights as a financial asset only when it actually has those rights, the enterprise will not recognise the asset that is the subject of the contract until it has obtained the asset. Similarly, as the recognition principles set out in paragraph 31 require an enterprise to recognise contractual obligations as a financial liability only when it has those obligations, the enterprise's obligation to pay for the asset will not be recognised until it is actually assumed.

215. A forward purchase contract is an example of a financial instrument that is an executory contract. The conditional rights and obligations that arise from financial instruments that are executory contracts will usually be recognised as a single asset or liability rather than as separate financial assets and financial liabilities.

216. The terms of executory contracts are often negotiated so that, at first, the fair values of the conditional rights and obligations underlying an executory contract will be equal, so that the fair value of the contract as a whole at that date is zero. Subsequently, the balance between the fair values may change, so the fair value of the contract may become positive (which would mean that the contract is an asset) or negative (meaning the contract is a liability).

Regular Way Security Transactions

217. A regular way security transaction is a transaction that involves the purchase or sale of a financial asset on terms that require its delivery, and therefore completion (or settlement) of the transaction, within the period established by regulations and conventions in the market place or by the exchange on which the transaction is executed. A regular way security transaction therefore involves acquiring a forward contract. Parties entering into such a transaction will initially recognise, as a single asset or liability, just the contractual commitment involved. Then, on delivery, the acquirer will recognise the security

purchased as a financial asset and the obligation to pay for the security as a financial liability.[13]

Security Interests

218. Another example of a financial instrument that involves conditional contractual rights and obligations is a security interest. A security interest arises if one party (the obligated party) gives another party (the secured party) rights to a financial asset—and perhaps some related obligations—that are wholly contingent on the obligated party defaulting on an obligation to the secured party. Those rights and obligations may include the ability of the secured party, upon default, to do one or more of the following:

(a) compel the sale of the financial asset to satisfy the liability, generally with any surplus being returned to the obligated party;

(b) acquire the financial asset and pass any value in excess of the liability to the obligated party; or

(c) relinquish the security interest in return for the obligated party's settlement of the liability.

219. The holder of a security interest in a financial asset does not have the asset in which the security interest has been given since, absent default and a resultant claim on the item, it does not have the contractual rights that make up the financial asset. Nor does the holder have the related obligations. It follows that, prior to default, the holder of a security interest recognises the rights conveyed by the security interest, together with the obligations that would arise if those rights were exercised, as a single item. Usually it would in fact be treated as part of the asset secured by that interest. Similarly, a granter of a security interest (the creditor) would recognise the interest as part of the liability secured.

Hybrid Contracts

220. In determining the recognition or derecognition treatment of a hybrid contract, an enterprise would apply the recognition and derecognition principles of the Draft Standard only to the parts of the contract that are within the scope of the Draft Standard. It would look to other relevant principles to determine the treatment of the rest of the contract.

Description Given to Assets and Liabilities on the Balance Sheet

221. Choosing the description (or label) to be applied on the balance sheet (or in the notes to the financial statements referenced from the balance sheet) to assets and liabilities is an

[13] In reality, as completion often takes the form of delivery against payment, the payment itself, rather than a liability, will usually be recognised.

important part of the recognition process. That is particularly true when the assets or liabilities involved are unusual in nature, are complex, or are connected in some way to other assets and liabilities, as will often be the case with assets and liabilities arising from transfers involving financial assets. That is because it will be the descriptions used, together with any other information provided in the notes to the financial statements, that inform users of the nature of the asset or liability involved. Therefore, in providing any sub-analysis of the balance sheet information required by paragraphs 131-135 (or of any analysis required by those paragraphs to be provided either in the balance sheet or the notes to the financial statements), it is important that assets and liabilities are appropriately labelled.

Transfers That Have Substance

222. As set out in paragraph 35, a transfer that lacks substance has no effect on the contractual rights and contractual obligations of the parties involved and is therefore not a recognition or derecognition event.

223. In a securitisation, the transferee is often an enterprise created solely for the purpose of the transaction and will therefore typically not conduct substantial business with parties other than the transferor. However, such securitisation transactions will still result in an eligible recognition or derecognition event if the financial assets (or components thereof) transferred have been isolated from the transferor, even in the event of the transferor's bankruptcy.

Derecognition

Components of Financial Assets and Financial Liabilities

224. Financial assets and financial liabilities are made up of bundles of contractual rights and contractual obligations that are financial assets and financial liabilities in their own right. The Draft Standard calls those contractual rights and obligations "components".

225. Financial instruments usually have a number of components. Some will be the contractual rights to future economic benefits or contractual obligations to transfer economic benefits that make up the financial instrument. The rest will be rights and obligations related to the economic benefits. Examples of this second type of component include:

    (a) the right to continue to hold the contractual rights to future economic benefits;

    (b) the obligation to transfer future economic benefits (i.e., a forward contract);

    (c) the right to exchange (including sell or pledge) or distribute the economic benefits or the obligation not to;

(d) the right to use a contractual right to settle a liability; and

(e) the right to acquire the economic benefits or the obligation to transfer them if requested to do so (i.e., an option held or written).

226. Some components of a financial asset or financial liability might expire before the other components. Similarly, some components of a financial asset might be transferred while others are retained, or some components of a financial liability might be settled while others remain outstanding. The derecognition principles in paragraph 37 recognise this by focussing on extant contractual rights and contractual obligations, rather than on assets and liabilities.

Obtaining Release from Primary Responsibility for an Obligation

227. An enterprise will derecognise a liability only when the obligation involved expires, the liability is settled in full, or the enterprise has obtained release from the primary responsibility for the obligation. Although an enterprise could enter into an arrangement that involves a third party agreeing to assume its liability to the creditor, that arrangement would have no effect on the first enterprise's liability unless the creditor also agreed to release it from the primary responsibility for the obligation. As such, transferring an obligation is not a derecognition event absent obtaining release from primary responsibility for that obligation.

228. A debtor may transfer assets, with cash flows of timing and amounts equivalent to the liability owed, to a third party and instruct that third party to pay the cash flows collected on the assets to the creditor to settle the liability (an arrangement that is sometimes called "in-substance defeasance"). The Draft Standard does not permit the liability to be derecognised when the assets are transferred to the third party because the debtor is not relieved of its primary obligation to the creditor.

229. An enterprise will be released from primary responsibility for the obligation underlying a debt instrument if it purchases it in the market, regardless of whether the debt instrument is cancelled or held for re-issue. That is because, in such circumstances, honouring the instrument will not result in any outflow of net assets from the enterprise.

230. In some transactions, an enterprise is released from its primary responsibility for a liability under an arrangement in which it guarantees the performance of the enterprise that has taken on primary responsibility for the liability. In other words, it has accepted an obligation to pay if the enterprise assuming the primary responsibility defaults. In such circumstances, the enterprise will derecognise the original liability and recognise the guarantee as a new liability.

Derecognition and Consolidation

231. The derecognition requirements set out in the Draft Standard are not intended to alter the requirements of consolidation standards. Whether a parent enterprise would derecognise a transferred financial asset in its unconsolidated financial statements and whether the transferee in that transaction would be included within the scope of any consolidated financial statements prepared by that parent enterprise are separate issues. Only the former issue is addressed in the Draft Standard. It follows that a transfer between a parent enterprise as transferor and one of its subsidiaries as transferee could result in a financial asset being derecognised in the parent's separate (unconsolidated) financial statements but not being derecognised in the parent's consolidated financial statements.

Transfers involving Financial Assets

Introduction

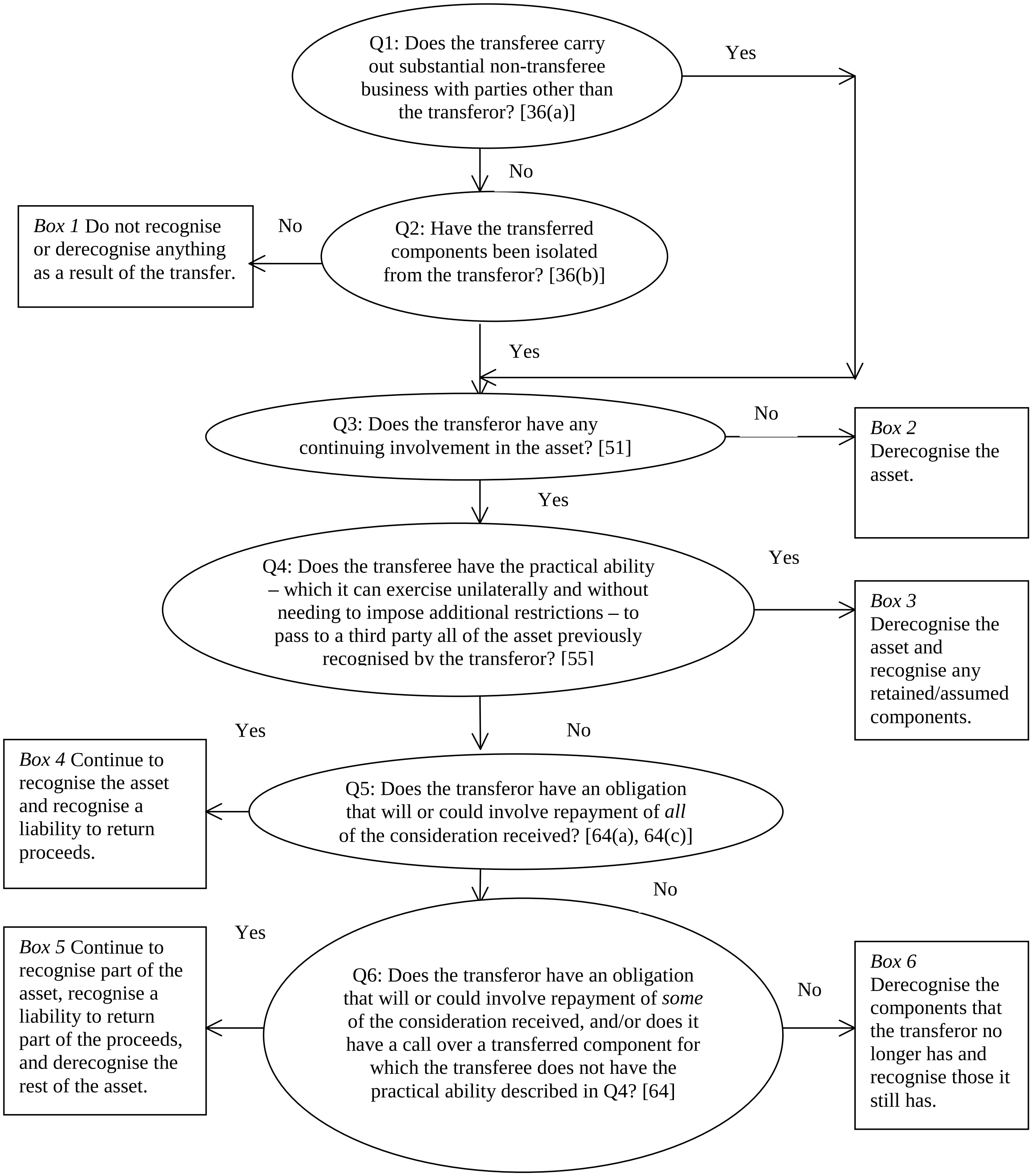
232. Paragraphs 49-68 set out the recognition and derecognition principles that would be followed by *transferors* that are accounting for transfers that have substance and involve financial assets. *Transferees* are required to follow the recognition principles set out in paragraph 31. Paragraphs 233-314 provide additional guidance on the accounting to be adopted both by transferors and by transferees.

233. Many transfer transactions involve an exchange of financial assets. Where that is the case, each transferor would apply paragraphs 49-68 separately to each transfer. For example, if Enterprise A transfers an equity security to Enterprise B and receives in return a government security, Enterprise A (the transferor in the equity transfer) will apply paragraphs 49-68 to the transfer of the equity security and Enterprise B (the transferor in the government security transfer) will apply those paragraphs to the transfer of the government security. If more than two financial assets are involved, the paragraphs will need to be applied separately to each financial asset.

Summary of the Transferor's Accounting

234. The approach to recognition and derecognition that paragraphs 49-68 require a transferor to adopt can be summarised as follows[14]:

[14] References to the Draft Standard are provided in square brackets.


Q1: Does the transferee carry out substantial non-transferee business with parties other than the transferor? [36(a)]
Yes
No
Q2: Have the transferred components been isolated from the transferor? [36(b)]
No
Box 1 Do not recognise or derecognise anything as a result of the transfer.
Yes
Q3: Does the transferor have any continuing involvement in the asset? [51]
No
Box 2 Derecognise the asset.
Yes
Q4: Does the transferee have the practical ability – which it can exercise unilaterally and without needing to impose additional restrictions – to pass to a third party all of the asset previously recognised by the transferor? [55]
Yes
Box 3 Derecognise the asset and recognise any retained/assumed components.
No
Q5: Does the transferor have an obligation that will or could involve repayment of *all* of the consideration received? [64(a), 64(c)]
Yes
Box 4 Continue to recognise the asset and recognise a liability to return proceeds.
No
Q6: Does the transferor have an obligation that will or could involve repayment of *some* of the consideration received, and/or does it have a call over a transferred component for which the transferee does not have the practical ability described in Q4? [64]
Yes
Box 5 Continue to recognise part of the asset, recognise a liability to return part of the proceeds, and derecognise the rest of the asset.
No
Box 6 Derecognise the components that the transferor no longer has and recognise those it still has.

Clean-up Call Options

235. Sub-paragraph 50(b) explains that call options of the type commonly referred to as "clean-up call options", which usually arise in the context of securitisations, would be ignored when determining which contractual rights and contractual obligations to recognise and which to derecognise. All references to options in the Draft Standard and Application Supplement are, unless stated otherwise, references to options other than clean-up options.

What is an Asset?

236. As most financial assets (and most financial liabilities) are capable of being unbundled into "smaller" assets (and liabilities) or components, it is not usually necessary to draw a distinction between an asset and a part of an asset; even a part of an asset will also be an asset in its own right. Similarly, no distinction usually needs to be drawn between an asset and a collection (or portfolio) of assets. However, the issue *is* of significance in the context of the questions asked in paragraphs 51 and 55 about financial assets that are the subject of a transfer. In particular, paragraph 51 asks whether the transferor has a continuing involvement in the financial asset that is the subject of the transfer and was previously recognised by the transferor. In this context, the identification of the asset "that is the subject of the transfer and was previously recognised by the transferor" is of considerable importance. Similarly, paragraph 55 asks whether the transferee has the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer the whole of the financial asset previously recognised by the transferor to a third party. Again, the identification of "the financial asset previously recognised by the transferor" is central to this question.

237. A loan of, say, $100 to a single debtor is clearly one asset, not one hundred assets. However, bearing in mind that financial assets comprise components that are themselves financial assets, it is not always such a simple matter to determine what is an asset (as opposed to a collection of assets, or a part of an asset) for the purposes of questions asked by paragraphs 51 and 55. The following (which uses loan assets as an example) is intended as guidance in more complex situations.

   (a) If the transfer involves a portfolio of loan assets, it will usually be appropriate to treat each loan asset as a separate asset. Therefore, if an individual loan asset has been transferred from the portfolio, the transferor does *not* have a continuing involvement in the asset previously recognised by the transferor even though it continues to hold the rest of the portfolio. Furthermore, if the transferee has the ability to transfer that loan asset to a third party, it *would* have the ability to transfer the asset previously recognised by the transferor *in its entirety*, as referred to in paragraph 55.

(b) If an interest in the portfolio as a whole is transferred, the portfolio, rather than the individual loan assets within that portfolio, is the asset for the purposes of the recognition and derecognition principles in the Draft Standard. Thus, a transferor of an interest in a portfolio of loan assets that retains, say, a residual interest *does* have a continuing involvement in the asset that it previously recognised. Similarly, even if the transferee has the ability to transfer its interest in the portfolio to a third party, it does *not* have the ability to transfer the asset previously recognised by the transferor *in its entirety* (i.e., the whole portfolio) because it is not able to transfer the part of the portfolio it does not have (i.e., the interest retained by the transferor).

(c) A common unbundling transaction is one in which an enterprise separates an interest-bearing debt security into two cash flow streams—the right to the interest payments only (the interest-only (IO) portion) and the right to the principal payments only (the principal-only (PO) portion). Then one portion (the IO portion for example) might be transferred and the other portion retained. As the transferor has retained the PO portion, it has a continuing involvement in its previously recognised asset. Similarly, even though the transferee may have the practical ability to transfer the IO portion to a third party, it does not have the practical ability to transfer the PO or, therefore, the transferor's previously recognised asset. (IO and PO strips are discussed further in paragraphs 284-287.)

Summary of the Transferee's Accounting

238. Although transferees are required to follow the recognition principles in paragraph 31 rather than those in paragraphs 49-68, their accounting will, with one exception, be the mirror image of the transferor's accounting. In other words, if the transferor is required to derecognise a particular financial asset or component thereof, the transferee will be required to recognise it, and if the transferor is required to continue recognising a particular financial asset or component, the transferee will not be permitted to recognise it. The one exception arises in paragraphs 63-67 (in other words, questions 5 and 6 in the flowchart in paragraph 234), which address the type of transfers that result in the transferor having either (or both) an obligation to repay consideration received and a call option over a transferred component. The transferor treats such a transfer as a loan secured by a financial asset or in some cases as part sale, part loan, whereas the transferee will treat such a transfer as the acquisition of the transferred asset.

239. The implications of this exception can be illustrated by considering a transfer of a security (Security X) that:

(a) does not result in the transferee having the practical ability to transfer the whole of Security X to a third party, and

(b) includes a forward contract that will require the transferor to repay all the consideration received (and, in exchange, receive back all of Security X).

Under paragraphs 63-67, the transferor is required to continue to recognise Security X and to recognise the consideration received and a liability to repay the whole of that consideration. The mirror-image of this would be for the transferee to recognise a receivable from the transferor for the amount of consideration paid (and to reduce its cash balances by that amount). However, the transferee, under paragraph 31, recognises Security X as its asset and a forward contract to exchange Security X for cash at a date in the future (as well as a reduction in its cash balances).

240. Paragraph 221 emphasised that an important part of the recognition process is the way in which an asset or liability is described or labelled on the balance sheet or in the notes to the financial statements referenced from the balance sheet. For example, in the case of the transaction described in the preceding paragraph:

(a) although Enterprise A is required to continue to recognise Security X, the nature of that asset has changed and it is important that the label used reflects that. Enterprise A will therefore use a label such as "security transferred subject to a repurchase agreement"; and

(b) although the transferee is also required to recognise Security X, the asset recognised will be described in terms such as "security held subject to a resale agreement".

241. Thus, in this example, although the accounting entries in paragraph 239 seem to suggest that both parties to the transaction will recognise the same asset, the labels used to describe the assets will highlight the differences. The same point could be made in the context of a number of other transactions discussed in the Application Supplement but, to avoid repetition, it is made here only.

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party

The Transferor's Previously Recognised Asset or a Transferred Component

242. The recognition and derecognition principles relating to transfers involving financial assets contain two principles that, although seeming similar, differ in important ways.

(a) Paragraph 55 asks whether the transferee has the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer the financial asset that was previously recognised by the transferor to a third party *in its entirety*.

(b) Sub-paragraph 64(b) asks whether the transferee has the practical ability to transfer some or all of the transferred components it acquired to a third party unilaterally and without having to impose additional restrictions.

243. Paragraph 55 focuses on the asset previously recognised by the transferor, and on the whole of that asset. In contrast, sub-paragraph 64(b) focuses on the components transferred and requires each to be considered in turn. For example, if an enterprise transfers part of an asset but retains the rest of it the following will be the case.

(a) The transferee will usually not have the ability to transfer to a third party the whole of the asset previously recognised by the transferor (in other words, the answer to the question asked by paragraph 55 will be "no"). The purpose of paragraph 55 is to identify transactions that do not need to be analysed in detail because it is clear that control of the whole asset has passed to the transferee. In our example, it is not clear that that has happened.

(b) The transferee may still have the ability to transfer some or all of the components transferred to it (in other words, the answer to the question asked by sub-paragraph 64(b) may still be "yes"). The purpose of sub-paragraph 64(b) is to consider whether, although control of the whole asset appears not to have been passed to the transferee, control of some of the transferred components has been passed.

"Practical Ability", "Unilaterally" and "Additional Restrictions"

244. Paragraph 55 and sub-paragraph 64(b) refer to the transferee having the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer a financial asset. Paragraphs 56-61 explain in greater detail the implications of these references to "practical ability", "unilaterally" and "additional restrictions". In particular, those paragraphs explain that the focus is not just on what contractual rights the transferee has with respect to the asset (or indeed what contractual prohibitions exist) but on what the transferee is able to do in practice. A contractual prohibition on disposing of an asset (or the absence of an explicit contractual right to dispose of it) may have no effect on the transferee's practical ability if it is easy to obtain identical replacement assets. On the other hand, a contractual right to dispose of the asset is of no practical use if it cannot be exercised freely or if there is no market for the asset. For that reason, paragraph 55 and sub-paragraph 64(b) ask whether:

(a) the transferee is able to dispose of the asset independently of the actions of others—in other words, whether it has a unilateral ability. An apparent ability to dispose of something is not a practical ability if another party can prevent its being used; and

(b) the transferee is able to dispose of the asset without needing to attach restrictive conditions or "strings" to the transfer (for example, conditions as to how a loan asset is serviced or an option to repurchase the asset).

Replacement Assets

245. As explained in the preceding paragraph, in considering the practical effect of any restrictions relating to the transferee's ability to transfer the assets to a third party, the ease with which replacement assets can be obtained is often an important factor. In essence, the issue is whether the transferee might find itself in default of any commitments or obligations to the transferor if it transfers the asset to a third party without attaching any restrictions to that transfer. For example, assume that a transferee has written a call option enabling the transferor to insist on the return of a transferred asset that is unique (and therefore irreplaceable). In such a circumstance, the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party without attaching a call option or forward purchase contract because, if the transferor exercises the call option, the transferee may be unable to get back the asset in order to deliver it to the transferor. The existence of the call option means that the transferee is not free to transfer the asset without restrictions.

246. It may be that, although the assets involved may not be capable of being easily replaced, because of market convention, other established practice or an express or implied term of the transaction, it is possible to be reasonably certain that an asset that is not identical to the asset transferred will be considered by the transferor to be an acceptable replacement for the transferred asset. If that is the case, a call option of the type described in the preceding paragraph will not prevent the transferee from transferring the asset.

Options that are Virtually Certain to be Exercised or Not to be Exercised

247. Sub-paragraphs 59(a) and (b) set out two circumstances in which the transferee will not have the practical ability to transfer the asset involved in the transfer to a third party without imposing additional restrictions on that transfer if replacement assets are not readily available:

(a) when the transferor has a call option over the asset, unless it is virtually certain that the transferor will not exercise that option; and

(b) when the transferee has a put option over the asset and it is virtually certain that the transferee will exercise that option.

Whether it is virtually certain that an option will, or will not, be exercised is a matter of judgement based on the circumstances involved.

248. One very important factor in that judgement will be price. When price is the only issue, whether an option is virtually certain to be exercised or not exercised will depend on the expected value of the underlying at the exercise date relative to the strike price. However, it would not be necessary to undertake detailed assessments of the likely value at the exercise date.

(a) In the case of a call option, if there is a genuine possibility that the option could be in the money at the exercise date, it will usually *not* be appropriate to conclude that it is virtually certain that the call option will *not* be exercised. Similarly, in the case of a put option, if there is a genuine possibility that the option could be out of the money, it will usually *not* be appropriate to conclude that it is virtually certain that the put option will be exercised.

(b) A call option may be so deep in the money at the transfer date that there is no genuine possibility that it will be out of the money at the exercise date. Similarly, a put option may be so out of the money at the transfer date that there is no genuine possibility that it will be in the money at the exercise date.

249. Other factors apart from price will also need to be taken into account in the assessment. For example, an asset underlying a call option may be one that, because of the nature of the option holder's activities or the way in which it operates, it would wish to reacquire even if the reacquisition cost appears higher than its market value to other potential buyers at that time.

Transferor's Continuing Involvement in an Asset the Transferee is Able to Transfer

250. Even though the transferee has the practical ability to transfer the asset previously recognised by the transferor in its entirety to a third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions, the transferor may still have a continuing involvement in the asset. That would be the case, for example, if one or other party has an option over a transferred asset that is easily replaceable or if a forward agreement had been entered into in respect of such an asset. Paragraph 55 requires paragraph 31 to be applied to the recognition of such continuing involvement.

Transfers Where the Transferor Has an Obligation to Repay Consideration Received or a Call Option over a Transferred Component

251. Paragraphs 63-67 identify the transfers involving financial assets that are to be treated by the transferor in whole or in part as loans secured by the transferred financial asset. Such transfers are transfers that meet all of the following criteria in the Draft Standard:

(a) the transfer has substance;

(b) the transfer leaves the transferor with a continuing involvement in the financial asset;

(c) the transferee does not have the practical ability to transfer the asset previously recognised by the transferor in its entirety to a third party or, if it does have that ability, it is not able to exercise that ability unilaterally or without needing to impose additional restrictions on the transfer;[15] and

(d) the transfer results in the transferor having either an obligation that could involve it repaying some of the consideration received or a call option over a component that is not at the disposal of the transferee to transfer to a third party.

252. Paragraph 64 prescribes how to determine the initial measure of the liability to be recognised. In essence, it will be:

(a) the maximum amount of the transfer consideration the transferor could be required to repay under any obligation that meets the criteria referred to in sub-paragraph 251(d); plus

(b) the amount of the transfer consideration received by the transferor in respect of any transferred component over which the transferor has a call option meeting the criteria referred to in sub-paragraph 251(d);

(c) adjusted to eliminate the effect of any overlap between the obligation and the call option.

Any transfer consideration that is not to be treated as having been received in the form of a loan will be sale proceeds received in exchange for the sale (in whole or in part) of the transferred asset.

253. The following example illustrates certain of the determinations that follow from these requirements. Assume Enterprise A (the transferor) holds a portfolio of receivables with a fair value of 90. It enters into a bankruptcy remote factoring arrangement[16] with Enterprise B (the transferee) that involves Enterprise B giving 80 of cash to Enterprise A in exchange for the rights to the first 80 of fair value[17] collected from the receivables. Enterprise A

[15] The similarities and differences between this test and the similarly worded test in paragraph 55 are discussed in paragraphs 242 and 243.

[16] Factoring arrangements are discussed in greater detail in paragraphs 294-304, and this particular transaction is discussed in paragraphs 302-304.

[17] Enterprise B will require rights to more than 80 of cash for it to receive a fair value return from the transaction, since the receivables will be collected over time. In practice, the agreement would typically specify that, from the cash collected from the receivables, Enterprise B would be entitled to 80 plus interest to be determined at a stipulated rate. However, the example has been simplified by incorporating the effect of both interest and the time value of money into Enterprise A's guarantee that Enterprise B will receive 80 of fair value from the receivables. Otherwise, details of interest rates and the timing of individual cash flows would have to be provided. These details are not germane to the concepts being illustrated, since the principle is that the amounts recognised will be fair values determined after taking these factors into account.

retains the right to any cash collected from the receivables in excess of that amount, and it also agrees to make good the first 5 fair value of Enterprise B's losses if less than 80 of fair value is collected from the receivables.

254. In accordance with the Draft Standard, the transaction would be analysed as follows.

(a) As the factoring arrangement is bankruptcy remote, the transfer transaction has substance. The existence of the guarantee means that Enterprise A has a continuing involvement in the entire asset (i.e., the portfolio), so the conditions for derecognition set out in paragraph 51 are not met. Its existence also means that the transferee is not able to transfer the entire asset to a third party, so the conditions for derecognition set out in paragraph 55 are not met either. The existence of the guarantee means that Enterprise A has an obligation that could involve it in repaying some of the consideration received. In other words, the transfer meets all the criteria referred to in paragraph 251, so the transfer involves, at least in part, a loan.

(b) Enterprise A's maximum fair value exposure under the obligation is 5 at the date of the transfer, so (in accordance with paragraph 64) it would recognise a liability to repay 5 of the cash it received. It will treat the other 75 of cash received from Enterprise B as sale proceeds, and will, therefore, continue to recognise an interest in the receivables (being an interest in all the cash collected from the receivables after the first 75 of fair value has been collected) of 15.

255. So, Enterprise A retains an interest in the receivables with a fair value of 15 (not 10), although the first 5 of fair value received from this retained interest will be paid to Enterprise B to settle the liability of 5. If less than 5 of fair value is collected from the interest in receivables, Enterprise A will pay the balance from its general assets. The expectation is, however, that that will not be necessary.

256. In accordance with the Draft Standard (i.e., as described in paragraph 255), Enterprise A has an obligation to make a payment to Enterprise B (of up to 5 of fair value) from its general assets if insufficient monies are collected from the receivables. Enterprise A, therefore, is considered to have control of the receivables involved, so will recognise them (fair value 5) and the liability that is expected to be met from their proceeds (fair value 5), in addition to its other interest in the receivables (fair value 10).

257. The assets and liabilities recognised as a result of the transfer transaction will be measured at fair value like other financial instruments. It is likely that the fair value of the assets and liabilities recognised in the above example will be estimated using valuation techniques.

(a) The fair value of the receivables would typically be based on the present value of the expected cash flow streams involved. The fair value of Enterprise A's interest in the receivables will be calculated as the present value of the cash receipts, taking into account the expected timing, the uncertainties and other risks involved, and after deducting Enterprise B's entitlement to 80 of fair value from the collections.

(b) The liability of 5 (fair value) is expected to be settled in full from Enterprise A's interest in the receivables. Enterprise A's credit worthiness would be factored into the fair value of the liability only to the extent of the probability that the fair value of its residual interest in the receivables will be less than 5 (the fair value of the recourse liability), so that it will be required to make a payment to Enterprise B from its general assets.[18]

(c) Cash collections from the portfolio of receivables will change the fair value of the transferor's residual interest only to the extent that the receivables perform differently from what was originally anticipated in estimating their fair value. Similarly, the fair value of Enterprise A's liability will not change, assuming that Enterprise B's entitlement to interest specified in the transfer agreement continues to be a market return for such an investment. For example, if these assumptions are accurate, up to and including when 75 of fair value has been collected from the receivables, Enterprise A will still have an interest in receivables of 15 and a liability of 5. Cash collected thereafter will reduce the fair value of both the receivables and liability until, when 80 in fair value has been collected, the liability will be extinguished.

258. Furthermore, for the purposes of the Draft Standard's income statement presentation principles, the gains and losses arising on the assets and liabilities recognised in the above example will be determined and presented in the same way as gains and losses on any other receivables and payables. That means, for example, that they will be treated as interest-bearing assets and liabilities.

Application of the Recognition and Derecognition Requirements to Various Transfers involving Financial Assets

259. Paragraphs 260-314 below consider the implications of paragraphs 31-68 for various common types of transfers. It is assumed throughout that the transfer involved has substance.

Sale and Repurchase Arrangements

With Cash Collateral

260. Sale and repurchase arrangements can take many forms, but probably the simplest form is where an enterprise (Enterprise A):

[18] At the date of the transfer, there will be some small probability that less than 5 fair value will be collected from Enterprise A's interest in the receivables. The probability may change over time, depending on the performance of the receivables.

(a) transfers all the rights attaching to a security (Security X) to another enterprise (Enterprise B);

(b) receives in return a cash payment equal in amount to the fair value of the security at the time of the transaction; and

(c) agrees that, at a specified future date, it will give a cash payment (equal in amount to the cash payment originally received plus an amount that is equivalent to the current market rate of interest on that first cash payment) to Enterprise B in exchange for the return of the rights attaching to the security.

261. The existence of the forward repurchase agreement means that Enterprise A has a continuing involvement in the security (so paragraph 51 does not apply). However, it is not clear from the information provided in paragraph 260 whether the transferee (Enterprise B) has the practical ability to transfer to a third party all the components of the security and whether that ability can be exercised unilaterally and without the transferee needing to impose additional restrictive components on the transfer to a third party.

Transferee is able to transfer the security to a third party

262. Let us assume that Enterprise B *does* have the practical ability to transfer to a third party all the components of the security and that it is also able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. (Paragraphs 266 and 267 discuss the treatment to be adopted if this is not the case.) In these circumstances, paragraph 55 will apply and Enterprise A's (the transferor's) accounting will be as follows.

(a) It will derecognise the security in its entirety.

(b) It will recognise the other contractual rights and contractual obligations it has acquired in respect of the transferred security. Enterprise A has a right to acquire from Enterprise B the rights attaching to the security at a specified future date and an obligation to pay an amount of cash to Enterprise B in exchange. This right and obligation make up a financial instrument that is an executory contract (see paragraphs 214-216) and Enterprise A would recognise that contract in the balance sheet as a single asset or liability.

(c) The contractual rights and contractual obligations relating to the transferred security that Enterprise A will have will depend on the terms of the transaction involved. For example, it is not uncommon in such transactions for Enterprise B to agree to make cash payments to Enterprise A that are the same in amount as the dividends or interest it receives on the security. If that is the case, Enterprise A has a right to "manufactured dividends/interest receipts" which it would recognise as an asset.

263. The transferee (Enterprise B), on the other hand, will apply paragraph 31.

(a) It has all the contractual rights attaching to the security and would therefore recognise the security as an asset.

(b) It has a conditional right to receive a cash amount from Enterprise A at a specified future date and a conditional obligation to transfer the rights attaching to the security to Enterprise A in exchange. Like most financial instruments that are executory contracts, those conditional rights and obligations would be recognised in the balance sheet as a single asset or liability.

(c) It may also have an obligation to pay manufactured dividends/interest receipts to Enterprise A. The assumption of this obligation would usually not amount to a transfer of the right to the dividends/interest payments (see paragraphs 41-48), so that obligation would be recognised as a financial liability.

264. The treatment of the other "leg" of the transfer transaction (the cash that Enterprise B transferred to Enterprise A) is much simpler because the transferee (Enterprise A) is able to transfer it to a third party. Thus, Enterprise B derecognises the cash and Enterprise A recognises it.

265. To summarise, Enterprise A will derecognise the security in its entirety and will recognise instead the cash received, the forward purchase agreement and any right to manufactured dividends/interest payments. Enterprise B will reduce its cash balances by the amount paid to Enterprise A, and will recognise the security in its entirety, a forward sale agreement and any obligation to pay manufactured dividends/interest payments.

Transferee is not able to transfer the security on to a third party

266. Now assume that the transferee (Enterprise B) does not have the practical ability to transfer to a third party all the components of the security unilaterally without needing to impose additional restrictions on the transfer. (For example, the security may not be readily obtainable so, if Enterprise B transferred the security to a third party, it would have to impose restrictions on that transfer to ensure that it could honour its forward agreement with Enterprise A.) In these circumstances, paragraph 55 will not apply. However, the existence of the forward purchase agreement means that Enterprise A has an obligation that will involve the repayment of all of the consideration it received under the transaction. Paragraphs 64 and 65 thus apply, and Enterprise A would treat the transaction as a secured loan. It would therefore continue to recognise the security and would also recognise the cash received from Enterprise B and a liability to repay that cash.

267. Enterprise B (the transferee) would, on the other hand, apply paragraph 31. As already explained in paragraph 263, that means that it would recognise the security and a forward sale agreement and any obligation to pay manufactured dividends/interest payments (and would reduce its cash balances by the amount paid to Enterprise A).

With a Security Given as Collateral

268. In the sale and repurchase arrangement described in paragraph 260, Enterprise B transfers *cash* to Enterprise A in exchange for the rights attaching to the security (Security X). However, a common variant of this transaction is one in which Enterprise B transfers a *security* (Security Y)—rather than cash—to Enterprise A. Such a transaction involves two transfers and two transferors, so the requirements relating to the accounting treatment of transfers involving financial assets will need to be applied twice: to the transfer by Enterprise A of Security X, and to the transfer by Enterprise B of Security Y.

269. This has no effect on the accounting for Security X: the analysis described in paragraphs 260-267 will continue to apply. Exactly the same analysis will also be used to determine the treatment of Security Y. The key issue for both transfers will, therefore, be whether the respective transferees have the practical ability to transfer to a third party all the components of the security they have received and are able to exercise that ability unilaterally and without needing to impose additional restrictions on that transfer.

Both transferees are able to transfer the security they received to a third party

270. If the sale and repurchase arrangement involves the exchange of rights attaching to securities, typically both of the securities are actively traded and, therefore, easily replaced. As such, both transferees will usually have the practical ability to transfer the components received to a third party, unilaterally and without imposing additional restrictions on the transfer. In such circumstances:

   (a) Enterprise A would derecognise Security X in its entirety and would recognise Security Y in its entirety. Enterprise B would do the opposite: recognise Security X in its entirety and derecognise Security Y in its entirety; and

   (b) both enterprises would also recognise, as a single balance sheet item, the forward agreement to exchange Securities X and Y at a specified future date. They would also recognise any rights and obligations in respect of manufactured dividends/interest payments.

Only one transferee is able to transfer the security it received to a third party

271. In some sale and repurchase arrangements, only one transferee has the ability to transfer the security received as described in the preceding paragraph. For example:

   (a) Enterprise A transfers all the rights attaching to an *easily replaced* security (Security X) to another enterprise (Enterprise B) and receives in return all the rights attached to a security that is *not easily replaced* (Security Y).

(b) Enterprise A also agrees that, at a specified future date, it will give the rights attaching to Security Y back to Enterprise B in exchange for the return of the rights attaching to Security X.[19]

272. The existence of the forward agreement described in sub-paragraph 271(b) means that both transferors have a continuing involvement in the asset each transferred.

273. Security X is an easily replaced security, and transferees usually have the practical ability—which can be exercised unilaterally and without needing to impose additional restrictions—to transfer to a third party the whole of securities that are easily replaced. In our example, we will assume that the transferee of Security X (Enterprise B) does have that ability. That means that paragraph 55 applies. Enterprise A would therefore derecognise Security X in its entirety. Enterprise B (the transferee in the transfer involving Security X) will apply paragraph 31 and, as a result, would recognise Security X in its entirety.

274. Security Y is not an easily replaced security. In view of the forward agreement, this means that the transferee (Enterprise A) does not have the practical ability to transfer the security to a third party. Paragraph 55 would therefore not apply to this "leg" of the transfer. However, the existence of the forward means that the transferor of Security Y (Enterprise B) has an obligation that will involve the repayment of all the consideration it received for Security Y. Enterprise B is therefore required by paragraphs 64 and 65 to continue to recognise Security Y. It is also required to recognise a liability to Enterprise A to repay the consideration it has received under the transaction (i.e., Security X). Enterprise A (the transferee), applying paragraph 31, would recognise Security Y and would also recognise a forward agreement to exchange Security Y for Security X.

275. Therefore, to summarise:

(a) Enterprise A would derecognise Security X and would recognise Security Y and a forward to reacquire Security X in exchange for giving up Security Y.

(b) Enterprise B would continue to recognise Security Y and would recognise Security X and a payable (to be met by transferring Security X to Enterprise A in exchange for nothing other than the release from the obligation).

Stock Lending (Sometimes Called Securities Lending)

276. Although the motivation that lies behind a stock lending transaction differs from the motivation that lies behind most sale and repurchase arrangements and the transactions differ from sale and repurchase arrangements in form and sometimes in risk protection,

[19] There may also be rights and obligations relating to manufactured dividends/interest payments and to maintained collateral but, as they will not affect the accounting treatment of the two securities, they are ignored in this example.

they are similar in substance. The Draft Standard therefore does not distinguish between transactions that are stock lending and transactions that are sale and repurchase arrangements.

277. The analysis set out in paragraphs 260-275 in the context of sale and repurchase arrangements therefore applies equally to stock lending transactions.

(a) If Enterprise A transfers *an easily replaced* security to Enterprise B in exchange for cash under a stock lending agreement, Enterprise A would derecognise the security and instead recognise the cash, a forward contract to reacquire the security, and any rights to receive manufactured dividends/interest payments. Enterprise B, on the other hand, would reduce its cash balances and would recognise the security, a forward contract to return the security, and any obligations to pay manufactured dividends/interest payments (this treatment is explained in paragraphs 260-265).

(b) If Enterprise A transfers a security *that is not easily replaced* to Enterprise B in exchange for cash under a stock lending agreement, Enterprise A would continue to recognise the security and would also recognise the cash received and a liability to pay that cash back to Enterprise B. Enterprise B would reduce its cash balances by the amount paid out, and would recognise the security, a forward sale agreement and any obligation to pay manufactured dividends/interest payments (this treatment is explained in paragraphs 266 and 267).

(c) If Enterprise A transfers *an easily replaced* security (Security X) to Enterprise B in exchange for another *easily replaced* security (Security Y) under a stock lending agreement, Enterprise A would derecognise Security X and instead recognise Security Y together with a forward contract to exchange the securities. Similarly, Enterprise B would derecognise Security Y and instead recognise Security X together with a forward contract to exchange the securities (this treatment is explained in paragraph 268-270).

(d) If Enterprise A transfers *an easily replaced* security (Security X) to Enterprise B in exchange for a security *that is not easily replaced* (Security Y) under a stock lending agreement, Enterprise A would derecognise Security X and would instead recognise Security Y and a forward agreement to reacquire Security X in exchange for giving up Security Y. Enterprise B, on the other hand, would continue to recognise Security Y and would recognise Security X and a payable to Enterprise A (this treatment is explained in paragraphs 271-275).

Transfers Where the Transferor Retains a Call Option to Reacquire the Rights or the Transferee Retains a Put Option to Return the Rights

Call Options

278. Consider a transaction in which an enterprise transfers the rights attaching to a financial asset—say, a security—to another enterprise in exchange for cash. The transferor also acquires a call option that enables it to insist that the security be returned on a specified future date in exchange for a cash payment on that date.

    (a) The existence of the option means that the transferor has a continuing involvement in the security.

    (b) Whether the transferee will have the practical ability—which can be exercised unilaterally and without the need to impose additional restrictions on the transfer—to transfer all of the previously recognised components of the security to a third party will depend on the terms of the transaction and call option. It will also depend on the availability of replacement assets (if the transferee disposes of the security and the transferor then exercises its option to reacquire). Sub-paragraph 59(a) sets out the circumstances in which the call option will prevent the transferee from having the practical ability to transfer the asset.

279. Assume that the transferee does have the practical ability to transfer the security to a third party. In such a circumstance, the transferor will derecognise the security and recognise instead the cash received and the call option. Similarly, the transferee will reduce its cash balances by the amount it has paid and will also recognise the security and the call option written.

280. If the transferee does not have the practical ability (which can be exercised unilaterally and without the need to impose additional restrictions on the transfer) to transfer all of the previously recognised components of the security to a third party, the existence of the call option means that, under sub-paragraph 64(b) and paragraph 65, the transferor will continue to recognise the security and will also recognise the cash received from the transferee and a liability for the amount of the original transfer consideration received. The transferee will reduce its cash balances by the amount paid and will recognise the security and the call option written.

Put Options

281. Now consider a transaction in which an enterprise (the transferor) transfers the rights attaching to a financial asset to another enterprise (the transferee) in exchange for cash and the transferee also acquires the right to insist that the transferor takes those rights back on a specified future date in exchange for a cash payment on that date that is equal in amount to the consideration received by the transferor plus interest (a put option that the transferor

has written). The existence of the put option means that the transferor has a continuing involvement in the asset and also an obligation that could involve it repaying all the consideration received. As such, the key issue is again the one raised in sub-paragraph 278(b) above: does the transferee have the practical ability to transfer the asset to a third party unilaterally and without needing to impose any additional restrictions on the transfer. As was the case with the call option, this will depend on a number of factors, including the terms of the transaction and the option and the availability of replacement assets. Paragraph 59(b) sets out the circumstances in which the put option will prevent the transferee from having that ability. In those circumstances, the transaction is considered a type of sale and repurchase arrangement, so the discussion in paragraphs 260-275 will apply.

Transfers with Some or All Gains and Losses Passed Back to the Transferor

282. Consider a transaction in which an enterprise transfers some or all the rights attaching to a financial asset to another enterprise in exchange for a cash payment. The transferee also agrees to transfer to the transferor some or all of the gains arising from those rights (in other words, cash flows derived from the asset in excess of a specified amount), while the transferor agrees to reimburse the transferee for some or all of the losses arising from those rights (in other words, amounts by which the cash flows derived from the asset fall short of a specified amount).

283. The transferor clearly has a continuing involvement in the asset. Whether the transferee has the practical ability—which can be exercised unilaterally and without the need to impose additional restrictions on the transfer—to transfer the asset that was previously recognised by the transferor to a third party will therefore need to be determined. If it does have that ability, the transferor will derecognise the asset and will instead recognise the cash received and its rights and obligations in respect of gains and losses arising from the transferred asset. However, if the transferee does not have the practical ability to transfer the asset, the fact that the transferor has agreed to reimburse the transferee for some or all of its losses means that the transferor has an obligation that will or could involve the repayment of some or all of the consideration received. Therefore, at least part of the transfer will be treated as a loan.

Income and Principal Strips

284. Assume that an enterprise (the transferor) holds a debt security on which it receives two cash flow streams: an interest income stream and a repayment of principal stream. The transferor then transfers the rights to the interest income stream to a second enterprise (the transferee) in exchange for a cash payment. The transferor retains no continuing involvement in that cash flow stream. Assume, also, that the transferee is free to deal with the transferred asset (i.e., the interest income stream) in whatever way it chooses. The transferor's rights to the principal stream are unaffected by the transaction. (When cash

flow streams are separated in this way, they are commonly called interest-only (IO) and principal-only (PO) strips.)

285. Although the transferor does not have a continuing involvement in *the interest income stream*, it still has (as explained in sub-paragraph 237(c)) a continuing involvement in *its previously recognised financial asset* (i.e., the debt security as a whole) through its interest in the principal stream. As such, the conditions for derecognition set out in paragraph 51 are not met. Similarly, as also explained in sub-paragraph 237(c), although the transferee has the practical ability to transfer *the interest income stream*, it does not have the practical ability to transfer *the entire debt security*. Therefore, the condition for derecognition set out in paragraph 55 is also not met.

286. On the other hand, as the transfer has not resulted in the transferor having an obligation that might involve repaying some of the transfer consideration or a call option over the interest income stream, the conditions set out in paragraph 64 for treating some or all of the transaction as a loan are not met either. In such circumstances, paragraphs 31 and 37 will need to be applied, which means that the transferor will derecognise the interest income stream but continue to recognise the principal stream, while the transferee will recognise the interest income stream.

287. The example in paragraph 284 relates to the transfer of rights to an interest income stream. Although such transfers usually involve a change in the recipient of the cash flows involved (i.e., the transferor ceases to receive the cash flows and the transferee starts to receive the cash flows), another way of transferring the rights would be for the transferor to assume a contractual obligation of the kind described in paragraphs 41-48.[20]

Loan Transfers

288. Some kinds of receivables cannot be "sold" in the same way as other types of assets, but they can be transferred by means of novation, assignment or certain types of back-to-back arrangements.

(a) A novation involves the cancellation of the original lender's (the transferor's) rights and obligations under the loan agreement and the creation of identical rights and obligations for the transferee.

(b) Under an assignment, the original lender (the transferor) agrees with another enterprise (the transferee) to transfer its rights (to principal and interest payments) relating to the receivables to that transferee. There are different types of assignment. For example, some require the whole of the loan (rather than just part) to be involved

[20] The application of paragraphs 41-48 to sub-participations is addressed in paragraphs 309-312.

in the transaction; and some require notice of the assignment to be given to the borrower.

(c) With back-to-back arrangements, the lender (the transferor) enters into a non-recourse back-to-back agreement with a third party (the transferee), under which the latter deposits with the lender an amount equal to the whole or part of the loan and in return receives from the lender all or a share of the cash flows arising on the loan.

Novations

289. Under a novation, the transferor will have no continuing involvement in the receivables unless there is a side agreement involved, such as a guarantee or other form of recourse arrangement, a forward purchase agreement or option of one kind or another. If there is no such side agreement and therefore no continuing involvement, the transferor will derecognise the receivables in their entirety and the transferee will recognise them in their entirety.

290. If there is a side agreement, the accounting treatment will depend on whether the transferee has the practical ability—which can be exercised unilaterally and without imposing additional restrictions on the transfer—to transfer the receivables to a third party. Whether it has that ability will usually depend partly on the nature of the receivables and partly on the terms of the side agreement.

291. If the transferee does not have the practical ability to transfer the receivables to a third party unilaterally and without the need to impose additional restrictions on the transfer, the accounting treatment will depend on whether any of the terms of the side agreement mean that the transferor has either an obligation that will or could involve the repayment of some or all of the consideration received in exchange for effecting the novation or a call option over some or all of the receivables involved.

Assignments

292. Assignments may or may not leave the transferor with a continuing involvement in the receivables depending on whether there are any residual interests, recourse provisions, buyback provisions, etc. involved. This issue is discussed below in the context of debt factorings and securitisations, most of which involve an assignment.

Back-to-back Arrangements

293. As already explained, with back-to-back arrangements, the transferor enters into an agreement that involves accepting one or more contractual obligations that are equal and opposite to some of its existing contractual rights—and thereby effectively transferring those rights to another party. (Legally, all the contractual rights and obligations will remain

outstanding.) Such arrangements are considered in detail in this Application Supplement in the context of sub-participations (see paragraphs 309-312).

Factoring Arrangements

294. A factoring transaction involves one enterprise (Enterprise A) transferring rights to some or all of the cash collected from some financial assets (usually receivables) to a second enterprise (the factor, known here as Enterprise B) in exchange for a cash payment. In addition, Enterprise A may retain the right to cash collected from the financial assets in excess of a specified sum (i.e., a residual interest), and may guarantee—by one means or another—the performance of some or all of the receivables.

295. If Enterprise A has neither retained a residual interest in the receivables it previously recognised nor given a guarantee concerning their performance, it will have no continuing involvement in the receivables. In such circumstances, it will derecognise the receivables in their entirety and the transferee will recognise them in their entirety.

296. However, the transferor usually retains a residual interest in the receivables and, as such, has a continuing involvement. If that is the case, it will be necessary to determine whether the transferee is able to transfer the factored financial assets to a third party, unilaterally and without the need to impose additional restrictions on the transfer. Generally speaking, the transferee will *not* have that ability (because it is unable to transfer the residual interest that the transferor has retained).

297. Assuming that to be the case, the transferor's treatment of the transaction will be determined by considering the recourse arrangements involved and, in particular, by considering what, if any, obligation the transferor has as a result of those arrangements. The transferee, however, will in all cases recognise the contractual rights it has to cash flows, any guarantee it has received in respect of those rights and any obligation it has to the transferor in respect of the residual interest.

Factoring with No Guarantee Given as to Performance

298. Assume that Enterprise A has not given any kind of guarantee about the performance of the receivables (i.e., the receivables have been factored without recourse). An example of such a factoring transaction is as follows.

(a) Enterprise A has receivables with a fair value of 90.

(b) Enterprise A transfers the receivables to Enterprise B in exchange for 80 of cash and the right to any cash collected from the receivables in excess of 80 of fair value to which Enterprise B is entitled.[21]

(c) Enterprise A does not agree to make good any of Enterprise B's losses.

299. The transferor (Enterprise A) has not given any kind of guarantee about the performance of the receivables, so it does not have an obligation that will or could involve the repayment of some of the cash received from Enterprise B. Nor does it have any call option over the transferred components. In such circumstances, Enterprise A will be required by paragraph 68 to derecognise all the receivables and to recognise instead the cash of 80 and a residual interest in the receivables with a fair value of 10. Enterprise B will also apply paragraph 68 and will, as a result, reduce its cash balance by 80 and recognise receivables with a fair value of 90 and an obligation of 10 to Enterprise A for the residual interest.

Full Recourse Factoring (including Protection Against Catastrophic Loss)

300. Now consider a transaction that is identical to the transaction just discussed except that Enterprise A has agreed to reimburse Enterprise B in cash for any shortfall between the fair value of the amount collected in total from the receivables and the cash amount Enterprise B paid Enterprise A for its right to 80 of fair value from the receivables. Under this arrangement, Enterprise A will make no payment if the receivables perform exactly as expected because the guarantee does not require Enterprise A to pay anything unless the fair value of the amount collected is less than 80 and the expectation is that fair value of 90 will be collected. On the other hand, Enterprise A's maximum possible exposure to Enterprise B is to repay 80 of fair value. Enterprise A therefore has an obligation that could involve it in repaying all the consideration it has received. Enterprise A will therefore not derecognise any of the receivables. Instead, it will increase its cash balances by 80 and will recognise a liability to repay that 80 of fair value.

301. Enterprise B will apply paragraph 31 and will therefore recognise the receivables of 90, the guarantee (fair value 0) and an obligation of 10 to Enterprise A for the residual interest. The receivables and guarantee will usually be shown together. Enterprise B will also reduce its cash balances by 80.

Factoring with a Limited Guarantee Given as to Performance

302. Now consider a transaction somewhere between the extremes described in paragraphs 298 and 299 (no recourse) and paragraphs 300 and 301 (recourse for everything); a transaction in which Enterprise A guarantees the performance of the factored receivables but that guarantee is capped (i.e., a factoring with partial recourse). For example:

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[21] As discussed in the second footnote to paragraph 253, Enterprise B would expect a fair value return on its investment in the receivables. This example has been simplified in the same way.

(a) Enterprise A has receivables with a fair value of 90.

(b) Enterprise A transfers the receivables to Enterprise B in exchange for 80 of cash and the right to any cash collected from the receivables in excess of 80 of fair value to which Enterprise B is entitled.

(c) Enterprise A agrees to make good the first 5 fair value of Enterprise B's losses if less than 80 of fair value is collected from the receivables.

303. The existence of the guarantee and residual interest means that Enterprise A has a continuing involvement in the assets, and Enterprise A's retention of the residual interest means Enterprise B is not able to transfer all the receivables to a third party. However, the existence of the guarantee means that Enterprise A has an obligation that could involve repaying at least some of the consideration received. As Enterprise A will reimburse the first 5 fair value of the losses only, it does *not* have an obligation that could involve it repaying *all* the consideration it received in the transfer. It would therefore derecognise some, but not all, of the receivables.

(a) It will recognise cash of 80.

(b) It will also recognise a liability to repay 5 of fair value, being its maximum possible exposure under the recourse arrangements.

(c) It will treat the other 75 of cash received from Enterprise B as proceeds from the sale of the receivables. 75 of receivables will therefore be derecognised.

(d) It will continue to recognise the remaining receivables of 5 (90 less 10 less 75) and will also recognise a residual interest in the receivables of 10 (90 less 80). Usually the receivables of 5 and the residual interest of 10 would be shown together on the balance sheet.

304. Therefore, to summarise, Enterprise A will apply paragraphs 49-68 and that will result in it showing cash (80), residual interest plus receivables (15), and a secured liability (5). Enterprise B, on the other hand, will apply paragraph 31 and will, as a result, recognise receivables of 90, the guarantee, and an obligation of 10 to Enterprise A for the residual interest. It will also reduce its cash balances by 80. The receivables and guarantee will usually be shown together on the balance sheet.

Securitisations

305. The term "securitisation" is generally used to describe the process by which some or all of a portfolio of financial assets is converted into asset-backed securities and some or all of those securities are then transferred in exchange for cash. The following outlines a typical securitisation transaction.

(a) The transferee has been set up solely for the purpose of being the transferee. However, if the transfer has substance, that will have no effect on the way in which the securitisation is accounted for under the Draft Standard.

(b) The transferee finances the transfer by the issue to investors of commercial paper, loan notes, participation or pass-through certificates, or similar securities. The transferee's shares or residual beneficial interests (if any) are usually held by a party other than the transferor (charitable trusts have often been used for this purpose) and its major financial and operating policies are usually predetermined to a greater or lesser degree by the agreements that establish the securitisation.

(c) Arrangements may be made to protect some or all of the investors from losses occurring on the assets by a process termed "credit enhancement". This may take the form of third party credit insurance, a cash collateral account, a third party guarantee of the transferee's obligations or an issue of subordinated beneficial interests (perhaps to the transferor). Analogous arrangements are sometimes made to protect investors against other kinds of risks. All the arrangements provide a cushion against losses up to some limit.

(d) The transferor is often granted rights to cash remaining after payment of amounts due on the debt securities and other expenses of the transferee. These rights are generally intended at least in part to compensate the transferor for assuming some of the risk of credit or other losses. The mechanisms used to grant these rights include servicing or other fees, deferred sale consideration, "super interest" on amounts owed to the transferor (for example, subordinated debt), dividend payments and swap payments.

(e) The transferor may continue to service the assets (i.e., to collect amounts due from borrowers, set interest rates etc).

(f) The transferee invests cash accumulations from the transferred assets until payments on the debt securities are made. Any difference between the interest rate obtained on the investments and that payable on the debt securities will normally affect the transferor's residual interest under (d) above. The terms of the debt securities may provide for them to be redeemed as assets are realised, thus minimising this reinvestment period. Alternatively, cash accumulations may be invested in a "guaranteed investment contract" that pays a guaranteed rate of interest (which may be determined by reference to a variable benchmark rate such as LIBOR) sufficient to meet interest payments on the debt securities. Another alternative, used particularly for securitisations of short-term receivables arising under an on-going facility (for example, credit card balances), is a provision for cash receipts (here from card repayments) to be used to acquire similar assets (for example, new balances on the same credit card accounts). This reinvestment in similar assets will occur for a specified period only, after which time cash accumulations will either be used to redeem the debt securities or be reinvested in other more liquid assets until the debt securities are repaid.

(g) In certain specified circumstances (for example, if tax changes affect the payment of interest to the debt security holders or if the principal amount of debt securities outstanding declines to a specified level), the transferee may have an option to redeem the notes. Similarly, the transferor may have an option to call back (or the transferee may have an option to put back to the transferor) what remains of the securitised assets if their level falls below the point at which the securitisation vehicle ceases to be economically viable. Such options are often referred to as “clean-up call options” (see paragraph 235). Such redemption may be funded by the transferor, in which case the transferor will receive back the securitised assets.

306. Consider the following securitisation transaction. The originator of loans with a fair value of 90 (Enterprise A) transfers the loans to a special-purpose entity (the transferee, Enterprise B) in exchange for cash of 80 and a subordinated interest in the loans. Enterprise B obtains the cash by issuing senior asset-backed securities to various investors for 80. Enterprise A provides no guarantee about the performance of the loans.

(a) The existence of the subordinated interest means that Enterprise A still has a continuing involvement in the loans.

(b) If Enterprise B has the practical ability to transfer the loans to a third party and can exercise that ability unilaterally and without needing to add restrictions to the transfer, Enterprise A will derecognise the loans and will recognise a subordinated residual interest in the loans of 10 and cash of 80. In such a circumstance, Enterprise B will recognise 90 of loans and an obligation of 10 to Enterprise A in respect of its subordinated interest. It will also reduce its cash balances by 80.

(c) Assume, however, that Enterprise B has no ability to transfer the loans. As Enterprise A has neither an obligation that will or could result in the repayment of any of the consideration received nor a call option over any of the transferred components, it derecognises the components it no longer has (i.e., the loans of 90) and recognises those it has (i.e., subordinated residual interest in the loans (10) and cash (80)). The transferee’s accounting will also be the same as in (b).

307. Consider now a variation of the securitisation described above. This time as part of the securitisation transaction, the transferor (Enterprise A) acquires a call option enabling it to insist on the return of some of the loan balances. (This is sometimes called a “removal of accounts provision” or a ROAP). The amount of loan balances that can be recalled in this way is restricted to 10 percent of the original value of the loans securitised. The transferor is entitled to choose the identity of the loan balances to be recalled, thus enabling it to call back any of the transferred loans. Enterprise A will still have a continuing involvement in

the loans and, if Enterprise B has the practical ability referred to in sub-paragraph 306(b), the accounting will be as described in that paragraph except that both parties will also recognise the call options. However, assume Enterprise B does not have that ability. In this transaction, the transferor is deemed (by sub-paragraph 60(b)) to have a call option over the whole of the portfolio of loans transferred to Enterprise B. As such, it will continue to recognise all the loans, will recognise the cash received (80) and will recognise a liability to repay all that cash. Enterprise B will recognise loans (90), an obligation to Enterprise A (10), and the call option, and will reduce its cash balances by 80. Once Enterprise A has exercised its call option to the full 10 percent maximum, the option ceases to exist and Enterprise A ceases to have control of the remainder of the transferred loans. Accordingly, It would derecognise the remainder of the transferred loans and recognise its subordinated residual interest.

308. Consider a further variation. The securitisation is as described in paragraph 307, except that the transferor has no discretion as to the identity of the actual loan balances repurchased (because they are to be selected at random). Although Enterprise A has a call option, under paragraph 60(c) it is not a call option over a transferred component, asset or group or pool of assets. As such, Enterprise A will apply paragraph 68, rather than paragraphs 64 and 65, and will derecognise the loans and recognise a subordinated residual interest in the loans of 10 and cash of 80. Enterprise B's accounting will be as described in the preceding paragraph.

Sub-participations

309. Assume that an enterprise (Enterprise A) makes an interest-bearing 5 year loan with a fair value of 100 to a borrower. It then enters into an agreement with another enterprise (Enterprise B) in which, in exchange for a cash payment of 10, it agrees to pass to Enterprise B 10 percent of all cash collected on its loan to the borrower. Enterprise A provides no guarantees about the performance of the loan and accepts no obligation to make any payments to Enterprise B other than 10 percent of exactly what has been received from the borrower.

310. The first issue that needs to be addressed in order to account for the transaction with Enterprise B is to determine whether the transaction amounts to a transfer of some of Enterprise A's rights to cash flows from the borrower. Paragraphs 41-48 are relevant here. If those criteria are met, Enterprise A has transferred 10 percent of the loan and has retained 90 percent of it. (If the criteria are not met, no transfer is involved and Enterprise A will continue to recognise a loan asset of 100, and will also recognise 10 of cash and a loan from Enterprise B of 10.)

311. It is then necessary to determine how to account for that transfer. The transferor still has a continuing involvement in its previously recognised financial asset because it still has an interest in 90 percent of the original loan. Furthermore, Enterprise B does not have the

practical ability—which it can exercise unilaterally and without needing to add restrictions to the transfer—to transfer to a third party 100 percent of the original loan to the borrower. Finally, Enterprise A does not have an obligation that will or could involve repaying any of the consideration. It has merely an obligation to pay Enterprise B exactly 10 percent of what has been received from the borrower. Nor does it have a call option over any of the transferred assets or over the transferred components.

312. In such circumstances, paragraph 68 requires both Enterprise A and Enterprise B to recognise the contractual rights and obligations each has and to derecognise those each does not have. In other words, Enterprise A will continue to recognise 90 percent of the original loan (while derecognising 10 percent of it) and will recognise an increase of 10 in its cash balances. Enterprise B will reduce its cash balances by 10 and will recognise a loan asset of 10.

Servicing Arrangements

313. In some ways, sub-participations can appear to be similar to servicing arrangements: one party collects the cash flows from a financial asset and passes them on to another party without adding to or subtracting from the cash flows that were received. There is, however, an important difference in that, in a sub-participation "the collector" has the contractual rights to receive and keep those cash flows (together with a contractual obligation to pay cash flows of the same amount to the "eventual recipient") and those rights and obligations are separate. A servicer does not have the right to keep the cash flows nor that contractual obligation, merely a servicing agreement that obliges it to collect cash flows as the agent of the eventual recipient and to pass them on. Paragraphs 41-48 do not therefore apply to servicing arrangements.

314. Servicing is an inherent part of all financial assets but, in accordance with paragraph 3, servicing rights and assets are recognised and accounted for separately from the assets involved only when a transfer or other transaction causes the assets to be held by one party and serviced by another. Thereafter, the recognition and derecognition principles set out in the Draft Standard apply to the assets and the servicing (or, to be precise, the servicing asset or servicing liability) separately.

Measurement

Initial Measurement

315. A financial instrument is measured at its estimated market exit price at all measurement dates including the date it is first recognised. A financial instrument's market exit price on the date it is acquired or incurred may differ from the fair value of the consideration exchanged for a financial instrument (its entry price) because the exit market is different from the entry market. For example, if the instrument originates in a transaction with a customer and the enterprise holds a portfolio of similar instruments, its price as a part of the portfolio may be more advantageous than its price as an individual instrument.

316. If a financial asset is acquired or a financial liability is incurred in exchange for a financial or a non-financial item, the face amount of the financial instrument is not necessarily its fair value. For example, if an enterprise sells an asset in exchange for a note receivable with no stated interest, the face amount of the note is not its fair value. The note would be reported at its fair value. If the note's fair value is not equal to the carrying amount of the asset sold, the enterprise would recognise the difference between the fair value of the note and the carrying amount of the asset sold as a gain or loss in the income statement in the period of the transaction.

317. If a financial instrument is exchanged for cash and other benefits or sacrifices, those other benefits or sacrifices would be separately distinguished and accounted for. For example:

    (a) If an enterprise receives an interest-free loan from a government agency, the fair value of the loan is not equal to its face amount. In the absence of evidence to the contrary, the difference between the fair value of the note and the cash received would be accounted for as a government grant.

    (b) If an enterprise extends an interest-free loan to an employee, the fair value of the loan is not equal to its face amount. In the absence of evidence to the contrary, the difference between the fair value of the loan and the cash paid to the employee would be accounted for as employee compensation.

Hybrid Contracts

318. For practical reasons, the market exit price of a financial instrument that is part of a hybrid contract that is to be separately accounted for would be estimated as if it were free-standing. Therefore, on initial recognition, the reported amount of the remaining non-financial portion of the hybrid contract will be the difference between the fair value of the hybrid instrument as a whole and the fair value of the financial instrument as a free-standing financial instrument. To illustrate, if a reporting enterprise issues debt convertible

into its own common shares, the fair value of the debt would be determined as if it did not include a conversion option. The enterprise would determine the fair value of the consideration exchanged, and the difference between the reported amount of the debt and the fair value of the hybrid instrument as a whole would become the initial measure of the equity conversion option. At future measurement dates, the financial instrument would be reported at its fair value as if it were free-standing, and the conversion option would continue to be reported at its initial value.

319. Paragraph 76 requires that, if an enterprise cannot reliably identify and measure the separate sets of financial instrument rights and obligations in a hybrid contract, it should account for the entire contract as if it were a financial instrument falling within the scope of the Draft Standard. However, an enterprise would always separately identify any component of a hybrid contract that comprises equity of the enterprise and exclude it from being accounted for in accordance with the Draft Standard.

Adjustments for the Passage of Time and Changes in Market Conditions

320. A market exit price from a transaction that took place other than at the measurement date would be adjusted to reflect changes due to the passage of time. It would also be adjusted if changes in market conditions indicate that transactions occurring at the end of the reporting period likely would not have occurred at that price. An example would be an observable price of an interest-sensitive instrument in a transaction that occurred before a change in market interest rates took place. That price would be adjusted to reflect the interest for the period between the transaction and the measurement date, the effect on fair value of the change in rates, and any cash distribution in that period.

321. Principal-to-principal or brokered trades, significant announcements, or other events may have occurred after the close of the market in which a financial instrument is traded. An enterprise would not be expected to seek out information about after-hours trading, but it would take into account information that is available. One example would be a large change in price on another market after the close of the principal market in which a financial instrument trades but before the end of the reporting period. Awareness of changes is particularly important for instruments traded in foreign markets that close before the end of the business day in the reporting jurisdiction.

322. Accounting standards in some jurisdictions provide for adjustment of amounts recognised in financial statements to reflect events after the balance sheet date if such subsequent events confirm conditions that existed at the balance sheet date. It would normally be presumed that changes in market prices after the reporting date do not confirm conditions existing at that date but reflect circumstances that have arisen in the following period.[22]

[22] See, for example, paragraph 10 of IAS 10, Events After the Balance Sheet Date.

Using Price Information about Similar Financial Instruments

323. Estimating the fair value of a financial instrument based on the market price of a similar financial instrument involves the following process:

(a) Identify the significant risk attributes and projected cash flows of the enterprise's financial instrument.

(b) Identify another financial instrument for which a market price is available that has risk attributes and projected cash flows that are similar to the financial instrument the enterprise is trying to measure.

(c) Quantify the effects on fair value of differences in cash flows and risks between the two financial instruments (including differences in marketability), and adjust the market price of the similar instrument for those effects to estimate the fair value of the enterprise's financial instrument.

324. For example, an enterprise may hold a private placement corporate bond for which there is no observable market price. The enterprise may be able to identify actively traded corporate bonds that appear to be similar to its bond. The characteristics of the enterprise's bond would be identified and compared to those of the identified actively traded bond. The major elements on which the two bonds would be compared are:

(a) The pattern of contracted cash flows, including prepayment expectations.

(b) The currency in which the bonds are payable.

(c) The credit risk rating and the factors on which changes in the credit risk rating are dependent. For example, the fair values of bonds issued by enterprises with different industry and geographical bases would be expected to respond differently to changes in market factors. However, the two issuers need not necessarily be in the same industry or geographic region if the difference would not be expected to affect fair value.

(d) Any other terms or conditions that could affect the fair value of the bonds.

325. By definition, similar financial instruments are not identical, and some of the differences will cause the fair values of the instruments to be different. For similar financial instruments to be used in estimating fair value, sub-paragraphs 77(c) and 77(d) require that measurement of the effect of the differences be practicable. That is, the effect on fair value of any significant differences between two similar financial instruments must be reasonably determinable. In the above example, the initial net effects of differences may be discerned by comparing the fair values of the two instruments at the date of the acquisition of the non-traded bond by the reporting enterprise, assuming that its fair value on acquisition was directly determinable from the consideration paid.

326. In this example, the fair value of an enterprise's private placement bond may be less than that of the market-traded bond because it is less marketable. It may be reasonable to assume that any premium for marketability differences between the effective interest rates of the two bonds at the date the enterprise acquired its bond remains unchanged from period to period, except if an observable event that could be expected to significantly affect marketability takes place.

327. Virtually no two equity investments can be expected to qualify as similar financial instruments under paragraph 77(c) because each equity investment is unique in significant respects. For example, even if two enterprises are similar with respect to size, products and clientele, there will be differences in their management, employee personnel and other intangible factors that could lead to very different future cash flow patterns and potential variability. Thus, with the exception of equity instruments that are contractually structured to replicate other equity instruments, it will not be appropriate to estimate fair values of equity investments directly by comparison to the market prices of other traded equity instruments. However, observable prices of traded equity instruments may be helpful as an input or check on estimations developed using internal valuation techniques such as multiples of earnings or discounted cash flow analysis (see also paragraphs 357 and 358 on non-traded equity instruments).

Prices Not Determined by Normal Market Interactions

328. Paragraph 88(a) states that an observed exit price for a financial instrument would not be used as the primary basis for determining its fair value if it reflects transactions between enterprises, one or more of which were experiencing severe financial difficulties. A sale of a financial instrument to meet a court order in a bankruptcy situation is an example of a transaction motivated by something other than normal business considerations. An enterprise trying to measure that instrument would need another source of reliable information about fair value, such as a less recent transaction not motivated by bankruptcy.

329. In contrast, if the entire market for a particular financial instrument is affected by a lack of liquidity or financial difficulties of many participants, the observed prices are evidence of fair value. For example, all recent transactions in a particular financial instrument may have involved sellers who were forced by circumstances to accept any available offers, while other enterprises who believe future prices will improve choose to wait. An enterprise holding an identical financial instrument would estimate its fair value on the basis of the observed recent market exit prices unless it could demonstrate that it could access a more advantageous market (see paragraphs 95-99). The determining factor is the price the reporting enterprise would have received or paid on the measurement date. The fact that the reporting enterprise expects prices to be more favourable later is not evidence of fair value on the measurement date.

330. Paragraph 88(b) states that an observed exit price would not provide evidence of fair value if the observed exit price would have been different if not for other transactions, contracts or agreements between the transacting parties. For example, if Enterprise A sells Enterprise B a bond with a fair value of 100, and, in a separate transaction, B sells A a different bond with a fair value of 80, only the net 20 affects the income statement of the two enterprises. If the two parties chose to add 100 to the stated price of each instrument, the prices would be 200 and 180 and the net effect still would be 20, but the prices would not represent market exit prices. In that example, the exit price in each transaction would have been different if the other transaction had not occurred.

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument

331. Paragraph 92 provides that expected benefits or sacrifices that are not directly attributable to existing contractual rights or obligations of a financial instrument at a measurement date would not enter into the estimation of the fair value of that financial instrument at that date.

Credit Card Contracts

332. In some countries there are observable transactions that involve portfolios of credit card contracts. The observed transaction price for such a portfolio covers two financial instruments—the cardholders' options to borrow (written by the card issuer) and the card issuer's receivables from cardholders—as well as non-contractual benefits of the credit card relationship.

The Cardholders' Options to Borrow

333. The card issuer may expect to receive significant future benefits because a proportion of cardholders can be expected to use their credit cards to borrow when the exercise price is to the advantage of the issuer, that is, at interest rates that are unfavourable to the borrowers in comparison with other sources of financing. The fair value of the written option to the issuer is to be estimated on the basis that the issuer has no contractual rights to such future benefits. In other words, the fair value of the option will be based on the assumption that the holders will exercise their options to borrow only when the options are in the money (that is, when the rates and terms are favourable to the holders in relation to market rates and terms available to them on the measurement date). Thus, any future benefits that are expected to be received as a result of cardholders exercising their options to borrow when it is to the advantage of the issuer are to be recognised only when those future transactions take place—that is, when the cardholder actually exercises the option to borrow (in which case the card issuer has a receivable from the cardholder).

334. There are unlikely to be any observable transactions for cardholders' options, or any similar options, because such options are normally traded only as part of a package that also

includes the card issuer's receivables and expected non-contractual benefits of the cardholder relationship. Thus, the card issuer will generally have to develop its own technique to estimate their fair values. The basic elements of such a valuation technique would include: (a) the term of the option (which will be the term to the date of expiry of the card unless the cardholder has an option to extend the term without consent of the card issuer), (b) the fair value of in the money loans expected to be made to cardholders (taking into account the current level of interest rates commensurate with the credit quality of the cardholders), (c) the exercise price for these loans (effectively the interest rates and conditions on which the cardholders can borrow), (d) the volatility of the fair values of the loans to the cardholders (which would depend to a significant extent on the potential for changes in market interest rates and the credit quality of the cardholders), and (e) costs to fulfil the obligations under the options that market participants would take into account in setting a price.

The Card Issuer's Loan Receivable

335. A prepayment option that is embedded in a loan asset is to be treated differently from a free-standing option to borrow. The fair value of the card issuer's loan receivable is determined on the basis of estimated market expectations of the probable timings and amounts to be received (taking into account the probable effects of defaults and the borrower's behaviour with respect to its repayment options). Thus, expectations with respect to the exercise or non-exercise of the borrower's option to prepay or delay payment, with consequent effects on the timing and amounts of cash flows, are to be taken into account when these options are embedded in the contract underlying a loan receivable. Card issuers often sell these receivables in securitisations and similar transactions. The fair value of credit card receivables may therefore be inferred from prices in observable market transactions involving similar loans. If there are no observable prices of similar receivables, fair value will be estimated using a valuation technique (see paragraphs 359-369 for guidance on using valuation techniques to estimate the fair value of loan assets).

Demand Deposit Liabilities

336. A demand deposit represents a promise by the depository institution to deliver cash either to the depositor or to third parties designated by the depositor. It imposes a contractual obligation that is a financial instrument. The depositor can demand settlement at any time, and the depository institution generally has the right to return the depositor's money (even though that right is seldom exercised).

337. The fair value to the depository institution of a demand deposit depends on the market's expectations of the timing and amounts of withdrawals of the existing balance at the measurement date, the level of interest rates on other borrowings with similar terms, the costs of servicing the deposit, and the institution's own credit risk (that is, the risk of

default taking into account expectations with respect to government and similar insurance, see paragraphs 373-375).

338. Demand deposit liabilities are on occasion transferred in portfolios along with items that are not financial instruments. The price at which portfolios of demand deposits are transferred generally includes not only the existing deposit balances but also future benefits expected to result from future transactions with the customers that are expected to occur because of the deposit relationship. These include the benefits of future interest free or low interest use of funds expected to be deposited in the future, rentals of customer lists and incremental cash flows from sales of products and services other than those set out in the deposit agreement. Such anticipated future benefits are not considered to be directly attributable to the rights and obligations that constitute the demand deposit liabilities existing at a measurement date, and accordingly would not enter into the estimation of their fair value.

339. An estimated market exit price for demand deposit liabilities might be imputed or modelled from observable market entry prices negotiated between depository institutions and depositors, or on the basis of a computation of the present value of projected cash flows reflecting market conditions and expectations at the reporting date.

(a) The entry market price for a demand deposit obligation is the exercise price of the depositor's option to demand its money. The exercise price is the face amount of the deposit plus the fair value of any accrued interest and services owing under the particular contract. This will be the exit price to the depositor (see paragraphs 100-101, on the effect of an embedded option on the enterprise holding the option).

(b) The exit price to the depository institution is likely to be less than the entry price because an enterprise accepting a transfer of the deposit obligation would expect that not all depositors will withdraw their money immediately. Valuation techniques to estimate the present value of projected cash flows related to the deposits would incorporate the expected amounts and timing of withdrawals of existing balances, based on past experience and market conditions at the reporting date. Expected future deposits would not be incorporated in these projected cash flows. Paragraph 112 provides that an enterprise may use its own assumptions in a fair value pricing model that are compatible with a fair value estimate as long as there are no data indicating that market participants would use different assumptions. The projected cash flows would be discounted at a rate equal to the interest rate that would be used by market participants at the reporting date to price loans of similar risk and term. In addition, significant net costs that can be expected to be necessary to service the deposits would also be considered in the present value computation. An enterprise's methods would be consistently applied.

Prices from More than One Market for the Same Instrument

340. Paragraph 95 states that, if an enterprise has access to more than one exit market for a financial instrument, and prices in those markets are different, the instrument's fair value would be based on the most advantageous market exit price. For example, the observable market exit price for a portfolio of promissory notes as a whole may be higher than the total of the market exit prices of the individual notes after taking into account any significant differences in costs that would have to be incurred to sell the notes. An enterprise need not conduct an exhaustive search for markets to which it could have access, but it would be expected to make reasonable efforts to become aware of significant differences in prices in known markets to which it has access.

341. Paragraph 96 requires that any significant difference in costs that would have to be incurred to sell a financial asset or obtain relief from a financial liability would be taken into account in determining the most advantageous price. These costs would include any incremental costs that would have to be incurred to access a market for a financial instrument. To illustrate the application of the requirement of paragraph 96, suppose that on a measurement date the market exit price of a financial asset in market A was 100 and in market B was 110, and that the costs to sell the asset in market A are 2 and in market B are 15. In this example the most advantageous price is that of market A. Thus, the financial asset would be reported at the market exit price of 100. This price would not be adjusted for the costs that the enterprise would expect to incur to sell the financial asset (see paragraph 72).

Effect of an Embedded Option on the Enterprise Holding the Option

342. The application of paragraphs 100-101 may be illustrated by an example. Suppose Enterprise A extends a five year loan to Enterprise B at the beginning of year 1 for 1000, which was its fair value at that date. Contractual interest of 80 is payable at the end of each year. Enterprise B has the contractual right to pay off the loan at any time for an amount equal to the contractual principal plus a pro rata portion of the next contractual interest coupon. Suppose that at the end of one year, immediately after the first interest payment is made, the market exit price of the loan held as an asset is 1,008. That price would be based on an average of the present values that would result from payments at different possible dates weighted according to the estimated probabilities that payment will occur on each of those dates.[23] In contrast, the fair value to Enterprise B would be 1,000, which is the amount at which it could prepay the loan on that date. In general, if the market price of a loan held as an asset is greater than the exercise price of the prepayment option (as it is in

[23] If no observable market exit price were available, a valuation technique would be used to estimate that price. Various lenders have developed techniques for estimating the fair value of financial instruments with early repayment provisions that reflect prepayment possibilities.

this example), the debtor's most advantageous market exit price would be the exercise price of the prepayment option.

343. As an extension of the above example, some loan agreements provide that a penalty be imposed (a) upon the borrower (Enterprise B) if it elects to repay the loan before maturity or (b) upon the lender if it initiates a demand for repayment prior to maturity. To illustrate, assume the facts in the above example except that there is a 50 charge to Enterprise B for early repayment and that the market price of the loan is 1036 because the penalty reduces the probability of prepayment. The prepayment option exercise price to Enterprise B is 1050. In this example, the exit price to both Enterprise A and Enterprise B is 1036, because it would not be advantageous for Enterprise B to exercise its option at 1050.

Estimating Fair Value without Observable Market Exit Prices

344. A valuation technique would be expected to arrive at a realistic estimate of a market exit price if (a) it reasonably mimics how the market could be expected to price the instrument, and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

345. The same information may not be available at each measurement date. For example, at the date that an enterprise makes a loan or acquires a debt instrument that is not actively traded, the enterprise usually has a transaction price that either is equal to the instrument's market exit price or can be used to estimate a market exit price. However, no new transaction information may be available at the next measurement date and, while the enterprise can determine the general level of market interest rates, it may not know what level of credit risk market participants would use in pricing the instrument on that date. An enterprise that makes loans as a primary business activity would be presumed to have in place a system to enable it to assess credit risk of its loan assets on an ongoing basis (see paragraphs 359-369). If an enterprise does not make loans as a primary business activity, it may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. The enterprise would be expected to make reasonable efforts to determine whether there is evidence that there has been a significant change in these factors. Where such evidence exists, the enterprise would consider the effects of the change in determining the fair value of the financial instrument.

Inputs to Valuation Techniques

346. An appropriate technique for estimating the market exit price of a particular financial instrument would incorporate available market information about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a

financial instrument will be based on one or more of the following (and perhaps other) factors:

(a) The time value of money (that is, interest at the basic or "risk-free" rate). Basic interest rates usually can be derived from observable government bond prices and often are quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows as a result of the "yield curve" effect. For practical reasons, an enterprise may use a well accepted and readily observable general rate, such as LIBOR/swap rate, as the benchmark rate. (Since a rate such as LIBOR is not the basic interest rate, the credit risk adjustment appropriate to the particular financial instrument would be determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a useful, stable benchmark basic interest rate for enterprises issuing financial statements in that reporting currency. Some enterprises in these countries may have better credit standings and lower borrowing rates than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

(b) Credit risk. The effect on fair value of credit risk (that is, the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded corporate bonds of varying credit quality or from observable interest rates charged by lenders for loans of various credit ratings (see paragraphs 359-369 on loan assets).

(c) Foreign currency exchange prices. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) Commodity prices. There are observable market prices for many commodities.

(e) Equity prices. Prices (and indexes of prices) of traded equity securities are readily observable in some markets. Present value based techniques may be used to estimate the current market exit price of equity instruments for which there are no observable prices. (Considerations with respect to estimating the fair value of non-traded equity instruments using such models are set out in paragraphs 357 and 358.)

(f) Probabilities that specified events will occur. Expected cash flows that depend on the outcome of specified future events (for example, the probability of occurrence of precipitation or other weather events that affect the value of a weather-based derivative) will require probability-weighted estimates of the nature illustrated in paragraphs 351 and 352.

(g) Marketability (the return market participants demand to compensate for the risk that they may not be able to sell an asset or obtain relief from a liability immediately). In some cases it may be reasonable to assume that the effects of marketability are included in the credit risk interest rate premium. In some other cases it may be reasonable to assume that there has been no significant change in the marketability of a financial instrument and the effect on the instrument's fair value during a reporting period.

(h) Volatility (that is, the frequency and magnitude of future changes in price of the financial instrument or other item that is the subject of an option). Measures of the volatility of actively traded items can normally be reasonably estimated based on historical market data. Certain considerations with respect to estimating the volatility of non-traded items are noted in paragraphs 355 and 356 on non-traded options.

The Relationship between Discount Rates and Projected Cash Flows

347. The present value of projected cash flows may be estimated using a discount rate adjustment approach or a cash flow adjustment approach.

348. <u>Discount rate adjustment approach.</u> Under the discount rate adjustment approach, the stream of contracted cash flows forms the basis for the present value computation, and the rate(s) used to discount those cash flows reflects the uncertainties of the cash flows. This approach is most readily applied to financial instrument contracts to receive or pay fixed cash flows at fixed future times, that is, instruments for which the only significant uncertainties in amount and timing of cash flows are due to credit risk.

349. The discount rate adjustment approach is consistent with the manner in which assets and liabilities with contractually specified cash flows are commonly described—as in “a 12 percent bond,”—and it is useful and well accepted for those instruments. However, because the discount rate adjustment approach places the emphasis on determining the interest rate, it is more difficult to apply to complex financial instruments where cash flows are conditional or optional, and where there are uncertainties in addition to credit risk that affect the amount and timing of future cash flows.

350. <u>Cash flow adjustment approach.</u> Under the cash flow adjustment approach, the projected cash flows for a financial instrument reflect the uncertainties in timing and amount, that is, they are weighted according to probability of their occurrence, and adjusted to reflect the market’s evaluation of the non-diversifiable risk relating to the uncertainty of those cash flows. The cash flow adjustment approach has advantages over the discount rate adjustment approach if an instrument’s cash flows are conditional, optional, or otherwise particularly uncertain for reasons other than credit risk.

351. To illustrate, suppose that the enterprise holds a financial asset such as a derivative that has no specified cash flows and the enterprise has estimated that there is a 10 percent probability that it will receive 100; a 60 percent probability that it will receive 200; and a

30 percent probability that it will receive 300. Further, suppose that the cash flows are expected to occur one year from the measurement date regardless of the amount. The expected cash flow is then 10 percent of 100 plus 60 percent of 200 plus 30 percent of 300, for a total of 220. The discount rate used to estimate the instrument's fair value based on that expected cash flow would then be the basic ("risk-free") rate adjusted for the premium that market participants would be expected to receive for bearing the uncertainty of expected cash flows with the same level of risk.[24]

352. The cash flow adjustment approach also can incorporate uncertainties with respect to the timing of projected cash flows. For example, if the cash flow in the previous example was certain to be 200, and there was a 50 percent chance it would be received in one year and a 50 percent chance it would be received in three years, the present value computation would weight those possibilities accordingly. Because the interest rate for a two-year instrument is not likely to be the weighted average of the rates for one-year and three-year instruments, two separate present value computations would be required. One computation would discount 200 for one year at the basic interest rate for a one-year instrument and the other would discount 200 for three years at the basic interest rate for a three-year instrument. The ultimate result would be determined by probability weighting the results of the two computations. Since the probabilities of each are 50 percent, the fair value would be the sum of 50 percent of the results of each present value computation, after adjustment for the estimated effect of any non-diversifiable risk related to the uncertainty of the timing of the cash flow.

353. The discount rate adjustment approach would be difficult to apply in the previous example because it would be difficult to find a discount rate that would reflect the uncertainties in timing.

354. The Draft Standard does not prescribe which of the two approaches to use. Nor does it preclude using a combination of the two with some risks reflected in cash flows and others in discount rates. Paragraph 113 makes the most important point, which is that the effects of each risk would be incorporated in either the projected cash flows or the discount rate but not both.

Non-traded Options and Other Derivatives

355. Option pricing models (such as the Black-Scholes model and binomial models, and models derived therefrom) are available in standard computer packages that enable computations of stock and equivalent options at a reasonable cost. Valuations using such models with

[24] In theory, the 220 could be adjusted to a certainty equivalent, that is, to the amount that a market participant would pay if it were certain of receipt. Under this Draft Standard, a risk premium and other factors would be incorporated into either the present value computation or as an adjustment of the result of the computation. If the 220 can be converted to a certainty equivalent, it will be unnecessary to consider the risk premium and other factors separately.

appropriate market-based data inputs are likely to be sufficiently reliable for financial reporting purposes in many circumstances. However, standard option pricing models require adaptations or modifications to fit custom-tailored instruments with unusual or unique characteristics and to reflect the appropriate counter-party credit risk.

356. Volatility of the variable on which an option is based is an important factor in determining the option's fair value. Estimating expected future volatility generally begins with calculating historical volatility and then considering the effects of ways in which the future is reasonably expected to differ from the past.[25]

Non-traded Equity Instruments

357. Techniques for measuring equity instruments are commonly based on discounting expected cash flows, which may be estimates of future dividend payments or of net cash flows to be generated by the issuing enterprise. Estimates are also made on the basis of multiples of earnings or the present value of expected future earnings, both of which are surrogates for expected future cash flows. It may also be necessary to consider such factors as expected future dividend payments or the net asset value of the enterprise. Fair value estimates determined using models would be checked for reasonableness by comparison to observable market prices for equity instruments of like enterprises.

358. It may be difficult to estimate the fair value of certain non-traded equity instruments on an ongoing basis, for example, those of private companies that have little history or track record. In many cases, the difficulties can be overcome, but on rare occasions making a reasonable estimate of fair value will not be practicable. Accordingly, paragraph 122 provides for an exception in those rare situations.

Loan Assets

359. The appropriate specifications of a technique for estimating fair values of loan assets will depend on the nature and extent of an enterprise's lending activities. For example, it could be based on an internal credit-grading system with the following general attributes:

    (a) A credit-grading classification scheme distinguishes significant categories of credit risk appropriate to the loans made by the enterprise. A credit-grading scheme could be based on a published external credit-rating system, or it may be internally developed.

    (b) Each credit grade category defines the range of interest rate premiums over the basic market rates of interest (the market "risk-free" rates) at which loans are made under current market conditions. Such a credit-grading system would represent the interest

[25] Appendix F of FASB Statement No. 123, Accounting for Stock-Based Compensation, provides explanations and guidance with respect to computing historical volatility of stock prices in some common situations.

rate premium ranges for progressive levels of credit risk for loans that are originated or acquired by the enterprise.

(c) The interest rate range for each credit grade category is consistent with observable market rates of interest for loans of equivalent credit risk and is adjusted as basic interest rates, credit, and other relevant market conditions change.

(d) A credit granting and lending process (i) assigns an appropriate credit grade to each loan at the time it is originated or acquired and (ii) re-evaluates the credit quality of outstanding loans on a regular basis and updates the credit grade assigned to a loan if necessary.

Within such a credit-grading system, the fair value of a loan may be estimated by using the contractual timing and amounts of cash flows (adjusted for expected prepayments if the loan agreement permits prepayments) and discounting these at a rate that reflects the credit grade of the loan. In addition, the computation would reflect servicing costs, risk premiums, profit margins, and other factors that market participants would be expected to consider in setting a price.

360. It is important to ensure that the risk-adjusted discount rate assigned to a loan within the rate range of the credit rating class appropriate to its evaluated credit standing is consistent from period to period. To illustrate, suppose the spread over the basic interest rate for a particular class of credit risk was 200-300 basis points at the date a loan was originated and that the specific loan was granted at 300 basis points over the basic interest rate. Suppose that at the next measurement date, the spread over the basic interest rate for that same class of credit risk was 175-250 basis points. If the credit standing of the loan had not changed, the rate premium assigned to this loan would be 250 basis points.

361. Credit grades might be assigned by groups of reasonably homogeneous loans and fair value estimated for the groups rather than on an individual loan basis. Loans could be considered reasonably homogeneous if they are of approximately the same credit standing with similar credit risk dependencies and have similar exposures to other risks, such that they have similar patterns of cash flows that can be expected to vary in a similar fashion to changes in economic conditions.

362. Techniques for pricing loans with prepayment options or penalties for early repayment, or that contain other contracted provisions that may affect future cash flows, would consider the effect of each of those factors.

363. An enterprise's internal loan credit grading system and present value-based estimation process would be based on documented policies and procedures that are consistently applied (see paragraph 129). The nature and degree of detail of these policies and

procedures will depend on the nature and complexity of loan contracts and the size of an enterprise's lending activities.

Impaired Loan Assets

364. The same measurement principles apply to impaired loan assets as to unimpaired loan assets. Thus, it is not necessary for measurement purposes to define such a category. However, sub-paragraph 134(a)(iii) requires that impaired loan assets be disclosed, and paragraph 137(c) requires that changes in their fair values be presented separately in the income statement or the notes to the financial statements.

365. In any group of loans there is a statistical probability that some will become impaired in the future. That probability would be considered in estimating the market exit price of the group of loans. However, an individual loan asset is not impaired unless there is evidence that it is more likely than not that the lender will not receive the full amounts owing on the scheduled payment dates in accordance with the terms of the loan contract.

366. An insignificant delay or insignificant shortfall in amount of payments does not mean that a loan is impaired. A loan is not impaired during a short period of delay in payment if the creditor expects to collect all amounts due including interest at the current risk adjusted rate for the period of delay.

367. A loan asset classified as impaired is not removed from that category and considered to be unimpaired unless (a) new evidence indicates that it is no longer more likely than not that the lender will fail to receive the full amounts owing on or before the scheduled payment dates in accordance with the original contracted terms, or (b) the lender and borrower have agreed to restructured terms and it is more likely than not that all amounts owing under the new restructured terms will be collected in accordance with those terms.

368. When estimating the market exit price of an impaired loan asset (or of any loan), the enterprise would consider the effects on expected cash flows or discount rates of collateral or other factors that affect the probability of collection. Financial guarantees that are separate financial instruments would be reported separately.

369. Impaired loans might be assigned a credit grade based on the evaluated credit risk of the projected cash flows and discounted at the current estimated market rate of interest appropriate to that category of credit risk. The projected cash flows would be the cash flows that would be contracted for at that level of credit risk and expected timing of recovery. However, the enterprise may not be willing to make a new loan with a credit risk as high as an existing impaired loan and, therefore, there may be no credit grade that fits its level of risk. In that case, the fair value of an impaired loan may be estimated based on the expected timing and amounts of future cash flows taking into consideration the default condition. The discount rate would be the current market basic interest rate for debts of

similar term, adjusted for the premium that market participants would be expected to receive for bearing the uncertainty of expected cash flows with the same level of risk.

Financial Liabilities

370. If there are no observable market exit prices for an enterprise's own financial liabilities, determining the appropriate interest rate to reflect the enterprise's credit standing may require internal estimates and assumptions. At the date a financial liability is incurred, the enterprise has a transaction price that usually represents the market entry price at that date. Even though that is an entry price instead of an exit price, it will be useful in determining such factors as the interest spread over the basic interest rate. At subsequent measurement dates, the enterprise probably will not have a transaction price to observe (unless it has recently incurred a similar liability), and it may be difficult to determine the spread over the basic interest rate that market participants would demand on that measurement date. However, an enterprise may assume that the net interest rate spread over the basic interest rate has not changed unless available information indicates otherwise. The enterprise need not conduct an exhaustive search of possible changes in the net rate spreads of its financial liabilities since the last reporting date. However it would be expected to make reasonable efforts to identify and consider available information as to whether one or more of the following events have occurred since the end of the last reporting period.

(a) A significant change in the market credit risk spread for liabilities of similar credit risk. If overall interest rates have changed significantly, an enterprise would consider whether the credit spread as a proportion of the basic interest rate has changed.

(b) The enterprise has issued or settled similar liabilities at a significantly different net rate spread.

(c) The fair value of collateral, or the extent of coverage, has changed to such an extent that it could change the credit risk quality of the liability.

(d) An external rating of the credit quality of the liability or of the enterprise has changed.

(e) A major change in the enterprise’s operating activities (for example, a large business combination or major decline in revenues or operating income), or in the market value of the enterprise, or in the technological, economic or legal environment in which it operates, that could be expected to affect the credit quality of the liability.

(f) The expected variability of the projected cash outflows of a liability that are dependent on the resolution of uncertainties other than credit risk has changed to such an extent that it could have affected the net rate spread of the liability.

371. If one or more of the above events has occurred, the enterprise would evaluate whether the spread over the basic interest rate has changed. If it has, the fair value of the liability would be estimated taking into account best estimates of the effects of this change. At subsequent measurement dates, the changed net spread would be assumed not to have changed again unless one or more of the events specified in paragraph 370 has occurred in the subsequent period.

372. However, if an enterprise holds or issues a derivative financial instrument whose price depends on an underlying variable based on its own credit standing, the enterprise would not be permitted to presume that its credit standing had not changed. Estimating the value of the derivative would require the enterprise to determine its current credit standing using whatever means available. In addition, the enterprise would be required to make its best estimate of the market exit price of its other financial liabilities on the basis of the information used in estimating the market exit price of the derivative.

Financial Guarantees of an Enterprise's Financial Liabilities

373. A financial guarantee is separate from the guaranteed liability and requires the guarantor to pay the creditor if a specific event, usually the debtor's default, occurs. The debtor's obligation is not affected by the guarantee, and an enterprise assuming the liability would not consider the guarantee in determining the price it would accept for the assumption.[26] Consequently, a financial guarantee does not affect the measurement of the guaranteed liability by the issuer. For example, if a guaranteed liability's fair value is estimated using a present value technique, the effect of the financial guarantee is not considered in determining the discount rate or the projected cash flows. The financial guarantee is a contract between the guarantor and the creditor and would be reported as a liability by the guarantor and as an asset by the creditor (usually included as part of the loan asset). If the amount an enterprise receives on issuing a financial liability exceeds the fair value of that liability at that date as a result of a third party guarantee (or for any other reason), the difference would be recognised immediately as a gain in the income statement. Such income statement effect would be offset in whole or in part by any expense incurred by the enterprise to obtain the guarantee.

374. Insurance on deposits in regulated financial institutions differs from commercial financial guarantees in several ways. That insurance is a guarantee by a government or government agency of the financial institution's liabilities to depositors. It is a blanket guarantee; that is, all deposits in the institution that meet specified requirements are automatically insured. Essentially all other obligations of the institution are subordinated to the claims of the

[26] Most liabilities are not contractually assumable by another party, and the creditor may demand payment at face amount if there is no contractual assumption provision. However, as discussed in sub-paragraph 90(b), the price for extinguishing an existing liability before its contractual settlement date is not a market exit price and thus does not determine its fair value.

depositors, and the insured institutions are subject to regulations intended to improve the probability that the institution will be able to settle its liabilities at face value. Guaranteed deposit liabilities may be transferred to another institution if its deposits are also insured, and the transferred liabilities continue to be insured.

375. The effect of deposit insurance is so pervasive that depositors often act as if their deposits were 100 percent insured even if there is a limit on the maximum amount insured; interest rates on uninsured deposits may not differ significantly from rates on insured deposits. That means that market participants (both depositors and institutions assuming deposit liabilities) consider the effect of the guarantee in pricing the deposits. Consequently, deposit insurance is not separately reported but would be considered in expected cash flows or discount rates in a present value computation.

Establishing Fair Value Estimation Policies and Procedures

376. Paragraph 129 requires that an enterprise establish appropriate policies and procedures for estimating the fair value of its financial instruments. An enterprise would be expected to provide for appropriate supervision and control over its fair value estimation process. That would include identification and senior management review of especially difficult measurements as well as measurements affected by events after the close of trading in an instrument, and other unusual measurement issues. Senior management also would be responsible for effective monitoring to ensure appropriate application and continued validity of its policies to the enterprise's financial activities, instruments held and issued, and market developments. The nature and extent of these policies and procedures will vary considerably between enterprises depending on the nature and extent of financial instruments held and issued. An enterprise with only short-term trade receivables and payables, and perhaps a short-term bank loan, will not need an extensive fair value estimation system. However, many enterprises will need more extensive and rigorous processes to apply reasonably the requirements of the Draft Standard to such financial instruments as non-traded loan assets, long-term debt, and derivatives.

377. Paragraph 129 requires that an enterprise's policies for estimating the fair value of its financial instruments be consistent from period to period except when a change will result in more accurate estimates. The validity and accuracy of fair value estimates would be assessed by comparing the results of valuation techniques to observable market prices (including back testing of previous estimations and comparing to actual outcomes). If an enterprise makes a change in its valuation techniques, the resulting effects on fair value estimates would be treated as a change in estimate as of the first measurement date when the new technique was used.

Use of Pricing Services

378. An enterprise may use estimates by qualified third parties, such as bond dealers, brokers or pricing services, to determine the market exit prices of some instruments in its portfolio. If the estimates are based primarily on techniques other than comparison to observed transaction prices, those techniques are subject to the same requirements as techniques used by the enterprise itself. If significant reliance is placed on such estimates, the enterprise would have procedures in place for assuring that the estimates provided are appropriate for the particular features and terms of its financial instruments, and that material error would be prevented or corrected. An enterprise's control activities may include the following:

    (a) Periodically checking pricing service quotations with estimates made by other qualified third parties on a test basis.

    (b) Verifying the reasonableness of any changes in estimates in excess of a stipulated percentage.

    (c) Reviewing market exit prices that have not changed for a stipulated period.

    (d) Understanding the procedures and controls in place at the pricing service, and obtaining assurance that the implementation of these procedures is subject to independent checks.

    (e) Understanding the bases of pricing models that are used by the pricing service to ensure that they are appropriate to the enterprise's financial instruments, and whether the resulting prices require adjustment for the effects of any dissimilarity between the instruments.

379. In particular, an enterprise would not rely solely on the estimates of the prices of instruments provided by the institution from which they were acquired or that is the counter-party, but would have in place procedures for independent checks on those prices.

Income Statement Presentation

Change in Fair Value of Financial Instruments

380. The change in fair value of a financial asset or financial liability, after adjustment for receipts and payments, is the difference between:

(a) its fair value at the end of the reporting period, or at the time it was derecognised during the reporting period, and

(b) its fair value at the beginning of the reporting period, or at the time it was first recognised during the reporting period,

adjusted to exclude any receipts or payments, such as in partially recovering the asset or partially settling the liability. The change in fair value so calculated represents the income or expense of a financial asset or financial liability for the reporting period.

381. The computation may be illustrated by the following example:

Suppose these facts –

	Fair value at	
	31/12/99	31/12/00
Loan assets	1,800	2,100
Financial liabilities	800	900

Cash receipts in period:		
Loan assets sold (fair value received on sale)	175	
Debt issued (fair value received on issue)	150	
Principal and interest received on loan assets	200	525
Cash payments in period:		
New loans made	500	
Debt payments made	75	575
Net decrease in cash		50

Given these facts, the fair value income and expense for the period would be computed as follows:

		Loan assets		Financial liabilities
Fair value at December 31, 1999		1,800		(800)
Cash receipts and payments:				
New loans/debt issued	500		(150)	
Sales of loans	(175)			
Other cash receipts	(200)			
Debt payment			75	
		125		(75)
		1,925		(875)
Fair value at December 31, 2000		(2,100)		900
Net change:				
Fair value income on loan assets		(175)		
Fair value expense on financial liabilities				25

These results may be reconciled as follows:

Change in fair value of loan assets (2,100-1,800)	300
Change in fair value of financial liabilities (900-800)	(100)
	200
This net change is represented by	
Fair value income on loan assets	(175)
Fair value expense on financial liabilities	25
Decrease in cash	(50)
	(200)

Fair Value Interest Revenue and Expense

Current Yield to Maturity Basis

382. On the current yield to maturity (CYTM) basis, the interest rate is the average per period rate that market participants would receive on an interest-bearing financial instrument reflecting its term and risks. CYTM is, therefore, the average per period rate that equates future contracted cash flows of an interest-bearing financial instrument (taking into account, where relevant,[27] expectations of the effects of any repayment options) with its

[27] See paragraph 100 on the effect of embedded options on fair value.

fair value. For example, assume a loan contract provides for coupon payments of 80 at the end of each of the next three years plus a 1,000 payment at the end of the third year. Suppose that this loan has a fair value of 1,053 at the beginning of year 1. The average annual interest rate that equates the contracted cash flows with this fair value is 6 percent. This then is the current yield to maturity rate on this financial instrument as at the beginning of year 1.

Current Market Expectations Basis

383. Paragraph 139 provides that an enterprise may elect to use the current market expectations basis to determine interest revenue and interest expense, if the chief operating decision maker relies primarily on this basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk. For the purposes of the Draft Standard, the current market expectations rate is defined as the current per period rate of interest reflected in current interest forward rates implicit in the current market interest rate yield curves. Current market expectations rates may be derived from current interest spot rates.

384. To illustrate, suppose a zero coupon bond of 1,000 is payable at the end of 3 years. If the 3-year spot rate appropriate to this bond is 6.0 percent at the beginning of year 1, the bond would be expected to have a fair value at that date of 840 [$1,000/(1.06)^3$] (Note that in this case the CYTM at the beginning of year 1 is 6.0 percent.). Suppose that the spot rate for a 1-year bond is 5.0 percent and for a 2-year bond is 5.5 percent. Forward interest rates may be derived from these spot rates as follows:

1 year forward rate for year 1 = 5.0%

1 year forward rate for year 2 = 6.0% ($[(1.055)^2/(1.05)]-1$)

1 year forward rate for year 3 = 7.0% ($[(1.06)^3/(1.05)(1.06)]-1$)

Thus, at the beginning of year 1, the market expectations for the interest rate in year 1 is 5.0%, and the expectations for the term of the bond would be:

Balance, beginning of year 1	840
+ interest at 5.0% for year 1	42
	882
+ interest at 6.0% for year 2	53
	935
+ interest at 7.0% for year 3	65
Balance, end of year 3	1,000

385. The effect is that the rate of interest on the current market expectations basis for a period is the current short-term rate of interest prevailing in that period, that is, the rate that would apply if the financial instrument matured at the end of the reporting period. The rate of interest applicable to year 2 in the above example would be the actual short-term rate prevailing in that year; it would only be 6 percent if the actual one-year rate in year 2 were 6 percent.[28]

Interest Calculation

386. The fair value interest rate applicable to an interest-bearing financial instrument changes with changes in the basic interest rate, the credit risk of the borrowing enterprise, and possibly other factors affecting market participants' expectations for future cash flows and their uncertainty. These changes tend to occur frequently so that a precise determination of interest on a fair value basis would require continuous re-calculations. For practical reasons, an enterprise may choose to accrue fair value interest on a quarterly basis by groups of similar interest-bearing financial instruments where rates have not undergone significant change in the quarter. This accrual could be based on multiplying the appropriate interest rate for each group at the beginning of the quarter by its average fair value during the quarter. Interest on interest-bearing financial instruments acquired or issued during a quarter could be accrued for the remaining period of the quarter at the average per period rates implicit in their fair values on initial recognition.

387. This calculation is illustrated by the following example:

	Fair value 31/12/00	Acquired/ issued in period	Interest rates	Fair value 31/03/01	Interest
Financial Assets					
Government bonds	500		1.35[29]	100	4.05
Acquisitions		100	0.50[30]	100	.50
Loan Assets					
High credit standing	1000		1.75[29]	900	16.65
Moderate credit standing	500		2.00[29]	400	9.00
Low credit standing	300		2.45[29]	300	7.35

[28] The basis for determining interest on the market expectations basis is not further discussed here, as the underlying concepts and determinants of the term structure of interest rates and forward interest rates are covered in finance texts.

[29] Current market 3-month rates of interest at the beginning of the quarter.

[30] Rates of interest implicit in fair values on initial recognition for the remaining portion of the quarter.

New loans		390	1.60[30]	400	6.25
Impaired loans	100		2.60[29]	100	2.60
					46.40
Financial Liabilities					
Unsecured debt	800		1.80[29]	800	14.40
Secured debt	1000		1.70[29]	1000	17.00
New issues		400	0.75[30]	400	3.00
					34.40

388. Where interest rates have undergone significant change during a quarterly period, or significant disposals, or changes in the credit risk of interest-bearing financial instruments have taken place near the beginning or end of the reporting period, the above calculation may need to be refined. For example, this may be accomplished by making separate calculations for the portions of the quarterly period before and after a significant rate or portfolio change.

389. Interest on a fair value basis would be calculated for all of an enterprise's interest-bearing financial assets and financial liabilities, including those that it intends to hold for short-term trading purposes.

Compound Financial Instruments

390. Some financial instruments include interest-bearing and other financial instrument rights and obligations. For example, the contract underlying a financial asset might specify an amount of principal to be repaid, with a return on principal to be determined at the greater of (a) a specified rate that is well below market rates of interest for financial assets of equivalent credit risk and term, and (b) an amount based on a stock index. The fair value would be estimated for each of the interest-bearing and equity elements in order to determine the amounts to be presented in the income statement disclosures required by the Draft Standard.

Disclosure

General Presentation Matters

391. Disclosures about financial risks and financial instruments are likely to be more readily understandable if they draw together relevant information in a combination of narrative and numerical analyses, rather than providing scattered information throughout the financial report. Sufficient information would be provided to indicate how amounts disclosed in notes to the financial statements relate to relevant line items on the balance sheet and income statement.

392. When an enterprise is party to large numbers of financial instruments with similar characteristics and no single instrument is individually significant to the future cash flows of the enterprise, disclosure would be provided by way of summarised information by reference to particular classes of financial instrument. However, when a single instrument is individually significant to the future cash flows of the enterprise, information would be disclosed about that particular instrument separately from disclosures about other financial instruments.

Significant Financial Risks

393. The purpose of the disclosures required by paragraphs 154-155 is to provide a focused description of the significant financial risks inherent in an enterprise's activities that, when considered with information provided in other parts of the financial statements, is sufficient to enable users of those financial statements to understand the nature and relative importance of the enterprise's significant financial risks. Some of this information might be contained in financial statement information that is required by other accounting standards. For example, where information on business segments is provided, that disclosure would provide information about products and services that are the source of exposures to commodity price risks. Information about geographical segments would provide some information about the sources of an enterprise's foreign currency risk exposures. Balance sheet information about how an enterprise is financed would provide some information about the source of its interest rate exposures. Balance sheet information on the nature and extent of an enterprise's lending activities would be an important part of the basis for understanding an enterprise's exposure to credit risk.

394. In describing its significant financial risks, an enterprise will usually need to elaborate on the nature of each risk involved. For example, it will usually not be sufficient to refer merely to currency risk without also explaining the principal currencies involved. Similarly, information about basic interest rate risk would identify the country or region in which each significant interest rate risk arises.

Financial Risk Position at the Reporting Date

Basic Interest Rate Risk and Currency Risk

395. The disclosure of fair value classified according to contractual interest re-pricing dates required by paragraph 170 would, at a minimum, present the fair values of financial instruments exposed to basic interest rate price risk, grouped by those that are contracted to re-price or mature (a) within three months from the reporting date, (b) more than three months and less than one year of the reporting date, (c) more than one year and less than five years from the reporting date, and (d) five years or more from the reporting date. Floating rate financial instruments would be classified according to the time when the floating rate re-sets. The contractual interest re-pricing date is the date on which the interest rate re-sets or, for instruments with no re-pricing date during their contractual term, is the maturity date. However, when a financial instrument includes prepayment conditions, the fair value would be included in the period in which the prepayment is expected to occur, using the same assumptions taken into account in determining the fair values. Individual interest rate risk positions associated with different financial instruments would not be offset unless they are permitted to be offset for balance sheet presentation purposes.

396. This disclosure is not restricted to interest-bearing financial instruments. It would also include those derivative instruments that are subject to basic interest rate risk.

397. When an enterprise has identified currency risk as a significant financial risk associated with particular financial instruments, instruments subject to currency risk would be grouped as separate classes for purposes of interest rate risk disclosures. An enterprise with financial instruments denominated in multiple currencies would analyse fair value separately for the currencies that most affect its activities. For example, disclosure of currency risk and basic interest rate risk might be provided by means of a table as follows:[31]

[31] Paragraph 170 requires that this disclosure be presented for each significant class of financial asset and financial liability. For simplicity, this example illustrates total financial assets and total financial liabilities only.

FINANCIAL ASSETS Currency	**Fair value total ’000**	**Not more than three months ’000**	**More than three months but not more than one year ’000**	**More than one year but not more than five years ’000**	**More than five years ’000**
Sterling	3,995	2,500	1,100	395	-
US dollar	900	900	-	-	-
Japanese yen	480	480	-	-	-
Australian dollar	500	250	130	80	40
Other	480	200	-	-	280
Total	6,355	4,330	1,230	475	320
FINANCIAL LIABILITIES Currency					
Sterling	995	660	110	100	125
US dollar	2,615	2,200	120	295	-
Japanese yen	507	150	200	157	-
Australian dollar	450	200	140	110	-
Other	307	50	160	97	-
Total	4,874	3,260	730	759	125
NET GAP Currency					
Sterling	3,000	1,840	990	295	(125)
US dollar	(1,715)	(1,300)	(120)	(295)	-
Japanese yen	(27)	330	(200)	(157)	-
Australian dollar	50	50	(10)	(30)	40
Other	173	150	(160)	(97)	280
Total	1,481	1,070	500	(284)	195

398. When financial assets or financial liabilities are held or issued by a foreign entity, the reporting enterprise might present the additional information required by sub-paragraph 171(b) in the following manner:[32]

> 3,297,000 of the fair value of the enterprise’s financial liabilities arises in foreign entities. Of this amount, 2,000,000 arises in foreign entities where the functional currency is the US dollar, 400,000 arises in foreign entities where the functional currency is the Japanese yen, and 400,000 arises in foreign entities where the functional currency is the Australian dollar.

399. Many enterprises manage their basic interest rate risk by managing the net gaps in the amounts, timing and uncertainties of future cash flows relating to assets and liabilities. Information about an enterprise’s exposure to these cash flows will typically be portrayed by information about the terms and conditions of financial instruments (see paragraphs 164-169), as well as information about contractual re-pricing and maturity dates (see paragraph 170) and the extent to which cash flows could vary as a result of changes in risk conditions (see paragraphs 179-180). An enterprise might supplement this information with an analysis of the fair value of financial assets and financial liabilities according to the time periods in which those cash flows are contracted to occur. The time grouping for such an analysis would be the same as that adopted for disclosure of interest rate risk in accordance with paragraph 395.

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[32] For simplicity, the disclosure for financial liabilities, only, is shown.

Credit Risk

400. Some exposures to concentrations of credit risk will be clearly evident from the enterprise's business operations. For example, it will be clear that an enterprise selling products in only one geographical area is exposed to credit risk associated with changes in the general circumstances affecting that geographical area. In such cases, a separate description of the region that is the basis of the concentration of credit risk, in accordance with sub-paragraph 173(a), is unnecessary.

401. When financial instruments are measured at fair value on the balance sheet, the carrying amount of most financial instruments will represent the maximum credit risk exposure. However, this is not the case for instruments such as credit guarantees written, financial assets against which collateral is held, or instruments subject to master netting or set-off arrangements that are reflected in the balance sheet presentation. In these cases, the fair value will reflect the market's expectation that the enterprise will have to deliver in accordance with the guarantee, or will be able to collect the collateral to recover an asset, or the fair value will represent only a net exposure. In these cases, the maximum credit exposure is the maximum amount that an enterprise would have to deliver in accordance with the guarantee in the event of a default, the maximum amount that the enterprise would lose in the event that the counter-party to a transaction for which collateral is held fails to deliver and the collateral proves not to be collectable or worthless, and the gross amount of the financial instruments subject to master netting or set-off arrangements.

Other Significant Financial Risks

402. The Draft Standard does not specify the manner in which quantitative information about significant financial risks other than basic interest rate risk, currency risk and credit risk at the reporting date would be disclosed. For each significant financial risk, the disclosure would provide an indication of the extent to which the fair values of financial assets and financial liabilities are affected by that risk at the reporting date.

403. Disclosure of the terms and conditions of financial instruments, in accordance with paragraphs 164-169, would provide basic information about the presence of particular risks. When a financial risk affects more than one class of financial instruments, information would be provided to disclose the overall effect of that financial risk on the enterprise. For example, a commodity price risk might be present in financial liabilities (such as gold loans) as well as in financial assets based on commodity prices (such as forward contracts to sell gold that can be settled net by a financial instrument). An enterprise would disclose information about the financial instruments that are exposed to that particular risk (such as their fair values) at the reporting date in a manner such that the magnitude of the total exposure to that risk is portrayed.

404. Appropriate ways of reporting the quantitative information required by paragraph 175 will differ for different enterprises and will probably evolve over time as management approaches and measurement techniques evolve. Some possible disclosures are set out in paragraphs 405-408. However, these are not exhaustive and enterprises are encouraged to develop other ways of reporting the quantitative information.

405. Quantitative disclosure of other significant financial risks need not identify the fair value amount that relates to the particular risk, but might be provided by disclosing the fair value of the financial assets and financial liabilities that are affected by that risk.

406. For prepayment risks, the disclosure of early settlement options in paragraph 166(e) might be extended to include an explanation of the circumstances under which they can be exercised and the conditions under which they might be exercised. An enterprise might disclose the fair values of financial assets and financial liabilities that are subject to prepayment risks, together with information about the periods in which those fair values are expected to re-price or mature when they differ significantly from the contractual dates.

407. For risks related to financial options, an enterprise might disclose information about the volatility of underlying benchmarks. One means of providing this might be to disclose the standard deviation of the enterprise's return, based on historical data for the previous twelve months.[33]

408. For liquidity risk, information about terms and conditions of financial instruments will generally provide some information—in particular, the information about restrictions on the enterprise's use of certain financial instruments (see paragraphs 168 and 169). Information about the methods used to determine fair value (see paragraphs 183 and 184) also provides some indication of liquidity risk in that it identifies which financial instruments are valued by reference to observable market exit prices and which are valued by other means. This information might need to be supplemented when other factors affect the enterprise's overall ability to liquidate financial instruments.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

409. An enterprise might take one or more of a variety of approaches to providing information about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions. Possible approaches include the following.

[33] For possible approaches to quantifying risks related to financial options see, for example, Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks, January 1996, pages 32 to 37, which discusses potential methods of measuring price risk for options.

(a) Disclosure of the effect of a hypothetical change in the prevailing level of market prices on the fair value of the enterprise's financial instruments and reported earnings and cash flows (sensitivity analysis). The hypothetical changes used would be those that the enterprise believes would be reasonably possible during the twelve months following the reporting date. For example, an enterprise might choose to indicate the effect of one or more of the following measures (assuming that the relevant change is reasonably possible):

   (i) 15 percent or 100 basis point (whichever is greater) adverse interest rate shift along the yield curve;

   (ii) 15 percent or 100 basis point (whichever is greater) adverse interest rate shift at the long end (over 7 years) or short end (under 7 years) of the yield curve relative to the rest of the curve;

   (iii) 50 basis point adverse credit spread change relative to government securities;

   (iv) 10 percent adverse change in any exchange rate in which the enterprise has 10 percent or more of its assets denominated;

   (v) 20 percent adverse change in any exchange rate in which the enterprise has 5 percent or more of its sales;

   (vi) 15 percent adverse movement in equity prices; or

   (vii) two annualised standard deviations or 20 percent (whichever is greater) price change in, for example, any physical commodity that has a material impact on the enterprise's operations.

(b) Disclosure of the expected loss from an adverse market movement with a specified probability over a specified period of time. Value-at-risk methodologies are a means of calculating such information.

Other risk measurement techniques are becoming established and might be used, as long as they are accompanied by the disclosures in paragraph 180.

410. An enterprise might choose to use a different approach for each financial risk. An enterprise might, for example, choose to disclose the results of sensitivity analysis for currency risk, notwithstanding that it uses a different methodology for its interest rate risk disclosure.

411. Many risk measurement techniques used are complex, so that a full description of them would involve providing a considerable amount of technical information. However,

disclosure of the methodology and the main parameters and assumptions used will help users to understand the extent to which the measures disclosed by different enterprises might be comparable. In the case of value-at-risk, for example, the information disclosed will usually include the holding period and confidence limits. It might also include the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations and what volatility and correlation assumptions (or, alternatively, Monte Carlo probability distribution simulations) are used.

Disclosure Example

412. An example of how the disclosures required by this Draft Standard, as they relate to an enterprise's foreign currency risk, might be provided follows (The disclosures required by paragraphs 164-169, concerning the terms and conditions of financial instruments, are not illustrated. The example assumes that the enterprise chooses to provide additional disclosures about its risk management activities associated with transactions expected to occur in future reporting periods, as encouraged in paragraph 182).

Example

<u>Foreign currency risk management policy.</u> UK Company uses forward currency exchange contracts, swaps, options and debt to reduce its exposure to fluctuations in currency exchange rates arising from export sales priced in US dollars and certain accounts and notes receivable denominated in US dollars. Export sales account for approximately 20 percent of the company's overall sales volume.

The company's objective is to maintain an immaterial net balance sheet foreign currency risk exposure at any given time, except with respect to positions taken to manage future foreign currency risks relating to certain highly probable future transactions. The company reviews its net balance sheet foreign currency exposure at each month end to assess the effectiveness of its risk management strategy.

<u>Foreign currency risk position.</u> At December 31, 2000, the company had a US dollar asset risk exposure (comprising US dollar denominated receivables and foreign currency swaps) of £130,000 (December 31, 1999 £80,000) and a US dollar liability risk exposure (comprising debt and foreign currency swaps) of £110,000, (December 31, 1999 £55,000), excluding positions taken to manage anticipated future transactions (see below). A net foreign currency loss of £2,000 (1999—£750) was recognised in the income statement in the year in respect of US dollar denominated financial assets and financial liabilities that were not managing foreign currency risks relating to future transactions.

<u>Future transactions</u>. The company acquires foreign currency put options and forward exchange contracts to manage a portion of the foreign currency risk in anticipated sales

denominated in US dollars. These contracts are entered into to help protect the company against the risk that the future cash inflows expected to result from such sales will be adversely affected by changes in exchange rates. Based on the company's expectations of future exchange rates, it enters into contracts to offset the foreign currency risk in 25 percent to 75 percent of anticipated sales for the following 6-8 months.

At December 31, 2000, the company had foreign exchange forward contracts to sell \$1,500,000 over an average period of 4.5 months (December 31, 1999—\$950,000 over an average period of 3.5 months) that were entered into to manage the foreign currency risk in anticipated sales. These forward contracts had a negative fair value of £100,000 at that date. This amount was recognised as a loss in the income statement of the current period (at December 31, 1999 forward contracts had a positive fair value of £25,000). All of the loss recognised in the current period's income statement is expected to represent an effective hedge of the foreign currency risk in anticipated sales denominated in US dollars.

Foreign exchange forward contracts held at the end of 1999 and identified as managing future US dollar risks relating to 2000 sales revenues were settled in January 2000 when management determined that its expectation was that future US dollar rates were likely to increase, rather than decrease.

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

BASIS FOR CONCLUSIONS

This Basis for Conclusions summarises considerations that members of the JWG deemed significant in reaching the conclusions in this Draft Standard. It includes reasons for adopting certain accounting methods while rejecting others.

Contents

Paragraphs

1. Objective 1.1-1.43

Comprehensive Approach 1.2

Conceptual Framework 1.3

Implementation 1.4

Fundamental Principles Underlying the Draft Standard 1.5-1.37

Fair Value Measurement Principle 1.6-1.26

Income Recognition Principle 1.27-1.28

Asset and Liability Recognition and Derecognition Principle 1.29-1.30

Disclosure Principle 1.31-1.37

Overall Evaluation and Implementation Considerations 1.38-1.43

2. Scope 2.1-2.70

Enterprises Included in Scope 2.1-2.12

Banks 2.2-2.5

Insurance, Pension and Similar Enterprises 2.6-2.9

Smaller or Non-public Enterprises 2.10-2.12

What is a "Financial Instrument"? 2.13-2.19

The Definition of a Financial Instrument 2.13-2.14

Derivative Financial Instruments 2.15

Financial Instruments Compared to Non-financial Resources 2.16-2.19

Financial Instruments Excluded from the Scope 2.20-2.36

Equity Interests in Subsidiaries, Associates and Joint Ventures 2.21-2.22

Basis for Conclusions - Contents

Employers' Assets and Liabilities under Employee Benefit Plans, Retirement Benefit Obligations of Defined Benefit Plans and Certain Rights and Obligations with Insurance Risk resulting from Insurance Contracts 2.23-2.30

Equity Instruments Issued and Classified as Equity by the Reporting Enterprise 2.31

Business Combination Contracts involving Contingent Consideration 2.32

Licence Fees, Royalties and Similar Items 2.33-2.36

Additional Items Included in Scope 2.37-2.47

Certain Contracts to Buy or Sell a Non-financial Item 2.39-2.43

Servicing Assets and Servicing Liabilities 2.44-2.47

Hybrid Contracts 2.48-2.52

Other Scope Considerations 2.53-2.70

Leases 2.54-2.57

Commitments to Buy or Sell a Non-financial Item at a Fixed Price in a Foreign Currency 2.58-2.62

Financial Instruments Held for "Strategic" Purposes 2.63-2.66

Indirect Investment in Non-financial Assets 2.67

Taxes, Legal Fees, Fines, etc. 2.68-2.69

Related Party Transactions/Inter-company Balances 2.70

3. Recognition and Derecognition 3.1-3.103

Approaches to Recognition and Derecognition That Could be Adopted 3.1-3.25

Implications of the Framework for Recognition and Derecognition 3.1-3.8

FRS 5, FASB Statement 140 and IAS 39 .... 3.9-3.14

An All-or-nothing Approach or a Components Approach? 3.15-3.25

Derecognition 3.26-3.30

Transfers involving Financial Assets 3.31-3.102

Arrangements to Pass Cash Flows Through One Enterprise to Another 3.32-3.37

The Difficulties and Issues That Can Arise in Determining Whether to Derecognise a Transferred Asset 3.38-3.42

Control Is the Key Determining Factor 3.43-3.45

Basis for Conclusions - Contents

Determining whether Control Has Been Relinquished 3.46-3.49

Application of the JWG's Recognition and Derecognition Principles to Transfers involving Financial Assets 3.50-3.71

Transfers That Lack Substance Should Have No Accounting Effect 3.72-3.80

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party 3.81-3.92

Transfers Where the Transferor has an Obligation to Repay Consideration Received 3.93-3.98

Transfers Where the Transferor Has a Call Option over a Transferred Component 3.99-3.102

Implications of the JWG's Recognition and Derecognition Proposals for Non-financial Items 3.103

4. Fair Value Measurement 4.1-4.69

Defining Fair Value—the Exit Price Objective 4.1-4.3

Value-in-use, Recoverable Amount and Deprival Value 4.4-4.10

Direct Costs to Sell or Obtain Relief (Exit Costs) 4.11

Hybrid Contracts 4.12-4.16

Differences between Bid and Asked Prices (Bid-asked Spreads) 4.17

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument 4.18-4.32

Written Options That Are Not Embedded in Other Financial Instruments ... 4.23-4.27

Financial Instruments That Contain Options 4.28-4.32

Application to Demand Deposit Liabilities 4.29-4.32

Prices from More than One Market for the Same Instrument 4.33

Large Blocks of Instruments and Control Premiums 4.34-4.35

Estimating Fair Value without Observable Market Exit Prices 4.36-4.47

Loan Assets and Credit Risk 4.36-4.41

Impaired Loan Assets 4.42-4.47

Financial Liabilities 4.48-4.63

Non-financial Assets Financed by Debt 4.49

The Implications of an Enterprise's Credit Risk 4.50-4.62

Basis for Conclusions - Contents

Financial Guarantees of an Enterprise's Financial Liabilities 4.63

Exception for Certain Private Equity Investments 4.64-4.67

Establishing Fair Value Estimation Policies and Procedures 4.68-4.69

5. Balance Sheet Presentation 5.1-5.5

6. Income Statement Presentation 6.1-6.86

Fair Value Changes as Income 6.2-6.13

The Concept of Fair Value Income 6.3-6.6

Reflecting the Effects of Events in the Periods They Occur 6.7

Basis for Prediction 6.8-6.12

Accountability for Income Performance 6.13

Concerns with Respect to Recognising All Fair Value Gains and Losses Immediately in the Income Statement 6.14-6.26

Relationship to Accounting for Non-financial Operating Activities 6.15-6.16

Presenting some or all Financial Instrument Gains and Losses outside the Income Statement 6.17-6.26

Exemption of Certain Foreign Currency Translation Gains and Losses 6.27-6.29

Disaggregation of Fair Value Income 6.30-6.45

The Need for Fair Value Income Disaggregation 6.30-6.31

JWG Approach 6.32-6.33

Existing Standards 6.34-6.36

Implications of the Fair Value Model and Financial Markets 6.37

Computational Issues 6.38-6.41

Other Possible Bases of Income Statement Presentation 6.42-6.45

Interest Revenue and Expense 6.46-6.77

Elements of an Interest Rate 6.48-6.49

What Are "Interest-bearing Financial Instruments"? 6.50-6.57

Determining Interest Revenue and Interest Expense within a Fair Value Model 6.58-6.76

Application of Fair Value Interest Determinations in Some Countries 6.77

Basis for Conclusions - Contents

Disclosure of the Fair Value Effects of Changes in the Issuer's Credit Risk on Financial Liabilities 6.78

Net Gain or Loss Resulting from Changes in Interest Rates 6.79-6.80

Net Gain or Loss on Impaired Loans 6.81

Foreign Currency Denominated Financial Instruments 6.82-6.84

Statement of Cash Flows 6.85-6.86

7. Hedges 7.1-7.22

Introduction 7.1-7.2

The Demand for Hedge Accounting 7.3-7.20

Hedge Accounting to Correct Accounting Inconsistencies 7.4-7.9

Hedges of Anticipated Future Transactions 7.10-7.20

Foreign Currency Hedges of the Net Investment in a Foreign Entity 7.21-7.22

8. Disclosure 8.1-8.56

Objectives of the Disclosure Requirements 8.1-8.4

Significant Financial Risks 8.5-8.8

Financial Risk Management Objectives and Policies 8.9-8.12

Terms and Conditions of Financial Instruments 8.13-8.17

Financial Risk Position at the Reporting Date 8.18-8.35

Basic Interest Rate Risk 8.19-8.21

Currency Risk 8.22-8.24

Credit Risk 8.25-8.27

Other Significant Financial Risks 8.28

Financial Risk Position at the Reporting Date Compared with that During the Reporting Period 8.29

Potential Effects of Changes in Risk Conditions on Financial Risk Position 8.30-8.35

Financial Instruments Used to Manage Risks Associated with Transactions Expected to Occur in Future Reporting Periods 8.36-8.43

Accounting Policies 8.44

Methods Used to Estimate Fair Value 8.45-8.50

Derecognition Disclosures 8.51-8.52

Basis for Conclusions - Contents

Sale and Repurchase Transactions and Stock Lending Transactions 8.51

Retained Interests in Transferred Assets 8.52

Location of Disclosures 8.53

Historical-cost-based Disclosures 8.54-8.55

Specific Industry Disclosures 8.56

9. Effective Date and Transition 9.1-9.21

Effective Date 9.1-9.4

Supplemental Financial Statements 9.5-9.7

Transition 9.8-9.21

Transition—Overall Approach 9.8-9.10

Transition—Valuation Adjustments 9.11-9.12

Transition—Unwinding Existing Hedge Accounting 9.13-9.15

Transition—Gains and Losses Previously Recorded Directly in Equity 9.16

Transition—Derecognition 9.17-9.18

Transition—Hybrid Contracts 9.19-9.20

Transition—Restatement of Prior Period Financial Statements 9.21

1. Objective

1.1 The JWG's objective has been to develop a Draft Standard and Application Supplement on financial instruments and similar items that are (a) comprehensive; (b) consistent with both relevant conceptual framework concepts for financial reporting and accepted economic principles evident in capital markets and finance theory; and (c) capable of reasonable implementation.

Comprehensive Approach

1.2 The IASC Discussion Paper[1] that has been the primary basis for the JWG's considerations recommended that the objective of accounting standard setters should be to develop a comprehensive set of standards for financial instruments. This means a set of standards for the recognition, derecognition, measurement, income statement presentation, and disclosure of all financial instruments for all enterprises. The IASC Discussion Paper demonstrated that principles in each of these areas of accounting and disclosure have important interdependencies, so that it is highly desirable to address them together, rather than on a piecemeal basis. In contrast, existing standards and practices have been developed on a piecemeal basis. The result has been major gaps and inconsistencies.

Conceptual Framework

1.3 A fundamental conclusion of the IASC Discussion Paper was that a sound and relevant conceptual framework for accounting for financial instruments must bridge two conceptual bases—that of financial accounting and that which underlies modern capital markets. It demonstrated that the latter conceptual basis has important implications for the recognition and measurement of financial instruments and for the disclosure of financial information to support investment and financial risk management purposes. Major developments have taken place in recent years in capital markets, in finance theory, in information technology, in the use of innovative derivative and other financial instruments, and in financial risk management approaches. The IASC Discussion Paper proposed fundamental changes to accounting for financial instruments to recognise the implications of these developments for improving the usefulness of accounting information.

Implementation

1.4 The Draft Standard attempts to strike a reasonable balance between conceptual ideals and practical cost-benefit considerations. See also paragraphs 1.38-1.43.

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[1] IASC, Accounting for Financial Assets and Financial Liabilities, March 1997.

Fundamental Principles Underlying the Draft Standard

1.5 The following four principles provide the cornerstones for this Draft Standard.

(a) Fair value is the most useful measure of financial instruments and similar items within the scope of this Draft Standard.

(b) All changes, after adjustment for receipts and payments, in the fair value of financial instruments and similar items within the scope of this Draft Standard are increases or decreases in the income of the reporting enterprise and should be recognised in its income statement in the periods in which they arise.[2]

(c) Only items that are assets or liabilities should be recognised and measured as such in financial statements.

(d) Financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies.

Fair Value Measurement Principle

1.6 Fair value is the most useful measure of financial instruments and similar items within the scope of this Draft Standard.

1.7 The two most important qualitative characteristics of accounting information are relevance and reliability. The JWG believes that fair value is the most relevant measurement attribute for financial instruments and that sufficiently reliable estimates of their fair value are generally obtainable for use in financial reporting.

Relevance

1.8 The JWG believes that the measurement of financial instruments at fair value has a number of major conceptual advantages. The more important of these are outlined below.[3]

(a) Fair value reflects the market's assessment of the effects on financial instruments of current economic conditions, and changes in fair value reflect the effects of changes

[2] The Draft Standard makes one exception for foreign currency translation gains and losses on financial instruments of certain foreign operations of an enterprise. See Draft Standard paragraph 136.

[3] The following sources provide further information on the underlying issues: IASC Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997; FASB, Preliminary Views, Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value, Appendix A, December 14, 1999; and Accounting Standards Board (U.K.), Derivatives and Other Financial Instruments—A Discussion Paper, July 1996.

in those economic conditions when they take place. This follows from the expectation that the fair value of a financial instrument determined in competitive, open market economies embodies all available information up to the measurement date. Cost-based measures reflect only the effects of conditions that existed when the transactions took place, and the effects of price changes are reflected only when they are realised or settled, even though realisations or settlements are not the events that caused the gains or losses.[4]

(b) Following from (a), fair value provides a better basis for prediction than other measures. The fair value of a financial instrument represents the present value (taking into account all available information) of its expected cash flows discounted at the current market rate of return for commensurate risk. Thus, fair value embodies the market's expectation that the fair value of the instrument will increase over time at that market rate. As a result, if an investor knows the fair value of a financial instrument and has information about its essential terms and risks, he or she has the basics for evaluating the market's expectations. The investor may then make his or her own adjustments for possibly different expectations from those of the market. Cost-based measures only enable extending the effects of past costs to the future by, for example, "predicting" future amortisation and interest coupon payments of a debt-type instrument, assuming no default, restructuring or early repayment effects.

(c) Because it is a market-based notion, fair value is unaffected by:

(i) *the history of the asset or liability*. Fair value does not depend on the date or cost at which an asset or liability was acquired or assumed;

(ii) *the specific enterprise that holds the asset or owes the liability*. Fair value is the same no matter which enterprise has an asset or liability if both enterprises have access to the same markets and, for a liability, if they have the same credit standing; or

(iii) *the future use of the asset or liability*. Fair value does not depend on whether or when it is intended to dispose of an asset or liability.

Thus, fair value represents an unbiased measure that is consistent from year to year within an enterprise and between enterprises. Fair values of financial instruments are comparative and additive at any measurement date, because fair values are current measurements of the present value of expected future cash flows. Cost-based measures, in contrast, impede comparability because they make like instruments look different and different instruments look alike. For example, two enterprises holding

[4] This is mitigated only to the extent of provisions for impairment of financial assets.

instruments with cash flows of identical timing, amounts and uncertainties probably would report different cost amounts if they were acquired at different times.

(d) Fair value reflects the effects of management's decisions to continue to hold assets or owe liabilities, as well as decisions to acquire or sell assets and to incur or settle liabilities. A historical-cost-based measure ignores the effects of decisions to hold or owe, because it reflects the effects of changes in fair value only when assets are sold or relief from liabilities is obtained, not during the period a financial instrument is held or owed.

(e) Reporting all financial instruments at fair value would reduce the anomalies of the existing mixed cost—fair value accounting for financial instruments. Therefore, it would reduce the need for complex and subjective hedge accounting requirements. If both the hedged item and the hedging instrument are measured at fair value, the degree to which a risk management strategy succeeded in mitigating the risk is readily apparent. (The implications of fair value measurement for hedge accounting are considered in paragraph 7.5.)

1.9 Reporting at fair value does not imply that the fair value will be immediately realised. The relevance of fair value is not affected by the ability to sell an asset immediately or obtain immediate relief from a liability, although marketability may affect the measure of the fair value of a financial instrument.

1.10 It is commonly argued that cost-based accounting is appropriate for financial assets and liabilities that are managed together on the basis of the expected timings and amounts of their net cash flows. Banks, for example, typically manage their "banking book" activities on a cost basis, utilising net cash flow gap analysis and other techniques for managing their financial risk exposures. Many banks strongly advocate cost-based accounting in preference to fair value measurement for financial assets and liabilities managed in their banking books. The JWG considered these arguments and underlying concerns and available evidence. It concluded that accounting for these financial assets and liabilities on a cost basis cannot provide as relevant a measure of their matched and mis-matched cash flow positions as can fair value measurement. In so concluding, the JWG observes that difficult issues arise in assessing the extent to which financial asset and liability positions are matched at any given time, taking into account expectations with respect to credit risk, complex payment options and other uncertainties relating to the timings and amounts of cash flows to result from these positions. It believes that comprehensive fair value measurement of financial assets and liabilities will provide a consistent current market measure of the effects of mis-matched positions, and consequently will provide relevant reporting of the effectiveness of netting strategies.

1.11 Some believe more generally that fair value measurement of financial instruments cannot be considered to be relevant, and should not be required, except when an enterprise manages its financial instruments on that basis. It is obviously desirable that there be consistency between external and internal reporting systems, and it is difficult to see how there could be fundamental and irreconcilable inconsistencies between sound external and internal financial risk management and investment bases. However, the objective of financial reporting is to meet the financial information needs of external stakeholders and, accordingly, the JWG believes that what constitutes appropriate financial accounting standards for financial instruments must be justified primarily from that perspective. The JWG believes that it is important that there be consistent methods for measuring and reporting the results of an enterprise's management strategy. This is not achieved if two enterprises with identical financial instruments and risks present different balance sheet positions and income statement results solely as a result of the way in which they choose to manage those instruments and risks.

1.12 The conceptual case for fair value measurement of financial instruments is supported by a growing body of market-based empirical research. Despite the limitations of fair value disclosures provided to date, the evaluation of a body of academics who have been involved in this research is that:

> The academic literature provides consistent evidence suggesting that fair values of (1) investment securities held by financial institutions, (2) derivatives held by banks for asset-liability management, (3) bank net loans, and (4) bank long term debt, should be recognised on the balance sheet. In addition, empirical results support the inclusion of changes in fair values of these financial instruments in income. Finally, the empirical evidence on comprehensive vs. partial fair value accounting indicates that for fair value accounting disclosures to be most useful, comprehensive, rather than partial, fair value accounting should be adopted.[5]

1.13 Surveys of financial analysts and other users have yielded mixed results. This is consistent with the possibilities that many users are not fully familiar with fair value information and that some analysts prefer cost-based information because it may be less volatile and they believe cost-based income may be more predictable than fair value-based income. A 1997 focus group survey on fair value was conducted by independent consultants on behalf of the Association for Investment Management and Research (AIMR), the FASB and the Canadian Institute of Chartered Accountants. That study found that users who were identified by the independent consultants as being "knowledgeable and informed about fair value accounting for financial instruments" were evenly divided on whether to measure financial instruments at fair value or cost. "The clear and prevailing view" of respondents was that they need more and better information regarding fair values of financial

[5] American Accounting Association's Financial Accounting Standards Committee, Response to a Discussion Paper Issued by the IASC/CICA Steering Committee on Financial Instruments, Accounting for Financial Assets and Financial Liabilities, in Accounting Horizons, March 1998, pages 90-97. This paper overviews empirical and conceptual research on the relevance and information value of fair value measurement of financial instruments, and includes references to specific studies.

instruments.[6] The Financial Accounting Policy Committee of the AIMR has indicated its support for fair value measurement of financial instruments.[7]

Reliability

1.14 The practical concerns most frequently cited by constituents are that observable market prices are not always available and that estimates may be unreliable if they are not based on observable market prices. There have, however, been major advances in valuation techniques that reasonably reflect market pricing methods. Even if a financial instrument does not have an observable market price, its fair value can be estimated using techniques that incorporate capital market pricing principles and information about current market conditions. Such techniques are often used in market price setting processes. Software now commonly available enables many types of computations to be made at reasonable cost.

1.15 However, a number of respondents to the IASC Discussion Paper indicated serious concerns about the ability of enterprises to develop fair value estimates that could be sufficiently reliable for financial accounting in all situations. For the most part, these concerns were expressed only in general terms. The JWG carried out a questionnaire-based survey aimed at more fully understanding the basis for the expressed concerns. The survey covered some of these respondents as well as some others who could be expected to have knowledge that could be helpful in understanding these concerns. There were sixty respondents from ten countries. These included a variety of financial and commercial enterprises as well as three accounting firms. Each respondent was asked to identify specific financial instruments or situations for which it believed it would not be practicable to make fair value estimates that would be sufficiently reliable for financial accounting purposes. Each respondent also was asked to provide details of each identified instrument or situation, and the nature of and reason for the fair value estimation difficulties, as well as information about its experience in addressing these difficulties. The survey and follow-up revealed a number of concerns relating to questions of fair value measurement principles and estimation approaches that the JWG believes are addressed in the Draft Standard and the Application Supplement. The only type of situation raised that the JWG believes might not be practicable of reliable fair value measurement involves certain private equity investments, and the Draft Standard provides an exemption for those investments (see paragraph 122).

1.16 Some believe that the liquidity risk component of fair value often will not be practicable of reliable estimation for financial instruments that are not readily marketable. They believe that the Discussion Paper should require that a liquidity adjustment not be made in estimating the fair value of such financial instruments if an enterprise believes that the

[6] Sirota Consulting, Investment Community Interest in Reporting the Fair Values of Financial Instruments in Financial Statements—A Focus Group Summary: Final Report, June 3, 1998.

[7] Association for Investment Management and Research, Comment letter of July 24, 1997 on IASC/CICA Discussion Paper, Accounting for Financial Assets and Financial Liabilities.

adjustment cannot be reliably estimated. The JWG believes that fair value measures of financial instruments should reflect reasonable estimates and assumptions for all potentially significant factors that market participants would be expected to consider in estimating a market exit price and that there should be no exception for liquidity risk. However, the Draft Standard provides that certain practical assumptions may be made where little or no market information is available on which to base an estimate of some factors that affect fair value, provided that consistent policies and procedures are applied.

1.17 The JWG believes that the range of acceptable fair value estimation variability for financial instruments should be evaluated in relation to the ranges of estimates accepted in other areas of accounting. The IASC Framework notes, for example, that:

> In many cases cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. (paragraph 86)

1.18 Potentially significant degrees of variability of estimates are accepted in many areas of accounting today. Examples include defined benefit pension obligations, certain liability provisions, provisions for impairment of financial and non-financial assets, and custom-designed derivatives that are presently measured at fair value in "trading" portfolios and are to be measured at fair value under accounting standards in some jurisdictions.

1.19 Some valuation techniques will require internally developed estimates and assumptions as well as judgement about which factors market participants would consider. The JWG believes that an important underpinning for ensuring that these estimates and assumptions are made on a reasonably reliable and consistent basis lies in an enterprise establishing a system of fair value measurement policies and procedures that is appropriate to the nature of its financial activities. The Draft Standard makes this an explicit requirement. Enterprises that are using fair value information about financial instruments for internal management purposes may presently have such systems in place. In some cases, systems developed for different purposes may be adapted for fair value measurement purposes, for example, a credit grading system used by a lender in extending loans and monitoring the credit quality of its loan portfolio.

1.20 Setting accounting standards often requires a trade-off between relevance and reliability. In almost all situations involving financial instruments the JWG believes that relevance should be given more weight. That is, the JWG believes that fair value estimates, even with their limitations, will be a significant improvement over cost-based measures. It notes that the measurement of the amortised or recoverable cost of many of these instruments is also subject to similar estimation difficulties. However, as noted above, the JWG believes that there is one possible exception—certain equity investments for which there is no observable market price.

1.21 Determining the fair value of some non-traded equity investments requires more significant internal information and assumptions than are required for other financial instruments. The JWG believes that an enterprise that invests in private equity investments as a primary business activity should be presumed to be able to make fair value estimates for financial reporting purposes. The JWG accepts, however, that other enterprises with private equity investments may determine that it is not possible, without incurring excessive costs, to regularly make reliable estimates of the fair value of these investments. For example, an enterprise in a development or start-up phase has little or no experience on which to base expectations of future cash flows, and an investor may not have access to some of the internal information of the enterprise.

Fair Value Risk Compared with Cash Flow Risk

1.22 Under the fair value model for financial instruments, financial statements reflect the results of taking fair value risk (that is, the risk of increases or decreases in the fair value of financial instruments). This has particularly important implications for interpreting the balance sheet and income statement effects of changes in basic interest rates on interest-bearing financial instruments.

1.23 Many enterprises focus more on managing cash flow interest rate risk (that is, the risk of increases or decreases in future cash flows resulting from changes in interest rates) than on fair value interest rate risk. In so doing they believe that it is floating rate, rather than fixed rate, interest-bearing assets and liabilities that are risky. The fair value market-based model reflects the opposite premise. If an enterprise has fully floating rate debt, and basic interest rates rise, the fair value of the debt will not be affected, and no gain or loss will be reported. This does not accord with the cash flow risk view, which is concerned that the interest coupon cash flows required under this loan will now increase. This may be seen as an adverse effect because the enterprise will have to pay out more cash, and it may not be able to increase asset cash flows to compensate. Furthermore, it will have to incur higher interest expense in future periods.

1.24 The fair value model, which reflects the basis on which capital markets price interest-bearing financial instruments, is founded on the premise that an enterprise has not gained or lost on its floating rate debt because the debt has maintained its value in terms of the current interest return that can be earned in the market place. When basic interest rates rise, the enterprise has the opportunity to earn a commensurately higher cash flow return on its assets if it has not locked in its investments to receive fixed cash flows. Thus, while an increase in basic interest rates has no effect on the fair value of the floating coupon debt, the value of the enterprise’s assets may decrease if they cannot be expected to generate an increase in cash flows commensurate with the increased rate of return currently available on interest-bearing assets in the market place. Of course, on a fair value basis, an enterprise that had issued fixed coupon debt would report a gain due to the increase in the basic interest rate. This enterprise is better off because its debt burden has reduced in terms of the current market cost of capital.

1.25 The historical cost basis does not reflect any gain or loss when basic market rates of interest change. No loss would be recorded on an enterprise's floating rate debt as a result of an increase in interest rates, even if management takes the cash flow risk view that the enterprise is worse off as a result. Neither would the enterprise reflect any gain in the period on fixed coupon debt, unless it decided to realise the gain by settling the debt and refinancing at the new market rate or by acquiring a fixed-floating interest rate swap.

1.26 No measure of a financial instrument of itself conveys information about its particular risk and return attributes. Thus, measurement needs to be supported by disclosures of this information. The Draft Standard would require disclosure of information about the timings, amounts and uncertainties of cash flows related to interest bearing financial instruments, including their floating or fixed nature and the significant contractual conditions that may affect these cash flows (see disclosure requirements in paragraphs 164-169). Thus financial statement users will have information to help them evaluate both cash flow and fair value risks.

Income Recognition Principle

1.27 All changes, after adjustment for receipts and payments, in the fair value of financial instruments and similar items within the scope of this Draft Standard are increases or decreases in the income of a reporting enterprise and should be recognised in its income statement in the periods in which they arise.

1.28 The JWG believes that there are compelling reasons for concluding that all increases and decreases in the fair value of financial instruments, after adjustment for receipts and payments, should be recognised in the income statement of the reporting enterprise. This conclusion is based on consideration of the economic properties of financial instrument income determined on a fair value basis, as well as on practical considerations related to the basis it provides for useful disaggregation and analysis. The JWG believes that fair value income for financial instruments can provide a richer basis for analysis than cost-based or mixed cost—fair value bases and that, in particular, it facilitates the predictive and stewardship purposes of financial statements. The basis for these conclusions is set out in paragraphs 6.2-6.26. This principle also has implications for the treatment of gains and losses arising on financial instruments used to manage risks associated with anticipated future transactions (see paragraphs 7.10-7.20).

Asset and Liability Recognition and Derecognition Principle

1.29 Only items that are assets or liabilities should be recognised and measured as such in financial statements.

1.30 A fundamental purpose of financial reporting is to recognise and measure assets and liabilities of an enterprise on a reporting date. This, in turn, provides the basis for presenting the income and cash flow results that have arisen from assets and liabilities during the reporting period ending on that date. This principle underlies the Draft Standard's definitions of financial assets and financial liabilities and its requirements for their recognition and derecognition. The JWG has concluded that the reasoned application of this principle would require some significant changes to existing standards and practices in accounting for financial instruments in the following areas:

(a) The recognition and derecognition of financial instruments (which are based on determining when financial instruments become assets or liabilities and when they, or parts of them, cease to be assets or liabilities, of the reporting enterprise). Particularly difficult issues arise in applying the basic asset and liability recognition principle to transfers involving financial assets where the transferor has a continuing involvement in the transferred assets. Many and varied forms of often highly complex transactions are now commonly carried out to unbundle, rebundle and transfer components of financial assets comprising certain of their rights and obligations. Traditional concepts have proven to be inadequate to deal with these transactions. Issues of accounting for transfers of financial assets have been subject to intensive study by several leading standard setting bodies in recent years, but there are significant differences in the treatments they prescribe. The JWG has concluded that a components approach best reflects the economics of the market place and the demands for the fair value measurement of financial instruments (see Basis for Conclusions, paragraphs 3.1-3.25).

(b) The prohibition of hedge accounting by deferring gains and losses on financial instruments (see Basis for Conclusions, paragraphs 7.1-7.19).

Disclosure Principle

1.31 Financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies.

1.32 The most convincing demonstration of the benefits of basing accounting for financial instruments on the above recognition, fair value measurement and financial performance reporting principles lies in the usefulness of the resulting information for analysis purposes. The primary objective of investors is to achieve a return on investment that is at least commensurate with the level of risk taken. Conceptual frameworks for accounting generally recognise this in concluding that a primary objective of financial statements is to provide information to help investors, creditors, and other participants in capital markets to evaluate:

(a) the abilities of enterprises to generate a return, that is, to generate net cash or equivalent inflows (and future earnings that are the source of those net cash inflows); and

(b) the timing and uncertainties (risks) of those expected net cash flows.[8]

The Draft Standard disclosure requirements are intended to provide basic information that will help meet these two objectives.

1.33 Different types of financial risk (including basic interest rate, currency, credit, liquidity, commodity price and equity price risks) have different sensitivities to economic events, conditions, and expectations. These risks are commonly managed separately, often by using derivatives or by transactions that isolate and transfer certain of these risks. Thus, investors and other market participants can be expected to seek information about each of the significant financial risks of an enterprise and their financial position, income and cash flow effects.

1.34 The JWG believes that the following disclosures, taken together, provide the fundamentals for analysis of financial risks and returns.

(a) Description of each of the significant financial risks inherent in an enterprise's activities, and the enterprise's objectives and policies for managing these risks.

The JWG believes that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments.

(b) Information about an enterprise's financial risk positions and performance effects during a reporting period for each significant type of financial risk identified in (a).

The Draft Standard would require disclosures that the JWG believes provide basic information to enable informed judgements of (i) an enterprise's future expectations and the potential volatility of those expectations and (ii) management's stewardship in the context of the enterprise's disclosed financial risk objectives and policies.

(c) Information about the methods used to estimate the fair value of financial instruments in order to help users evaluate fair value measurement uncertainties.

1.35 The Draft Standard would require presentations and disclosures directed at meeting the basic informational objectives in each of the above areas. A number of the disclosures required by the Draft Standard are already required by accounting standards in a number of jurisdictions. However, to date, financial instrument disclosure standards have been

[8] See, for example, paragraph 15 of the IASC Framework.

piecemeal and incomplete. Income statement disclosures, in particular, have reflected a cost basis perspective or an inconsistent mix of cost and fair value figures (for example, computing interest on a cost basis even for interest-bearing financial instruments that are measured at fair value). The Draft Standard attempts to put in place a coherent framework of presentations and disclosures to enable the analytical benefits of the fair value model to be realised.

1.36 The development of fully effective fair value presentation and disclosure standards requires addressing a number of issues that have not been the subject of accounting study and that require application experience and field testing to enable full evaluation of the practical and conceptual issues in particular circumstances. For example:

(a) While the concepts underlying the term structure of interest rates are well established in finance literature, there has, until very recently, been no consideration of their implications for the determination of interest revenue and expense within a fair value model (see discussion in paragraphs 6.58-6.76).

(b) A number of analysts, securities regulators and others have indicated a need for quantitative information on financial risk sensitivities. Some financial institutions have developed various value-at-risk and other sensitivity measures. However, the JWG believes that these have not yet been sufficiently defined and standardised to be required to be disclosed in financial statements (see discussion in paragraphs 8.30-8.35).

(c) The Draft Standard would require only fairly basic disaggregation of fair value income, because more detailed breakdowns are subject to questions related to methodology and cost-benefit trade-offs. The JWG believes that these questions can only be satisfactorily addressed on the basis of field testing, and after a period of experience with the requirements set out in the Draft Standard.

1.37 The JWG believes that, while further study and testing will probably enable improvements, the presentation and disclosure standards set out in the Draft Standard represent an important base of information that constitutes a significant advance over that provided under existing disclosure standards.

Overall Evaluation and Implementation Considerations

1.38 The JWG recognises that it is a very serious step to put in place accounting standards that fully embrace these four principles and, in particular, to let go of the historical cost basis of accounting for financial instruments. The JWG's conclusion that this step should be taken now reflects its belief that:

(a) Existing mixed cost—fair value accounting for financial instruments is not sustainable in the longer term, and cannot provide a satisfactory basis for financial accounting, because it is based on mixing elements of two incompatible measurement systems for financial instruments. The JWG believes that this is clearly evident from the complexities and inconsistencies of existing mixed cost—fair value standards and practices.

(b) A comprehensive fair value model for financial instruments that is founded on the above four principles is superior in relevance and, therefore, in the usefulness of the information that can be derived from it for economic decision-making purposes, to cost or mixed cost—fair value models.

(c) The Draft Standard is capable of reasonable and reliable implementation. It attempts to balance practical and theoretical considerations on the basis of present knowledge and evidence. It is expected that the requirements will be refined in future periods as experience is gained in applying them and as capital markets and financial risk management practices continue to evolve.

1.39 Some believe that the Draft Standard and Application Supplement should provide specific rules for the estimation of fair value of financial instruments, particularly where valuation techniques must be used. They believe that the Draft Standard cannot be operational unless it specifies when particular techniques should be used (when, for example, particular option pricing models should be used and what adjustments should be made to them in particular circumstances), and unless it provides explicit rules with respect to assumptions that should be made for specific types of instruments in particular circumstances. The JWG does not believe that it is possible or desirable to provide detailed rules covering all situations. Requirements for application are provided where the JWG believes that existing knowledge permits, and where they will not prevent, enterprises from exercising reasonable judgement in applying the principles to new situations and in adopting improved methodologies as markets continue to develop. Furthermore, enterprises would be required to establish policies and procedures to enable reliable and consistent application of the requirements of the Draft Standard.

1.40 There are some unresolved issues, and the Basis for Conclusions outlines those identified by the JWG and the reasons for the approaches the JWG has taken. The JWG believes that they are reasonably accommodated within the Draft Standard, and that their implications are no more serious than many difficult issues that are accommodated within existing standards in other areas of financial accounting. The JWG has concluded that many of these issues cannot be expected to be resolved without field testing and experience in applying the Draft Standard. The JWG understands that enterprises are not prepared to consider detailed application implications for their operations on the basis of only broad principles and objectives.

1.41 Successfully implementing a fair value measurement model for financial instruments requires integrating certain finance and capital markets concepts within financial accounting objectives and concepts. The JWG recognises that understanding and effectively implementing fair value measurement principles require a different "mind set" and expertise from that appropriate to historical-cost accounting for financial instruments. Many financial statement preparers, auditors, analysts and others will likely need some time to develop expertise in fair value measurement objectives and methodologies. The JWG believes that this can be best accomplished by putting the Draft Standard in place, so that everyone will know what is to be required, and then providing a reasonable transition period to enable training and the development of fair value systems and supporting activities.

1.42 The JWG believes that it is of utmost importance to put in place a well planned and internationally co-ordinated implementation process to include education and field testing. It is important that there be a sufficient transition period to enable this. Some considerations in this regard are set out in paragraphs 9.1-9.7.

1.43 The JWG strongly encourages enterprises to work with member accounting standard setting bodies during the exposure period to field test the Draft Standard requirements. The JWG also strongly encourages accounting standard setting bodies to work with representatives of the financial analyst and academic communities to further develop and refine fair-value-based information that would be useful for analysis purposes.

2. Scope

Enterprises Included in Scope

2.1 The JWG has concluded that the proposed accounting principles in this Draft Standard are applicable to all enterprises. A financial instrument has the same economic benefits and risks, and is affected by financial market forces in the same manner, irrespective of who holds it. Accordingly, the JWG believes that accounting should be consistent with the attributes of the particular financial instruments, rather than being based on the industry or type of enterprise that might feature these instruments.

Banks

2.2 A number of banks and banking associations have indicated to the JWG that they strongly believe that, while fair value measurement is relevant to financial instruments held in banks' trading books, it is not relevant to financial instruments that are managed within their banking books. Banks typically manage their banking book activities on a cost basis, using net cash flow analyses and other techniques that do not place a significant emphasis on the fair value of financial instruments. They advocate exempting banks or banking book activities from the Draft Standard.

2.3 The JWG has considered the nature of banking book activities and the concerns raised by banks and their associations. Various members of the JWG have met with bankers and banking regulators and the JWG consulted, and exchanged papers, with The Joint Working Group of Banking Associations on Financial Instruments.[9]

2.4 The JWG believes that the principles of this Draft Standard are fully applicable to banks and that the unique aspects of banking book activities can be reasonably accommodated within the basic requirements of the Draft Standard. It believes that the major issues raised by banking interests about the usefulness of fair value measurement for financial instruments are addressed in this document.

2.5 The JWG recognises that certain issues of application to banking book activities would benefit from additional consideration before the Draft Standard is put in place—for example, the application of fair value measurement principles to bank deposit liabilities and adaptation of the requirements for balance sheet and income statement presentation and supporting disclosures. The JWG expects that a transitional period will be necessary to

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[9] See, Financial Instruments Joint Working Group of Standard Setters, Financial Instruments: Issues Relating to Banks, August 31, 1999; The Joint Working Group of Banking Associations on Financial Instruments, Accounting for Financial Instruments for Banks, and Financial Instruments: Issues Relating to Banks, October 4, 1999.

develop systems, or extend existing systems, to implement valuation techniques for estimating the fair value of financial instruments such as loan asset portfolios. The JWG strongly encourages the banking industry and accounting standard setters to work together to conduct field tests of the Draft Standard using the internal data and actual situations of a number of banks in several countries. This would provide a fully informed basis for adapting, refining, and perhaps improving upon the application of the Draft Standard and Application Supplement to banks.

Insurance, Pension and Similar Enterprises

2.6 Paragraph 1 of the Draft Standard excludes from its scope certain insurance contracts and employers' assets and liabilities under employee benefit plans (see paragraphs 2.23-2.30 for further discussion). However, it does not exempt other financial assets and financial liabilities of insurance enterprises, defined benefit pension and other post-employment benefit plans and similar enterprises.

2.7 Some are concerned that this could result in inconsistencies between financial instruments measured at fair value and insurance contracts and employee benefit and similar obligations that are accounted for on other bases. They advocate that the Draft Standard should not apply to these enterprises and that they should be free to adopt methods of accounting for their financial assets and financial liabilities that they believe are consistent with present methods used to measure insurance contracts and employee benefit and similar obligations.

2.8 There is currently great diversity in accounting practice for insurance enterprises internationally and for employee benefit obligations in a number of countries. There is concern that this diversity has made it difficult for users to evaluate financial statements of these enterprises, and to compare them both with each other and with enterprises in other business sectors. Consistent accounting for all financial instruments held by such enterprises, other than those for which special considerations apply, is one step towards alleviating these concerns.

2.9 Implementation of this Draft Standard for all financial instruments other than those for which special considerations apply will result in a period of time during which most financial assets and financial liabilities are measured at fair value, but certain insurance contracts and employee benefit obligations continue to be measured on a different basis. However, the JWG believes that the benefits of measuring financial instruments at fair value exceed any possible benefits that could result from temporarily measuring them on bases that are presently used to measure insurance contracts and employee benefit obligations.

Smaller or Non-public Enterprises

2.10 Some suggest that smaller, non-public or non-listed enterprises should be exempt from the Draft Standard because many may lack the capabilities and resources to implement the proposed recognition and measurement principles. In addition, many such enterprises may have fairly simple capital structures, and less complex financial instruments, so that financial statement users may not have as much need for fair value based accounting in their financial statements. For these enterprises, the cost of implementing this Draft Standard might outweigh the benefits.

2.11 The JWG believes that the accounting principles in the Draft Standard are equally applicable to all enterprises, regardless of whether they are public or private, large or small. To require differential accounting bases is fundamentally inconsistent with the notion that financial instruments have the same economic benefits and risks and are affected by financial market forces in the same manner, irrespective of the enterprise that holds them. Further, smaller or non-public enterprises are in no way insulated from developments in the markets for swaps and other derivatives and may be in just as much need as larger or public enterprises of a standard that fully reflects the fair values of financial instruments in their financial statements.

2.12 On the other hand, the JWG accepts that other issues related to differential reporting might be considered in some jurisdictions. The criteria under which some jurisdictions make accounting distinctions between large or public enterprises and smaller or non-public enterprises differ and involve broader considerations than those relating to financial instruments alone. The JWG believes that it is not the purpose of the its project to consider the broad issues of differential accounting.

What is a "Financial Instrument"?

The Definition of a Financial Instrument

2.13 Definitions of a financial instrument adopted in most jurisdictions are broadly similar, but with a number of differences in the details. For example, IAS 32, in common with similar standards in a number of other jurisdictions, contains the following definitions of a financial instrument, a financial asset, a financial liability and an equity instrument:

> A *financial instrument* is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.
>
> A *financial asset* is any asset that is:
>
> (a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity instrument of another enterprise.

A *financial liability* is any liability that is a contractual obligation:

(a) to deliver cash or another financial asset to another enterprise; or

(b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

An *equity instrument* is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.

2.14 The Draft Standard adopts different definitions of these terms, primarily to clarify aspects of the IAS 32 definitions. These changes to the definitions are based on improvements identified by users of the definitions and are not intended to involve fundamental changes of meaning. These changes include the following:

(a) The IAS 32 definitions require all financial instruments to be contracts. Some question whether cash can be considered to be a contract. Further, the IAS 32 definitions require all financial instruments to give rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise, yet some argue that cash does not do that. These concerns are overcome by amending the definition so that it specifically states that cash is a financial instrument.

(b) The IAS 32 definition of a financial instrument can be interpreted to mean that, whenever a contract gives rise to a financial asset of one party and a financial liability of another party the entire contract is a financial instrument. However, a contract might include financial and non-financial components. In such circumstances, only the financial components constitute a financial instrument. Amending the definition so that it specifies that it is the contractual rights to require delivery or exchange of financial instruments and the contractual obligations to deliver or exchange financial instruments that comprise financial instruments, overcomes this difficulty.

(c) Some believe that the references in the IAS 32 definitions to exchanges on “potentially favourable terms” or “potentially unfavourable terms” preclude an option to put or call a financial instrument at the market price on the exercise date from meeting the definitions. However, it is accepted that such options are financial instruments. These references do not seem to be essential to the definition. By deleting them, the difficulty is overcome.

(d) The IAS 32 definition of a financial instrument refers only to a contractual right to exchange financial instruments, rather than to a contractual right to require such an exchange. It is the right to *require* an exchange of financial instruments that creates a right to an economic resource and, hence, an asset. A reference to the right to require an exchange has, therefore, been added to the definition.

(e) Some believe that a forward contract to purchase or sell non-financial items might meet the IAS 32 definition of a financial instrument. They claim that one party has a contractual right to receive cash or another financial asset from the other party and the second party has a contractual obligation to deliver cash or another financial asset to the first party. However, this interpretation of the definition overlooks the other leg of the transaction, which requires delivery of non-financial items. Adding the words "in exchange for no consideration other than release from the obligation" makes it clear that such an interpretation is not appropriate.

Derivative Financial Instruments

2.15 This Draft Standard does not separately define derivative financial instruments, because the JWG believes that the same accounting principles should apply to all financial instruments and similar items. The complexity of separately defining derivative financial instruments is, therefore, unnecessary.

Financial Instruments Compared to Non-financial Resources

2.16 The Draft Standard contains principles for the recognition and measurement of financial instruments that differ from conventional accounting for non-financial items. Some believe that it is internally inconsistent to measure financial instruments at their fair values while some or all non-financial items continue to be carried on an historical cost basis.

2.17 The JWG believes that there is a real difference between financial instruments and non-financial items and that this difference gives rise to different accounting considerations. Financial instruments represent contractual rights or obligations to receive or pay cash or other financial instruments or residual interests in the net assets of an enterprise. Non-financial items have a more indirect, non-contractual relationship to future cash flows. The non-financial assets of a business (such as most raw materials, plant and equipment, prepaid expenses and intangibles) are all inputs to some productive process. They are expected to contribute, along with other inputs, to the production and sale of goods or services. They must be used in a productive activity, and effectively transformed into goods or services, which must be sold, before there is any right to receive cash.

2.18 The significance of a non-financial asset depends on how effectively it is used in the production or revenue-generating process. Under historical cost, accrual accounting, non-financial assets are carried at cost, or lower of cost and market, until the point at which they are considered to be used up, or until the point of their deemed "realisation" into revenues consisting of cash or claims to cash (i.e., into financial assets). The economic significance of a financial instrument does not depend on a transformation and realisation process; its significance is determined by the value under current conditions of its contractual rights to receive or obligations to pay cash flows.

2.19 This is not to judge the most appropriate accounting for non-financial items, as that is beyond the subject of this Draft Standard. (Some advocate fair value accounting for certain non-financial assets, and some standards permit revaluation of certain non-financial assets as an acceptable alternative treatment.) However, the JWG believes that a distinction can be made between carrying non-financial items on a cost basis, pending their use to generate financial instruments, and recognising and measuring financial instruments on a basis that reflects the fair value of their contractual rights and obligations. In other words, appropriate recognition and measurement of financial instruments should not be limited by cost-based accounting that may be considered to be appropriate for non-financial items.

Financial Instruments Excluded from the Scope

2.20 Certain financial instruments are excluded from the scope of this Draft Standard if, for instance, their characteristics are such that they are better addressed by other accounting standards. The following paragraphs consider these financial instruments.

Equity Interests in Subsidiaries, Associates and Joint Ventures

2.21 Equity interests in subsidiaries, associates and joint ventures are financial instruments. However, any consideration of their treatment as financial instruments would require a reconsideration of existing consolidation and equity accounting principles. Most jurisdictions address accounting for these instruments in separate standards. The JWG thus believes that equity interests in subsidiaries, associates and joint ventures should be excluded from the scope of standards on financial instruments.

2.22 Some have expressed the view that existing accounting for these equity interests is inadequate, particularly the use of the "equity accounting" method for investments in associates and proportionate consolidation for joint ventures. The JWG believes that these matters are beyond the scope of this project on financial instruments.

Employers' Assets and Liabilities under Employee Benefit Plans, Retirement Benefit Obligations of Defined Benefit Plans and Certain Rights and Obligations with Insurance Risk resulting from Insurance Contracts

2.23 Most employers' assets and liabilities under employee benefit plans, retirement benefit obligations of defined benefit plans and rights and obligations with insurance risk resulting from insurance contracts are financial instruments. They are contractual rights or obligations to deliver financial instruments in exchange for no consideration other than release from the obligation. However, these items present unique estimation problems.

2.24 Accounting standards and established practices for accounting for pension and similar post-employment obligations now exist in most jurisdictions.[10] The JWG believes that it is beyond its mandate and expertise to re-examine these standards in the light of the principles in this Draft Standard. Rather, it accepts that enterprises should apply these other standards and that the relevant financial assets and financial liabilities should be excluded from the scope of this Draft Standard. The JWG recommends that these standards be reviewed in due course to determine whether any amendments need to be made to them to ensure that they are fully consistent with the principles in this Draft Standard. However, the JWG also believes that application of the principles in this Draft Standard to other financial instruments is too important to be delayed until such amendments are considered.

2.25 There is currently great diversity in accounting practice for insurance contracts internationally. The insurance industry and the accounting and actuarial professions are working to reach a common understanding about the application of a fair value model to insurance contracts but have not yet reached conclusions in that regard. These efforts are seeking to develop appropriate bases for recognition and measurement of insurance contracts that are consistent with the principles in this Draft Standard.[11] The JWG thus accepts that this Draft Standard should not be applied to such contracts until the application issues have been resolved. However, the JWG also believes that this should not result in delay in adopting the principles in this Draft Standard for financial instruments other than insurance contracts.

2.26 In defining the scope exception for insurance contracts, the JWG has adopted the definition of an insurance contract proposed in the IASC Insurance Steering Committee's Issues Paper: Insurance, November 1999, but believes that certain financial instruments that fall within that definition should not be excluded from the Draft Standard (for reasons described in paragraphs 2.27 and 2.28, below). In the longer term, if insurance contracts were measured on the same basis as financial instruments, a distinction would become unnecessary.

2.27 The JWG believes that financial guarantees, as defined in the Draft Standard, are financial instruments that should be included within the scope of the Draft Standard, even though they may be regarded as a form of insurance. The effect of changes in credit risk is one of the key financial risks addressed by this Draft Standard.

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[10] See, for example, IAS 19, Employee Benefits, and IAS 26, Accounting and Reporting by Retirement Benefit Plans.

[11] See IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999.

2.28 Contracts that require a payment based on climatic, geological or other physical variables are commonly considered to be insurance contracts. In many cases, the payment made is based on an amount of loss suffered by an insured party as a result of an underlying event. Such contracts are insurance contracts and they are excluded from this Draft Standard. However, under some contracts, payments arise that are not based on a loss suffered by a party to the contract as a result of an event. For example, a contract might require a payment based on whether more than a specified amount of rain falls in a certain location during a certain time period, regardless of whether this causes a loss to the contract holder due to flooding. Such contracts are economically no different from financial instruments such as conditional receivables, and the JWG believes that they should be accounted for in accordance with the principles in this Draft Standard.

2.29 Certain items resulting from insurance contracts, such as premium receivables and payables, meet part (c) of the definition of a financial instrument (see Draft Standard, paragraph 7). These items are not subject to insurance risk and are not economically different from other receivables and payables. The JWG, therefore, specifies that only those rights and obligations arising from insurance contracts that are subject to insurance risk qualify for the exemption in paragraph 1(d).

2.30 The JWG also considered whether warranties should be included within the scope of this Draft Standard. If warranty contracts are to be settled by provision of replacement products or services, they do not meet the definition of a financial instrument. However, if such contracts are settled in cash, they do meet the definition of a financial instrument, as well as the definition of an insurance contract. The JWG concluded that both types of contract are akin to insurance contracts, since they are subject to occurrence, severity and development risk. Therefore, all warranty contracts are excluded from the scope of the Draft Standard.

Equity Instruments Issued and Classified as Equity by the Reporting Enterprise

2.31 Equity instruments of the reporting enterprise are subject to different measurement considerations than those relevant for financial assets and financial liabilities as a result of their nature as residual interests in the assets and liabilities of the enterprise. The Draft Standard therefore excludes a financial instrument that is appropriately classified as equity of the enterprise.[12]

Business Combination Contracts involving Contingent Consideration

2.32 An enterprise that accounts for a business combination by the purchase method might issue financial instruments as contingent consideration for the purchase. The accounting for such

[12] IAS 32, Financial Instruments: Disclosure and Presentation, specifies when a financial instrument is appropriately classified as equity of the enterprise.

contracts is addressed by standards on business combinations. Therefore, the JWG has excluded such contracts from this Draft Standard.

Licence Fees, Royalties and Similar Items

2.33 An enterprise might enter into a contract to receive or pay royalties or similar fees based on the future use of, or right to use, non-financial items. For example, an author might enter into a contract with a publisher whereby the author gives the publisher the right to sell books in exchange for a fixed royalty for each book that the publisher sells. Such a contract has value to the author, and a third party might be expected to pay a significant amount to assume that contract from the author. At the reporting date there is clearly a financial instrument related to any amounts payable or receivable relating to past sales of books. The publisher has a contractual obligation to pay royalties to the author, and the author has a contractual right to receive royalties in exchange for no consideration other than to release the publisher from the obligation. Differences of opinion exist, however, about the nature of the contract relating to future sales.

2.34 Some view the right to sell books as an option written by the author and held by the publisher. This option contract gives the publisher the right to demand permission to sell a book (a call option on the rights to sell the books). They view the contract as imposing an obligation on the publisher to pay for the right when the publisher "calls" that option in the future. Viewed in this way, the contract is not a financial instrument—it is an option to acquire a right to sell books (a non-financial right) in exchange for a financial instrument. The promise to pay, when it arises in the future, would be a separate financial instrument.

2.35 Others view the exchange of rights contemplated by the contract as having occurred when the contract was signed. In accordance with this view, the author delivered to the publisher rights to sell books. In exchange, the publisher delivered a promise to make future payments. Viewed in this way a royalty contract is a promise to pay a determinable (but not yet fixed) amount. The payment is for the past exchange of rights, but the amount depends on the number of books sold. In accordance with this view, the royalty is a financial instrument, which is a liability of the publisher and an asset of the author.

2.36 Given the above difference of views as to whether royalties may, or may not, be financial instruments, paragraph 1(g) of this Draft Standard avoids uncertainty by specifically excluding contractual rights and contractual obligations that are contingent on the future use of, or right to use, a non-financial item.

Additional Items Included in Scope

2.37 Some believe that only items that meet the definition of a financial instrument should be included in the scope of this Draft Standard. They believe that this definition is sufficient to define the scope of the Draft Standard and that standard setters should separately consider accounting for non-financial items that do not meet the definition of a financial instrument. Standard setters might determine that certain non-financial items should be accounted for on a similar basis as are financial instruments, but, in their view, such considerations are outside the terms of reference of the JWG. As a result, they would not extend the scope of the Draft Standard to include contracts to buy or sell non-financial items that do not explicitly permit either party to settle net by a financial instrument, servicing assets and liabilities, or hybrid contracts that are not separated into their financial and non-financial elements, because they are not financial instruments.

2.38 The JWG disagrees with this view. The JWG has concluded that, for the Draft Standard to be most relevant, its scope should include certain non-financial items that are so similar to financial instruments in their contractual risk bases, settlement conditions and use that they are usefully accounted for on the same basis as financial instruments. The JWG's evaluation and basis for conclusions about such non-financial items is set out in the balance of this section (paragraphs 2.39-2.70).

Certain Contracts to Buy or Sell a Non-financial Item

2.39 Some contracts to buy or sell a non-financial item (such as a commodity) may be settled net by a financial instrument. That could be because the terms of the contract explicitly permit, or implicitly allow, settlement in that way, or because there is an established market mechanism, or side agreement, outside the contract that facilitates settlement net by a financial instrument, or because the non-financial item that is the subject of the contract has interchangeable (fungible) units that are exactly the same as those for which an active market exists, in which offsetting contracts might be obtained. Although such contracts are not financial instruments, the distinction between such contracts and financial instruments for which the net settlement amount is indexed to an underlying price seems to have little economic significance. For example, in commodity forward markets in which few participants hold commodity contracts to maturity and actively take or make delivery of the physical commodity, the contractual rights and obligations in the commodity contracts are effectively the same as those of a financial instrument. Indeed, such contracts can be used interchangeably with other financial instruments. In addition, if such contracts were not accounted for in the same manner as financial instruments, it would be possible to circumvent the requirements of the Draft Standard by including non-substantive delivery provisions in a contract that otherwise would be considered a financial instrument. The JWG, therefore, believes that it is necessary to extend the scope of the Draft Standard to include such contracts.

2.40 Although many contracts to buy or sell a non-financial item are settled net by a financial instrument, many others are entered into for delivery of the non-financial item. The JWG's objective is not to prescribe accounting principles for inventory or capital expenditures, both of which are outside the scope of the JWG's project. The JWG, therefore, proposes not to include within the scope of the Draft Standard, contracts entered into, and continuing to be, for the purpose of delivery of a non-financial item in accordance with the enterprise's normal purchase and sale activities.

2.41 The JWG is concerned that there be clear criteria for making this determination, so that an enterprise does not have an open choice whether particular commodity contracts that can be settled net by a financial instrument will be accounted for as financial instruments or non-financial items. The JWG believes that, in most cases, contracts that are for the purpose of delivery of a non-financial item under an enterprise's normal purchase and sale activities would be evident from established policies that can be seen to be consistent with the nature of its particular activities under current economic conditions. Paragraph 206 of the Application Supplement would require that an enterprise be able to justify its conclusions in terms of its established policy and operating activities.

2.42 A particular issue arises where a series of sequential contracts that can be settled net are entered into with the purpose of ultimate acquisition or sale of a non-financial item in accordance with the enterprise's normal operating activities. Sub-paragraph 205(a) of the Application Supplement explicitly addresses this issue, concluding that all contracts in the series, except for the final purchase or sales contract for delivery, should be treated as financial instruments. There is no obligation for delivery in the earlier contracts in the series.

2.43 Some argue that all commodity contracts should be included within the scope of the Draft Standard, regardless of whether the enterprise has the ability to settle net with a financial instrument. They believe that contracts to buy or sell commodities have characteristics that are very similar to financial instruments and that, even if the contract does not permit settlement net, offsetting contracts can be entered into to mitigate the risks of changes in commodity prices in the same way that financial risks can be managed. However, to include all commodity contracts within the scope of the Draft Standard would require reconsideration of inventory accounting, which the JWG considers to be beyond the scope of its project.

Servicing Assets and Servicing Liabilities

2.44 Rights to service financial assets (servicing rights) are not financial instruments, since they do not give rise to an obligation to deliver or exchange financial instruments—the servicing enterprise provides a service, not a financial asset or financial liability. Nevertheless, servicing rights and obligations are inherent in many financial instruments and, before their separation from the financial instrument, are accounted for as part of the value of those financial instruments. The Draft Standard would continue to account for servicing rights that have not been separated as part of the value of the financial instrument.

2.45 In the United States and some other countries, markets have developed for the sale or assumption of servicing rights separately from the related financial asset being serviced. As a result, it has become clear that (a) rights to servicing have a value at the time of derecognition of underlying financial instruments and (b) that value can be recognised separately on the sale of the financial assets. As international financial markets develop, this practice is expected to become more widespread.

2.46 The JWG believes that servicing assets and liabilities that are separated from financial instruments should be accounted for at fair value, as they are when included as part of a financial instrument. Recognising such servicing assets or servicing liabilities, whether acquired through purchase transactions or origination activities, is consistent with the notion that servicing assets and servicing liabilities developed through origination activities are no different from those purchased and should be accounted for in the same way. Furthermore, recognising such servicing assets and servicing liabilities and measuring them at fair value avoids misstating net servicing income after the assets being serviced are derecognised. Accordingly, the JWG proposes to include within the scope of the Draft Standard all separated servicing assets and servicing liabilities.

2.47 While the JWG believes that both servicing and the interest-only strip (or other retained interest in the transferred asset) that often accompanies servicing should be accounted for at fair value, it does not believe that the Draft Standard should require that those two items always be presented together. In some instances, there might be valid reasons for presenting those items separately. The two items, while related, are not both dependent on the servicing enterprise remaining as servicer. As a result, the JWG concluded that while both should be measured in the same manner, a servicing asset *need not* be presented together with the interest-only strip.

Hybrid Contracts

2.48 A single contract might contain financial and non-financial rights or obligations, or include some financial instruments that are within the scope of this Draft Standard and some that are not. In these cases, special rules are necessary to determine how such contracts should be accounted for. The JWG considered a number of alternative approaches to this issue.

2.49 One alternative considered was based on identifying the predominant characteristics in a contract and accounting for the entire contract based on those characteristics. However, the JWG believes that such an approach is likely to have a number of drawbacks.

(a) It can be difficult to determine which characteristics predominate, particularly if the balance is relatively even.

(b) Whichever characteristics are determined to predominate, the less dominant characteristics may be accounted for on a basis that is not consistent with their nature, even if they are significant.

(c) The basis for accounting for such a contract could change significantly at the point when the less significant terms and conditions become the dominant ones.

(d) Such an approach can result in different accounting depending upon whether all of the terms and conditions are included in a single contract, with either financial or non-financial characteristics predominant, or whether the financial terms are included in a separate contract from the non-financial terms.

(e) Such accounting is inconsistent with financial risk management approaches under which financial risks and benefits are managed by type, rather than by contracts.

The JWG also notes that measurement and recognition approaches based on predominant characteristics of assets and liabilities have proved problematic in other areas of accounting, such as lease accounting.

2.50 Another alternative considered was to require that a contract for which the sets of rights and obligations are clearly and closely related be accounted for in its entirety as a non-financial contract. This would be similar to the accounting required by IAS 39, Financial Instruments: Recognition and Measurement, and FASB Statement 133, Accounting for Derivative Instruments and Hedging Activities, when a derivative contract is embedded in a non-derivative host contract and is clearly and closely related to that host contract. In such circumstances those standards require that the entire contract be accounted for in accordance with the accounting for the host contract. This approach, however, has the significant drawback that it would result in financial instruments incorporated in such contracts not being measured at fair value, however small or insignificant the set of rights and obligations making up the non-financial items. Furthermore, it is difficult to determine when sets of rights and obligations are considered to be clearly and closely related to one another. The JWG, therefore, rejected this alternative.

2.51 The JWG concluded that a better approach would be to require that sets of rights and obligations that, if they were separated from the contract, would be accounted for as financial instruments in accordance with the Draft Standard be accounted for as such, and that sets of rights and obligations that do not fall within the scope of the Draft Standard be excluded. This approach ensures that a financial instrument falling within the scope of the Draft Standard is accounted for in the same way, regardless of whether it is a stand-alone instrument or is combined with non-financial or excluded items in a single contract. It also overcomes many of the difficulties of the alternative approaches considered in paragraphs 2.49 and 2.50. At the same time, this requirement will limit the circumstances in which non-financial items that are generally measured on another basis are measured at fair value. By focusing on sets of rights and obligations, this approach is consistent with the risk management practices of many financial market participants that focus on managing those sets of rights and obligations within a contract that are subject to a common financial risk.

2.52 In a few instances, a hybrid contract might contain sets of rights and obligations that would be accounted for at fair value in accordance with this Draft Standard as well as sets of rights and obligations that would be accounted for at fair value in accordance with other accounting standards. In such circumstances the JWG believes that an enterprise should not separately account for the sets of rights and obligations in the hybrid contract. If an enterprise were permitted to choose whether to measure these sets of rights and obligations separately, or to measure them as a single contract, possible measurement inconsistencies might arise. Accordingly, the JWG decided that in such circumstances, the entire contract should be accounted for in accordance with the Draft Standard, including requirements for recognition and derecognition, balance sheet and income statement presentation and disclosure. Some believe that the possible measurement inconsistencies that could arise are not likely to be significant. They would not require non-financial rights and obligations arising from a hybrid contract that it is feasible to account for separately from the financial rights and obligations to be included within the Draft Standard.

Other Scope Considerations

2.53 The JWG also considered a number of other questions relating to the scope of this Draft Standard. The main matters considered are addressed in this section.

Leases

2.54 In accordance with the view taken in existing accounting standards for leases, a lease contract is not a financial instrument. It does not meet part (c) of the definition, since the lessor is required to deliver additional consideration other than release from the obligation—the right to continued use of the asset. It does not meet part (d) of the definition, since one party (the lessor) provides the right to use a non-financial asset—not a financial instrument. Neither is it cash or an equity instrument (parts (a) and (b) of the definition). However, a lease contract might contain sets of rights and obligations that if separated from the contract would be a free-standing financial instrument. In order to ensure that financial instruments included within these lease contracts are accounted for in accordance with the Draft Standard, those sets of rights and obligations would be accounted for in accordance with the Draft Standard requirements for hybrid contracts.

2.55 Accounting standards typically distinguish finance (or capital) leases from other leases (operating leases). In finance leases, substantially all the risks and rewards incident to ownership of the leased asset are transferred to the lessee. Finance leases are accounted for by recognising the leased assets and a liability to the lessor in the balance sheet of the lessee. The lessor recognises a receivable and derecognises the leased assets. Commitments under operating leases are not recognised under existing lease accounting standards.

2.56 When an enterprise accounts for a lease contract as a finance lease, the lessor's receivable from the lessee and the lessee's liability to the lessor each meet the definition of a financial instrument and, therefore, fall within the scope of this Draft Standard. Because substantially all the risks and rewards incident to ownership of the leased asset have been transferred to the lessee, there is not considered to be any additional consideration to be provided by the lessor other than to release the lessee from the obligation as the lessee makes payments in accordance with the terms of the lease contract.

2.57 This Draft Standard does not reconsider the fundamental bases for recognition and measurement of finance leases. Lease accounting, addressed in separate accounting standards in most jurisdictions, is based on a complex set of rules that has developed over a long period of time. Some advocate that all leases should be accounted for similar to finance leases and some go on to suggest that the lessor's asset and lessee's liability be measured at fair value both on initial recognition and subsequently.[13] However, this is not the practice in accounting today. The JWG believes a fundamental reconsideration of those rules to be beyond the scope of this project.

Commitments to Buy or Sell a Non-financial Item at a Fixed Price in a Foreign Currency

2.58 The JWG considered whether a firm commitment to buy or sell a non-financial item at a fixed price in a foreign currency should be considered to represent a foreign currency risk exposure that should be recognised at current exchange rates, with gains or losses recognised in the income statement when exchange rates change. The JWG understands that many enterprises acquire financial instruments (for example, forward exchange contracts or options) as hedges of the foreign currency risks in such commitments. If financial instruments are measured at fair value, then accounting for these commitments as current foreign exchange risk exposures would result in gains or losses arising from changes in exchange rates on these commitments being recognised in the income statement in the same periods as offsetting losses or gains are recognised on the hedging instruments. This would not be the case if these commitments are treated as non-financial commitments that are not recognised until the non-financial item is actually acquired or sold, unless hedge accounting permits adjustment to the non-financial item.

2.59 The JWG concluded that these commitments taken as a whole do not have the essential characteristics of financial instruments (since they are contracts to exchange financial instruments for non-financial items).[14] Reconsideration of accounting for non-financial items is beyond the scope of a standard on financial instruments, and a requirement to recognise and measure non-financial commitments at fair value would constitute a major change in generally accepted cost-based accounting principles for non-financial items.

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[13] See, for example, G4+1 Position Paper: Leases: Implementation of a New Approach, February 2000.

[14] The Draft Standard would require that contracts to buy or sell non-financial items be accounted for as financial instruments only if they meet the conditions for settlement net by financial instruments and are not for the purpose of delivery of the non-financial items in accordance with the enterprise's normal purchase or sale requirements.

2.60 As an alternative, the JWG considered the possibility of separating out the foreign currency risk element of such a commitment and treating it as if it were a separate forward exchange contract. The element of the commitment that would be left would then be treated as a non-financial commitment at a fixed domestic currency price determined by the forward exchange rate at the date the commitment was entered into. In other words, a commitment to buy or sell a non-financial item at a fixed price in a foreign currency would be treated as if it were a hybrid contract with two elements—a forward exchange contract (which would be treated as a financial instrument to be measured at fair value with gains and losses recognised immediately in the income statement), and a fixed price non-financial commitment in the domestic currency (which would be accounted for as such, and therefore would not be within the scope of this Draft Standard).

2.61 Some believe that this accounting would have the following significant benefits. It would result in the same recognition and fair value accounting for the foreign currency forward element of the commitment as for any financial instrument used to hedge the foreign currency risk. It would also remove the possibility that an enterprise could embed a foreign currency exposure in a non-financial commitment, in order to avoid recognising it as a financial instrument, and thus avoid accounting for it on a fair value basis.

2.62 However, the JWG decided that the Draft Standard should not allow enterprises to account separately for the foreign currency risk element in such a commitment for the following reasons:

(a) The foreign currency forward element as defined cannot be relied upon to reflect the foreign currency risk that is inherent in the commitment as a whole if there is the possibility of any correlation between changes in the domestic currency price for the non-financial item and changes in the foreign exchange rate. To the extent that the price in the domestic currency of the non-financial item that is the subject of the commitment changes with changes in the foreign currency exchange rate, the commitment as a whole could have little or no foreign currency risk exposure. The JWG does not believe that a practical basis could be determined at this time to effectively distinguish domestic currency prices of non-financial items that are significantly correlated with particular foreign currency exchange rates, and the extent of such correlation.

(b) A commitment to buy or sell a non-financial item at a price fixed in a foreign currency is not directly analogous to a hybrid contract. A hybrid contract is a contract that has one or more sets of rights or obligations that, if they were separated from the contract, would be accounted for as a financial instrument, and one or more sets of rights or obligations that do not fall within the scope of the Draft Standard. A fixed price foreign currency-denominated commitment to buy or sell a non-financial item consists of only one set of rights and obligations—the right and obligation to exchange a non-financial item for a fixed amount of a foreign currency. The separation of this commitment into a foreign currency forward and domestic currency commitment is artificial.

(c) Some believe that this accounting results in a form of "basis adjustment" of the amount recorded for the non-financial item on its acquisition or sale because the amount to be recorded will not be the actual amount paid or received for it on that date. Indeed, it results in adjusting the recorded amount of the non-financial asset away from fair value.

(d) Some believe that if such accounting were to be required for the foreign currency element of a commitment to buy or sell a non-financial item, then it should also be required for other financial risks in non-financial commitments.

Financial Instruments Held for "Strategic" Purposes

2.63 Sometimes, an enterprise makes what it views as a "strategic" investment in either traded or non-traded equity instruments issued by another enterprise, with the predominant intention of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made. For example, an investment of this kind might be necessary to obtain expected operating benefits in excess of the benefits resulting from holding an equity instrument, either directly from the other enterprise or as a result of the operating relationship. Such relationships include mutual shareholdings or "keiretsu" (historically prevalent in Japan) and co-operative agreements whereby enterprises benefit from synergies such as joint marketing or bulk purchasing arrangements.

2.64 Some suggest that such investments are of a different nature from other financial instruments and that, therefore, a different measurement basis should apply or that changes in fair value should be presented in a different manner. They argue that the purpose of such investments is broader than the generation of economic benefits from rights to residual interests in the net assets of an enterprise, because other non-financial benefits are also associated with the investment. For example, there might be additional economic benefits arising from purchasing, manufacturing, selling, or research and development activities of the investee.

2.65 The JWG believes that an equity instrument that contains no other rights should be accounted for as an equity instrument in accordance with the Draft Standard, regardless of the intent. An equity instrument is a financial instrument with the same rights and financial risk exposures regardless of the purpose for which it is held. Equity instruments that convey significant influence, control, or a joint venture interest are excluded from the scope of this Draft Standard.

2.66 Some believe that a contract that contains some non-financial rights in addition to being an equity instrument should be subject to different accounting. However, such contracts are hybrid contracts. Therefore, the portion that is a financial instrument falling within the scope of this Draft Standard would be recognised and measured in accordance with the principles in this Draft Standard (for example, a traded equity investment would be measured at its market value). However, any non-financial portion, or portion falling outside the scope of this Draft Standard (for example, a premium paid for access to additional non-contractual benefits, such as those arising from research and development or marketing synergies) would be separated, if material, and accounted for in accordance with principles for such items. The objective is to achieve the same accounting result whether contractual rights to benefit from “strategic” synergies are embedded in a financial instrument or are contracted for separately.

Indirect Investment in Non-financial Assets

2.67 The Draft Standard would require all equity investments in other enterprises that are not interests in subsidiaries, associates or joint ventures to be accounted for in accordance with the Draft Standard. Some believe that this can result in an inconsistency in accounting for equity investments in research and development activities. Generally, research costs are charged as an expense of the period in which they are incurred. However, by measuring an equity investment in an enterprise that undertakes such research at fair value it might appear that such costs are effectively being capitalised. The JWG believes that fair value accounting for such investments is appropriate unless they represent a position of control or significant influence (in which case they are accounted for in accordance with other standards). When the investing enterprise has no direct ability to benefit from the research other than by selling or holding the investment, its asset is no different from any other equity instrument.

Taxes, Legal Fees, Fines, etc.

2.68 Some believe there to be little if any difference in substance between a liability to pay cash that is required as a result of a contractual obligation and one that is required by broader legislated requirements (i.e., by the macro "contracts" between government authorities and society). Such liabilities or assets may expose an enterprise to one or more financial risks (for example, interest rate or foreign currency risks) in some circumstances. However, the JWG believes that accounting for such items requires consideration of recognition and measurement issues that are dealt with in separate standards[15] and should not be dealt with in this Draft Standard.

2.69 Payments that have been reduced to a fixed payment schedule continue to involve a government authority as one party to the agreement. There is no exchange of consideration to establish a contract at any time and, therefore, the JWG believes that such payments also fall outside the scope of this Draft Standard.

[15] The IASC requires income taxes to be accounted for in accordance with IAS 12, Income Taxes.

Related Party Transactions/Inter-company Balances

2.70 Some argue that financial instruments issued and held by related parties, and inter-company balances, should be excluded from the scope of the Draft Standard because:

(a) they are not subject to arm's-length valuation and the related parties could change the terms at any time; and

(b) the contractual rights and obligations of inter-company balances and loans might not be fully specified and, in some cases, might be more in the nature of equity instruments or capital than receivables or payables.

However, the JWG believes that, despite the valuation difficulties that might arise, a financial instrument, not appropriately classified as equity of the reporting enterprise, arising from a related party transaction should be valued on the basis of its contractual rights and obligations like any other financial instrument.

3. Recognition and Derecognition

Approaches to Recognition and Derecognition That Could be Adopted

Implications of the Framework for Recognition and Derecognition

3.1 Conceptual frameworks for financial accounting generally require that, to be recognised as an asset (or liability), an item needs to meet three criteria[16]:

(a) it should be probable that any future economic benefit associated with the item will flow to (or from) the enterprise;

(b) the item should have a cost or value that can be measured with reliability; and

(c) the item should meet the definition of an asset (or liability).

Probable that Any Future Economic Benefit Associated with the Item Will Flow to (or from) the Enterprise

3.2 In accounting, the probability that an economic benefit will flow to (or from) the reporting enterprise has traditionally been considered to be a factor in determining whether an asset (or a liability) should be recognised. The recognition process seems to use the notion in two rather different ways.

(a) Sometimes probability has been used to establish a recognition hurdle based on the likelihood of there being a future flow of economic benefits. The belief seems to have been that an asset or liability should not be recognised if there is only a low probability that conditions will occur that will result in a future inflow or outflow of economic benefits. However, the Draft Standard is reasoned from a premise that is well recognised and accepted in finance theory and in capital markets pricing practices. This premise is that the likelihood of there being a future flow of economic benefits arising from the financial instrument, and the probable amount of those future inflows or outflows, is a matter entering into the measurement of its fair value, not a matter affecting whether it should be recognised.

(b) Sometimes probability has been used to determine whether, if there is to be a future flow of economic benefits associated with an item, it is likely that those benefits will flow to or from the enterprise. However, that is not an issue in the case of financial instruments because the contract establishing a financial instrument determines that any economic benefits that result from the instrument will flow to or from the enterprise.

[16] See, for example, paragraphs 83, 80 and 91 of the IASC Framework.

The Item Should have a Cost or Value that Can be Measured with Reliability

3.3 Issues that relate to the reliability of the measures that the Draft Standard would require be used for financial instruments are discussed in detail in paragraphs 1.14-1.21 and 4.64-4.67. However to summarise, the JWG believes that it will be possible to measure all financial assets and all financial liabilities with sufficient reliability for them to be recognised.[17]

The Item Should Meet the Definition of an Asset (or Liability)

3.4 Therefore the factor that determines whether, and when, a financial asset or financial liability should be recognised is whether the item involved has the essential conditions of an asset or liability. For that reason, the recognition and derecognition principles proposed by the JWG focus on the definitions of assets and liabilities.

3.5 The IASC Framework defines "assets" and "liabilities" in the following terms:

> An asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
>
> A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

In the case of a financial asset, it is the contractual right that gives rise to the resource (i.e., the expected future inflow of economic benefits) and an enterprise's control over that resource is usually[18] specified by the contract. When control is specified by the contract, the past event will be when the enterprise becomes a party to the underlying contract, because it is that event that establishes the rights that make up the asset. Similarly, in the case of a financial liability, the expected outflow is defined by the contract, and the past event is becoming a party to a contract that allows the enterprise little, if any, discretion to avoid the outflow of resources it specifies.

3.6 An enterprise therefore usually controls the rights to economic benefits or is obligated to deliver benefits to another party from the time that it becomes a party to the contractual rights or subject to the contractual obligations that make up the instrument. That is the point at which it *has* the contractual rights or contractual obligations, and that is the time at which the essential conditions of being an "asset" or a "liability" are met.

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[17] Although the JWG believes it is possible to reliably measure all financial instruments, it accepts that it might not always be practicable to make a reliable estimate of the fair value of certain private equity investments (as explained more fully in paragraphs 1.14-1.21 and 4.64-4.67).

[18] Paragraphs 3.51-3.63 explain that a transferor's continuing involvement in contractual rights it has transferred to another enterprise could mean that it continues to have the benefits of those rights even though it is no longer a party to the contract that gives rise to the rights.

3.7 Thus, where relatively simple financial instruments are involved and the potential recognition or derecognition event is a relatively straightforward transaction, an enterprise wishing to determine whether to recognise a financial instrument need only ask whether it has an asset (or liability). Similarly, when considering whether to cease recognising (i.e., derecognise) a financial asset (or liability), all it needs to ask is whether it still has that asset (or liability).

3.8 However, many financial assets comprise components—i.e., bundles of contractual rights (and sometimes also contractual obligations) that are financial assets (and perhaps also financial liabilities) in their own right. Also, many potential recognition/derecognition events involve unbundling financial assets into their components, transferring some of the components to one or more other parties, and rebundling the other components either with themselves or with other contractual rights and obligations. In such circumstances, some rather more difficult recognition and derecognition issues arise. It is not only in the context of financial assets that complex recognition and derecognition issues can arise. For example, practices such as in-substance defeasance have raised issues about when a liability should be derecognised.

FRS 5, FASB Statement 140 and IAS 39

3.9 The complex recognition and derecognition issues that arise in the context of financial instruments have been studied by a number of standard setters over the years, and a number of accounting standards and other authoritative statements have been issued on the subject. The two main accounting standards on the subject are the United Kingdom's FRS 5, Reporting the Substance of Transactions, (effective 1994), and the United States' FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement 125, which was effective from 1997). Important new standards on the subject have more recently been issued by the IASC and by Japan's Business Accounting Deliberation Council (BADC).[19]

3.10 The approaches adopted in these standards and other pronouncements are not the same and, as a result, there are significant differences in the accounting treatment they prescribe. In developing its proposals on recognition and derecognition, the JWG has, therefore, sought to develop an approach that can be adopted in all jurisdictions.

3.11 The JWG's first thought was to try to develop a common approach by either reconciling the approaches adopted in the two standards that were at that time in issue (FRS 5 and FASB Statement 125) or extracting common principles from those standards that could

[19] IAS 39, Financial Instruments: Recognition and Measurement, (effective from January 2001) and, BADC, Accounting Standards for Financial Instruments, (effective from April 2000). Other authoritative statements that have been issued include CICA Emerging Issues Committee, EIC-9, Transfers of Receivables, November 1989.

form the basis of a harmonised approach. However, the JWG found this impossible and eventually had to conclude that the two approaches are mutually incompatible.

3.12 The JWG also considered adopting either the FRS 5 approach or the FASB Statement 125 approach in its entirety. However, although both clearly have many strengths and are well-established in their own jurisdictions, the JWG does not believe that either approach would always provide the best framework through which to analyse accounting issues arising on current transactions in all jurisdictions. It also has doubts as to both approaches' ability to address appropriately the transactions that may develop in the future. Finally, the JWG believes that its fair value measurement proposals make demands of the recognition and derecognition criteria that neither approach can meet.

3.13 IAS 39 was issued during the early stages of the JWG's work, giving the JWG the opportunity to consider basing its proposals on the approach adopted in that standard. However, the JWG has a number of concerns about that approach and is not convinced that it is sufficiently coherent to provide the basis for a common approach to the subject.[20]

3.14 The JWG therefore concluded that its best hope of achieving convergence was to develop a new approach rather than simply to adopt one of the existing approaches or to try to refine those approaches in some way.

An All-or-nothing Approach or a Components Approach?

3.15 All approaches to the recognition and derecognition of financial instruments fall into one of two broad categories: all-or-nothing approaches and components approaches.

(a) All-or-nothing approaches look at potential derecognition events and ask whether circumstances are such that the whole of the previously recognised asset should be derecognised or the whole of the asset should continue to be recognised. Different all-or-nothing approaches assess the circumstances involved in different ways. For example, some ask which enterprise has all, or substantially all, the risks and rewards arising from the asset, while others try to determine which enterprise has overall control of the asset. However, the principle is the same: each financial instrument is treated as an indivisible unit.[21]

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[20] The JWG's attempt to extract common principles from FRS 5 and FASB Statement 125 provided some of the source material for IAS 39's principles on recognition and derecognition material.

[21] FRS 5 mostly adopts an all-or-nothing approach, although it modifies that approach for certain "special cases" for which it requires accounting that is similar in many respects to a components approach.

(b) Components approaches treat financial instruments as divisible units (or components) and ask, in respect of each component, whether circumstances are such that that component should be derecognised or whether it should continue to be recognised.[22]

3.16 The JWG has chosen to adopt a components approach to the recognition and derecognition of financial instruments. It has adopted this approach because it believes that, for financial instruments, components approaches best reflect the economics of the market place and best meet the demands of the fair value measurement system—both of which are, in the JWG's view, prerequisites of any framework that is to be successful in analysing the recognition and derecognition issues that arise on current transactions and that could arise on transactions that may develop in the future around the world. The JWG also believes that, contrary to the views that some have expressed about components approaches, such approaches *are* capable of being implemented and they *do* result in accounting information that can be understood by users.

Reflecting the Economics of the Market Place

3.17 As already mentioned, most financial instruments comprise bundles of contractual rights and/or contractual obligations, and transactions are taking place all the time that unbundle those rights and obligations and rebundle them in different ways. The JWG believes that if financial statements are to give a faithful representation of transactions and events, the recognition and derecognition approach adopted needs to reflect this unbundling and rebundling fully.

3.18 That seems to suggest that the approach should focus on component contractual rights and obligations, rather than on the entire assets and liabilities in which they were originally contained, and that the approach should be that if an enterprise ceases to have a contractual right that was previously part of an asset it was recognising, it should derecognise that right and continue to recognise the rest of the asset. Such an approach would be consistent with the way participants in financial markets look at financial assets and manage risk components.

3.19 Assessed against this benchmark, all-or-nothing approaches, by treating the financial instrument as an indivisible unit, seem to provide a rather simplistic and incomplete representation of many modern-day transactions. Components approaches, on the other hand, measure up well.

[22] FASB Statement 140 mostly adopts a components approach, although some aspects of its approach can be characterised as nearer to an "all-or-nothing" approach. A components approach was also proposed by the IASC/CICA Steering Committee on Financial Instruments, in its Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997.

The Demands of the Fair Value Measurement System

3.20 The Draft Standard would require that financial instruments should be measured in the financial statements at fair value. The fair value of a financial instrument reflects the value of the contracted cash flows embodied in the instrument so, to measure the fair value of an instrument properly, it is necessary that all the contractual rights and contractual obligations that the reporting enterprise has are taken into account and that contractual rights and obligations that the reporting enterprise no longer has are ignored. Components approaches clearly do that. All-or-nothing approaches, on the other hand, seem to do it rather less well. For example, under an all-or-nothing approach an enterprise will sometimes continue to recognise and measure, as part of a "larger" asset, some contractual rights that it no longer has. This is because it continues to have overall control of the larger asset or still has substantially all the risks and rewards arising from that larger asset. Unbundling and rebundling of financial assets is often designed to unlock value and enhance value. In such cases, it is wrong to measure the original asset or liability at fair value as if nothing has happened.

Capable of Implementation

3.21 The implementation issue most often raised by critics of components approaches concerns measurement—if the approach results in the recognition of new and unusual assets and liabilities, will they not present new and unusual measurement issues that will not necessarily be capable of being resolved? The JWG does not believe that the measurement difficulties created by components approaches are as significant as is sometimes made out. First, there will not be many "new and unusual" assets and liabilities recognised. The vast majority of the unbundled components recognised will be similar in nature to assets and liabilities that are already being recognised. Second, as components approaches reflect the economics of the market, those involved in carrying out the transactions will usually have had to determine the fair value of all the components in order to ensure that the transaction is correctly priced and all its implications fully understood. That means that the valuation methodology and sources of information needed will generally have been established at the outset, thereby significantly reducing the likelihood of later measurement difficulties. As a result, the JWG has concluded that there is no reason why such items will be any more difficult to measure at fair value than other financial instruments.

3.22 The main implementation issue concerning all-or-nothing approaches relates to the "risks and rewards" tests on which such approaches are usually based, particularly the notion of "substantially all the risks and rewards" that is at the heart of some approaches. This notion has been criticised by some as being difficult to apply. The issues that are seen as operationally difficult include:

(a) determining whether each identified risk and reward should be substantially surrendered to allow derecognition;

(b) determining whether all risks should be aggregated separately from all rewards or whether risks and rewards should be offset and then combined for evaluation; and

(c) interpreting what *substantially all* means in the evaluation of those risks and rewards.

Some standard setters have reached the conclusion that such difficulties introduce an unacceptable degree of uncertainty into the recognition process.

3.23 In consequence, although accepting that the "substantially all the risks and rewards" approach may have a role to play in the analysis of complex or linked transactions, the JWG prefers to take a components approach as its starting point for the recognition and derecognition of financial instruments.

Result in Accounting Information that Can Be Understood by Users

3.24 Regardless of the conceptual merits of components approaches, it is also important that they provide information that users can understand. Some think that components approaches do not provide understandable information. They argue that components approaches have the effect of decreasing the number of familiar, traditional assets and liabilities that are recognised in the balance sheet and increasing the number of unfamiliar rights and obligations recognised. As a result, balance sheets would become unfamiliar and more difficult for users to understand. The JWG considers such criticism to be misconceived: it is the financial markets, and the financial engineers, that are unbundling traditional assets and liabilities through complex transactions; components approaches are simply trying to faithfully represent such transactions in the financial statements. Complex transactions that have non-traditional effects can result in recognition of complex and non-traditional assets and liabilities.

3.25 Similarly, critics of components approaches claim that, although users understand the benefits and risks inherent in "traditional" financial assets and liabilities, they would not know what to make of the "new" financial assets and liabilities that would result from the adoption of a components approach. The JWG does not accept this argument for two main reasons. First, although it might once have been possible for users to make assumptions about the benefits and risks inherent in assets and liabilities shown under the various balance sheet captions, that has not been the case for some time now because of the increased complexity of transactions over the last few decades. For example, balance sheets already show assets that have a "density" of risk far greater than "traditional" assets. That is one of the reasons why there has been an increased demand for comprehensive risk disclosures and more precise balance sheet descriptions; such disclosures serve to alert users to the unusual benefits and/or risks inherent in particular balance sheet items. Second, as already mentioned, the JWG believes that the extent to which the unbundled components will be novel forms of asset and liability is exaggerated. Most of the components recognised will be similar in nature to assets and liabilities that enterprises are already recognising.

Derecognition

3.26 As already explained, the essence of the components approach is that it treats each financial asset and each financial liability as a divisible unit (or component) comprising "smaller" financial assets and financial liabilities. It asks, in respect of each component, whether that component should be derecognised or should continue to be recognised. Therefore, because the factor that determines whether a component should be derecognised is whether it ceases to be an asset (or liability) of the reporting enterprise, paragraph 37 of the Draft Standard asks, in respect of each component, whether the essential conditions of being an asset or a liability continue to be met—i.e., does the enterprise still have the contractual rights (or contractual obligations)?

3.27 There are three types of event that result in an enterprise no longer being entitled to the contractual rights, or no longer being subject to the contractual obligations, that make up a financial instrument or component thereof:

(a) the expiry of the contractual right or contractual obligation involved;

(b) the fulfilment of the contractual right or obligation; or

(c) the transfer and relinquishment to another party of a contractual right.

3.28 Most of these events are quite straightforward and non-controversial. Few would question that a financial instrument should be derecognised when it is extinguished, in the normal course, by payment of the entire amount due, thereby discharging the debtor from any further obligation under the contract. Similarly, few issues arise when a right or obligation from a financial option is extinguished as a result of the contractual term expiring without the holder requiring the writer to deliver or purchase the underlying financial instrument.

3.29 There has been some debate in the past about the circumstances in which an enterprise should be considered to have fulfilled an obligation. The JWG believes that the only circumstance in which an enterprise has fulfilled a contractual obligation is when it has been released from primary responsibility for that obligation. That might be achieved through settlement, by accommodation with the creditor or by process of law. It will not, however, be achieved by the practice known as "in-substance defeasance" of debt[23] because, in those circumstances, the debtor is not released from the primary obligation under the debt agreement. If the assets in the trust prove to be insufficient, for example,

[23] Under this practice, the debtor transfers essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets, which are used to meet obligations to the creditor, closely approximate the scheduled interest and principal payments of the liability.

because default by the debtor accelerates its debt repayment, the debtor must make up the difference. The rights of the creditor, who may not know of the defeasance arrangements, are not limited to the cash flows from the assets in the trust.

3.30 Some transfers involving financial assets can give rise both to derecognition issues and consolidation issues. For example, it may be that an enterprise transfers a financial asset in a transfer that has substance to an enterprise that may be part of the transferor's group for financial reporting purposes. In such circumstances, it is necessary first to decide whether the transferor should derecognise the transferred asset and then to decide whether the transferee forms part of the transferor's group. Some believe that the criteria that should be used to address both these issues are the same and that the two issues can therefore be combined. Others believe that, although they are not the same issue (and, as a result, different criteria may be involved), a derecognition framework that addresses the derecognition of financial assets in an individual enterprise's financial statements without also addressing consolidation issues is incomplete. However, the JWG has taken the view that consolidation issues are outside the scope of its project. It has not carried out the analysis necessary to determine whether the same criteria can be used to address both the derecognition issue and the consolidation issue. It has, therefore, made proposals only about the first issue.

Transfers involving Financial Assets

3.31 The most difficult recognition/derecognition issues arise in the context of transfers involving financial assets, particularly where either:

(a) an enterprise has entered into an arrangement that results in cash flows passing from one enterprise to another and it is not clear whether the arrangement has had the effect of transferring a financial asset; or

(b) an enterprise has a continuing involvement in a financial asset it has transferred and, as a result, it is not clear whether it has retained control of that asset.

Arrangements to Pass Cash Flows Through One Enterprise to Another

3.32 As discussed in paragraph 3.5, in essence an asset of an enterprise is a resource that the enterprise controls from which future economic benefits are expected to flow to the enterprise. An item that was an enterprise's asset would therefore cease to be its asset if the future economic benefits that are expected to flow from the item will no longer flow to the enterprise. Paragraphs 41-48 of the Draft Standard focus on this issue.

3.33 The IASC Framework explains:

> The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. (paragraph 53)

The proposals in paragraphs 41-48 are based on the JWG's view that a right to receive a cash flow will not represent a future economic benefit to the holder of that right in certain circumstances in which the holder of that right also has an obligation to pay exactly the amount received to a third party. Instead, the effect of assuming the obligation will be to transfer the flow of future economic benefits from the resource, leaving the enterprise with neither an asset nor a liability. The JWG decided that the "certain circumstances" in question will be when the effect of the contractual right and contractual obligation is that the cash flows required to be passed on to a third party fully reflect all (and only) the cash received.

3.34 The JWG believes that a significant advantage of the proposed approach is that the expectations of future cash in-flows that are controlled by the transferor, and the risks that arise from those expectations, will be correctly stated on the balance sheet and in the note disclosures analysing the balance sheet amounts.

3.35 Some believe that this proposal is wrong and that, despite the back-to-back arrangements, no transfer has taken place. They believe that this view is supported by the fact that, if the original lender became bankrupt, its receiver would treat the transaction as involving two separate transactions. However, as explained in paragraphs 3.78-3.80, the JWG has concluded that it is not necessary for a transfer to be bankruptcy remote for it to have an accounting effect. Others believe the proposal is wrong because there has been no transfer of legal title. However, as explained in paragraphs 3.46 and 3.47, the JWG does not believe that the notion of legal title should be used to determine who has which asset.

3.36 Some have also expressed the view that the proposals in this area are not consistent with the offset rules set out in IAS 32 (paragraph 33)[24]. However, the JWG believes that its proposal and IAS 32's offset rules deal with fundamentally different issues.

(a) IAS 32's offset rules relate to the *presentation* of financial assets and financial liabilities that should be recognised in the financial statements.

(b) The JWG's proposals address a *recognition/derecognition* issue relating to whether the effect of the obligations taken on as a result of a transaction has been that a holder of a contractual right to future cash flows has transferred its right to future economic benefits.

As such, the JWG believes that the notion that there are inconsistencies between its proposals and IAS 32's offset rules has no validity.

[24] IAS 32's offset rules state that a financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

3.37 Having said that, the JWG's proposals in this area have an implication for an aspect of IAS 32's offset rules. Paragraph 36 of IAS 32 deals with three party offsetting arrangements, explaining that:

> In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off.

Some commentators are of the view that three party offsetting arrangements, despite being treated in IAS 32 as a presentation issue, raise issues about which assets and liabilities the enterprise has and should, therefore, not be dealt with in the offset rules. Implementation of the JWG's proposals in this area would enable the three party offset provisions of IAS 32 to be deleted from its offset rules and put into what some would consider to be a more appropriate recognition and derecognition context.

The Difficulties and Issues That Can Arise in Determining Whether to Derecognise a Transferred Asset

3.38 As mentioned in paragraph 3.31, one source of difficult recognition and derecognition issues is transfers that result in the transferor having a continuing involvement in the asset that is the subject of the transfer. The main principles involved are those that underlie all recognition and derecognition decisions. Each party to the transfer should recognise the contractual rights and contractual obligations it has acquired as a result of the transaction and should derecognise those that it no longer has. However, in a transfer that leaves the transferor with a continuing involvement in the asset, it can be difficult to determine precisely which contractual rights and obligations the transferor still has and which have been relinquished.

3.39 A transfer might, for example, involve an enterprise transferring a contractual right to another party while retaining an involvement in the performance of that right. Residual interests (such as retained subordinated interests) and recourse and guarantee obligations are examples of a continuing involvement. Such involvement can mean that:

(a) the transferor has an obligation that could result in it repaying all the consideration received under the transfer. Some argue that, if that is the case, the transfer transaction sounds very similar to a traditional financing transaction; and

(b) the transferee will receive a fixed return from the asset and the transferor will receive the benefit of any surplus over that return and will suffer any shortfall. If that is the case, the effect of the continuing involvement is that the transferor's exposure to the performance of the asset has been unaffected by the transaction. Some argue that such transactions also sound much more like a financing transaction than a traditional sale transaction.

3.40 On the other hand, a transfer may leave the transferor with a continuing involvement that involves it either having the right or being obliged (or both) to take the asset back. Such arrangements are typically achieved through the use of call options, put options or forward contracts. Some argue that a transaction in which, say, an enterprise transfers an asset to another enterprise while at the same time agreeing to take that same asset back at some future date is also more in the nature of a loan (either of the asset or of the transfer consideration) than a sale. This is the case, particularly, if the terms of the transaction effectively give the transferee the equivalent of an interest return on its money for the period it holds the assets.

3.41 If the transferee has been set up specifically to hold the transferred financial assets and, perhaps, is limited in the activities and actions it can undertake, further complications may be created because it might not be clear whether the transaction has any substance. Similar concerns can arise if the transaction can be reversed by one or both parties if one or the other becomes bankrupt. Resolving that issue involves determining whether a transaction that will not be confirmed as a true sale at law for bankruptcy purposes should ever be treated as a sale for accounting purposes.

3.42 In all such cases, although the transferor may appear to have transferred a contractual right, it is not clear that it no longer *has* the right.

Control Is the Key Determining Factor

3.43 Assets are defined in the IASC Framework as resources "*controlled* by the enterprise as a result of past events…" (paragraph 49, emphasis added). The concept of control is, therefore, fundamental to the determination of whether an enterprise has an asset (or component thereof) or whether it no longer has an asset (or component thereof). The JWG believes that it is also at the heart of the derecognition issues raised above and that paragraph 3.42 is, in effect, asking whether the transferor has relinquished or surrendered control of the contractual right that it has transferred. If control has been relinquished, the contractual right involved has been sold and should be derecognised. If control has not been relinquished, the contractual right has been transferred but not sold, so it should continue to be recognised.

3.44 "Control" in this context means, in general terms, the ability to obtain the future economic benefits that arise and the ability to restrict the access of others to those benefits, i.e., the ability to deploy the economic resources involved and the ability to benefit from that deployment.

3.45 In transfers that leave the transferor with no continuing involvement in the transferred contractual right, it is clear that control over the resource that the contractual right represents has been relinquished. However, the existence of a continuing involvement in the transferred right could mean that the transferee's ability to deploy the economic resources involved and to benefit from that deployment is constrained so much that control of the right has not passed.

Determining whether Control Has Been Relinquished

Legal Ownership and Legal Title

3.46 It is sometimes suggested that it ought to be possible to determine whether an enterprise has relinquished control of a resource solely by reference to the notions of legal ownership and legal title. The IASC Framework, however, takes a different view:

> Many assets … are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the enterprise controls the benefits which are expected to flow from the property. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. (paragraph 57)

3.47 The JWG believes the Framework's comments are equally valid for financial assets, even though they are based on *contractual* rights. Although the contractual rights are the resource that represents the asset, and the contract is the source of that resource, the contract itself will not necessarily be the means by which the resource is controlled. Furthermore, with financial assets and financial liabilities it is easy to separate legal title from access to future economic benefits. These points can be illustrated by considering the position of an enterprise that registers its securities investments in a nominee name. In such a situation, legal title and legal ownership of the securities rest with the nominee company, even though the enterprise has beneficial ownership through its contractual relationship with the nominee company or, in some jurisdictions, because trust law applies. As a result, the nominee company has the contractual rights embodied in the financial instrument, but the beneficial owners have the right to direct how those contractual rights are employed, i.e., they control the contractual rights.

A Lack of Detailed Concepts

3.48 Although the JWG has concluded that it is not possible to determine whether an enterprise has relinquished control of an asset by focusing on legal ownership and legal title, it has not been able to identify any other existing concepts and principles that *are* sufficiently developed to represent an overarching derecognition framework that can be used to determine where to draw the distinction between transfers where control has passed and transfers where control has not passed. Most of the conceptual framework documents that have been issued around the world do not make any specific reference to derecognition and those that do refer to it do not deal with the subject in any detail. Furthermore, although much has been written in various documents issued by standard setters about the notion of control, little agreement seems to have been reached on the most difficult issues that arise when there has been a complex transfer involving a financial instrument. Finally, even the accounting standards that are based on a components approach (and those consultative documents that have proposed or recommended the use of a components approach) do not contain an overarching framework that can be used to determine where control lies in any particular case.

3.49 Yet, the JWG knows that it needs to draw a distinction between transfers where control has been passed and transfers where control has been retained if it is to propose the adoption of a components approach. In particular, the distinction is needed in order to differentiate between transfers that involve the sale of a financial asset and transfers that involve a loan secured by the transferred asset. If no distinction is drawn and every transfer of a component of a financial asset is treated as involving a loss of control over that component, a loan secured by a financial asset would be represented in the financial statements by derecognising the asset used as security. However, it is generally accepted that the faithful representation of a loan secured by a financial asset requires that the borrower continue to recognise the asset used as security while also recognising the assets loaned and a liability to return them.

Application of the JWG's Recognition and Derecognition Principles to Transfers involving Financial Assets

3.50 As existing concepts and principles that can be used to distinguish between transfers where control has passed and transfers where control has not passed are incomplete, the JWG has developed some criteria. The following principles, which deal with the simpler transfers, are, the JWG believes, reasonably uncontentious.

(a) <u>Transfers that lack substance should have no accounting effect.</u> If a transaction or other event is to be treated as having the effect of passing control of a resource from one enterprise to another, that event needs to be something more than a nominal bookkeeping entry. It needs to have substance. (The characteristics that give a transfer substance are discussed in paragraphs 3.72-3.80 below.)

(b) <u>If, following a transfer, the transferor has no continuing involvement of any kind in the transferred asset, it no longer controls the asset.</u> It is easy to forget that, amongst all the complex transactions involving financial instruments, most are very straightforward, every-day transactions where one enterprise transfers all its rights and obligations relating to a financial asset to another enterprise and acquires no new rights and obligations relating to that asset. In such transfers there is no doubt that control passes from the transferor to the transferee.

(c) <u>If the transferee is free and able to transfer the whole of the asset that the transferor had to a third party, the transferee has control of that asset.</u> The JWG believes that an enterprise is only able to give control of an asset to a third party if it, itself, has that control. That will, furthermore, be the case even if the transferor has a continuing involvement in some (and maybe all) of the rights transferred. (The Draft Standard expresses the notion of the transferee being "free and able" to transfer an asset by focusing on whether the transferee has the practical ability to transfer the financial asset in its entirety to a third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. This is discussed further in paragraphs 3.81-3.92 below.)

3.51 That leaves the most complex transfers, where the transfer results both in the transferor continuing to have an involvement in the "larger" asset of which the transferred contractual rights were previously part and in the transferee not being free and able to dispose of that larger asset. For the reasons explained above, the JWG believes that at least some of these transfers are loans secured by the transferred asset. In the absence of any existing concepts that help it to identify which of the transfers are loans, the JWG decided that the best approach was to devise a set of principles based on the essential characteristics of loans and other financing transactions.

Obligations to Repay the Transfer Consideration

3.52 An essential characteristic of a loan is that the borrower receives something now that it is obliged to return at a later date. The JWG therefore believes that a key factor in determining whether a transfer involving a financial asset is in the nature of a loan is whether the transfer results in the transferor having an obligation to repay the transfer consideration it received. A transfer that is part loan, part sale would therefore involve an obligation to repay some, but not all, of the transfer consideration. If it is determined that a transfer is a loan, control of the transferred asset will not have passed to the transferee. This means that the transferor will continue to recognise the transferred asset. If it is determined that a transfer is part loan, part sale, control of part only of the transferred asset will have been retained and control of the remainder of the asset will have passed to the transferee. In this latter circumstance, the transferred asset will be partially derecognised. Paragraphs 3.93-3.98 discuss in greater detail the determination of the amount of the loan.

3.53 In the case of most traditional forms of loan, the obligation that the borrower has to repay the loan is unconditional. However, some transfers involve the transferor receiving cash that the transferee will receive back either from the cash flows arising on the transferred asset or, if those cash flows are exhausted, from the transferor itself. In such a transfer, the transferor has an obligation, but whether that obligation will result in the transferor having to pay cash to the transferee will be conditional on the transferred asset's performance. For example, assume an enterprise (the transferor) transfers a portfolio of receivables to a factor in exchange for a cash payment, and the transferor undertakes to make good any and all losses incurred by the transferee in collecting the amounts due on the receivables. The transferor will therefore have a conditional obligation that could, depending on the performance of the transferred receivables, involve it repaying all the consideration it received.

3.54 The JWG has considered whether such a transfer has the essential characteristic of a loan. Although the transaction could be described as the transferor taking on a conditional obligation, the JWG believes that an alternative description would be to say that it has taken on an obligation that it has agreed will be met initially out of the proceeds of its receivables and, if that source of funds becomes exhausted, then from its general assets. When the transfer is viewed in this way, it can be seen that, although it may not at this stage be any clearer who controls the receivables, it is clear that the transferor has an obligation that could involve it repaying all the transfer consideration. The JWG believes that, if an enterprise enters into a transaction that involves it receiving cash and accepting an obligation that may involve it paying that cash back, the transaction is more in the nature of a loan than a sale.

3.55 The discussion in the last few paragraphs has been about identifying whether a transfer has the essential characteristics of a loan. If, and to the extent that, it does have such characteristics, control of the transferred asset will have been retained by the transferor. For example, in the preceding paragraph we described the transaction as involving the transferor taking on a loan that will be repaid initially out of the proceeds of the receivables and, if that source of funds becomes exhausted, from the general assets of the transferor. As a result, control of the receivables involved will be deemed to have been retained by the transferor. The JWG accepts that there will sometimes not be many outward signs of the transferor exerting control over the transferred assets: control has been so obscured that its existence is apparent only by analysing the rest of the transaction.

3.56 Such obligations arise from a variety of sources, including guarantees, forward contracts, put options written, and recourse arrangements. In developing its derecognition framework, the JWG has not seen any reason to differentiate between obligations depending on their source. As a result, all obligations to repay consideration that result from a transfer involving a financial instrument are treated in exactly the same way.

The Transferee Cannot Transfer the Contractual Right and the Transferor Has the Right to Get it Back

3.57 One implication of the JWG's conclusions about obligations to repay consideration is that an enterprise that transfers a financial asset in a transfer that meets all the following criteria will be deemed to have retained control of the transferred asset:

(a) the transfer has substance;

(b) the transferor has a continuing involvement in the asset the transferor had;

(c) the transferee is not free and able to transfer the asset the transferor had to a third party; and

(d) the transferee has a put option enabling it to insist that the transferor accept the transferred asset back and return the transfer proceeds.

3.58 The JWG believes that, if a put option held by the transferee will ensure that the transferor still has control of a transferred asset in the circumstances described in sub-paragraphs 3.57(a)-(c), a call option should usually have the same effect. Indeed, if the transferee is not free and able to dispose of the transferred asset, a call option held by the transferor will give the transferor the ability to choose what to do with the assets. It can leave them with the transferee, or recall them and then retain or dispose of them itself, i.e., it has the abilities that paragraph 3.44 explained were the essence of control—the ability to deploy the economic resources involved and the ability to benefit from that deployment.

3.59 On the other hand, if the transferee is free and able to transfer the transferred contractual right, whatever the nature of the transferor's continuing involvement in the asset, it must have passed control of the resource represented by the contractual right to the transferee.

3.60 The JWG has therefore concluded that, in the circumstances described in sub-paragraphs 3.57(a)-(c), a call option held by the transferor over a transferred component will ensure that control has been retained, as long as the transferee is not free and able to dispose of the transferred asset.

3.61 Some argue that, in all cases in which an enterprise transfers a contractual right but retains a call option requiring the transferee to return that right, the transferor has retained control of the contractual right. The JWG does not accept that argument. Holding a call option over an asset is not always the same as holding the asset itself. For example, if the transferee is free and able to transfer the asset to a third party, any influence that the transferor might be able to exert through the call option will be minimal. Furthermore, if a call option over an asset always enables the option holder to control the underlying asset, it would seem to follow that the enterprise should also recognise an asset it has never held when it acquires a call option over such an asset.

Other Types of Transfer

3.62 The types of transfer described in paragraphs 3.52-3.61 are, in the JWG's view, the only transfers that involve a component being transferred but control of that component being retained. It follows that, in all other cases, an enterprise that has transferred a component of a financial asset will also have passed control of that component to the transferee. Therefore, for such transfers the transferor can determine what to recognise and what to derecognise by determining which components have been transferred and should be derecognised and which have been retained and should continue to be recognised.

The JWG's Principles for Transfers involving Financial Assets

3.63 To summarise the discussion in paragraphs 3.50-3.62, the JWG has decided that its recognition and derecognition principles for transfers involving financial assets should be applied by transferors as follows.

(a) Transfers that lack substance should have no accounting effect.

(b) If, following a transfer, the transferor has no continuing involvement of any kind in the asset involved, it no longer controls the asset.

(c) If the transferee has the practical ability to transfer to a third party, unilaterally and without imposing additional restrictions on the transfer, the whole of the asset previously recognised by the transferor that is the subject of the transfer, the transferee has control of that asset.

(d) If a transfer that is not described in sub-paragraphs (a)-(c) results in the transferor having an obligation that could or will involve it repaying transfer consideration, the transfer is a loan to the extent of that obligation.

(e) If a transfer that is not described in sub-paragraphs (a)-(c) results in the transferor having a call option over a transferred component, such component being one that the transferee is not free and able to dispose of, the transfer is a loan to the extent of that call option.

(f) If the transfer is not as described in sub-paragraphs (a)-(e), the transferor has not retained control of any of the transferred components, although it will have retained control of any components that have not been transferred.

Mirror-image accounting, symmetry and history not mattering

3.64 In determining the principles that should underlie its derecognition requirements, the JWG would ideally liked to have identified principles that met the following, somewhat overlapping, objectives.

(a) The principles could be applied by both transferors and transferees, resulting in *mirror image accounting*.

(b) The principles would make *derecognition symmetrical with recognition,* rather than making it more difficult to derecognise an asset than to recognise it.

(c) The principles would require two enterprises that arrive at the same financial position by two different routes to recognise identical assets and liabilities, so that *history does not matter*. Put another way, if two enterprises are in the same financial position, it should not matter for accounting purposes what transactions they went through to get there.

3.65 However, although that was the JWG's aim, it has been only partially achieved: the principles set out in sub-paragraphs 3.63(a)-(c) meet the objectives, but the principles set out in sub-paragraphs 3.63(d) and 3.63(e) do not. That is because the JWG has not found it possible to agree on a set of principles that meets the objectives while at the same time drawing a clear distinction between transfers that are sales and transfers that are loans that results in transferor accounting that seems appropriate in all circumstances.

3.66 In developing its principles the JWG was faced with a choice: either adopt an approach that results in some accounting treatments that do not appear to reflect appropriately the transactions, or allow an element of asymmetry between recognition and derecognition and allow some of the influence of history to remain. The JWG has chosen the latter option, primarily because the approach seems to result in accounting which, taken as a whole, produces more appropriate results. Therefore, just like other aspects of existing accounting practice, some aspects of the Draft Standard's principles involve asymmetry and are influenced by history.

3.67 It is usual for the accounting by two parties to a contract to be the mirror image of each other. That is, if the transferor is required to derecognise an asset, the transferee is required to recognise it and, if the transferor is required to continue to recognise an asset, the transferee is required not to recognise the asset. Notwithstanding this, the JWG is proposing to require the transferee to adopt accounting that will *not* be the mirror-image of the transferor's accounting in certain circumstances in which the transferor's accounting is affected by history. Although the JWG reluctantly concluded that the accounting it should require transferors to adopt should be affected by history, it does not see why that should result in transferee accounting that depends on the transferor's history. In its view, it is more important to keep the incidence of asymmetry and historical dependence to a minimum than it is to achieve mirror image accounting for transferees and transferors. It also notes that in many cases the only implication for the transferor's financial statements of adopting non-mirror image accounting will be that some of the transferee's balance sheet classifications will be different from what they would otherwise have been.

3.68 Some believe that this approach is wrong, and that having reached the conclusions summarised in paragraph 3.63, the JWG should have applied them to the accounting of both transferors and transferees; not just transferors. Such people generally accept that it can be difficult to draw a distinction between transfers in which control of the transferred asset has been passed and transfers in which control has been retained, but see little difficulty (and much merit) in drawing the same distinction for both parties to the transaction. The JWG does not accept this view for the reasons set out in paragraph 3.67.

Is the components approach being consistently applied?

3.69 Some believe the adoption of the principles summarised in sub-paragraphs 3.63(d) and (e) is not consistent with the components approach. In their view:

(a) if the transferee is not free and able to dispose of the transferor's previously recognised asset and the transferor has an obligation in the form, say, of a forward purchase agreement that will involve repaying some or all of the transfer consideration received (i.e., the type of transaction that falls within sub-paragraph 3.63(d)), a "pure" components approach would require the transfer to be accounted for by the transferor as a sale of the asset together with the purchase of a forward purchase agreement. The transferee would treat it as a purchase of the asset together with entering into a forward sale agreement; and

(b) if the transferee is not free and able to dispose of the transferor's previously recognised asset and the transferor has a call option over a transferred component that the transferee is not free and able to dispose of (i.e., the type of transaction that falls within sub-paragraph 3.63(e)), a "pure" components approach would require the transfer to be accounted for by the transferor as a sale of the asset together with the acquisition of a call option. The transferee would treat it as a purchase of the asset and the writing of a call option.

That view leads them to conclude that the approach being proposed is an exception to the components approach. In their view, the underlying reasons for adopting a components approach for financial instruments, particularly under a fair value model, is so compelling that any exception to the approach will be unjustified. They are concerned that, by "modifying" the components approach in this way, there is a danger that the advantages that components approaches are perceived to have over other approaches will all be lost. They also argue that, as with any inconsistent application of a concept, modifying the components approach is likely to address only one issue while raising a number of others. The mirror-image accounting issue is, they argue, an example of this.

3.70 Others believe that, although the principle *does* represent an exception to the basic recognition framework, and should be presented as such in the Draft Standard, it *is* justified because, without it, few transactions would be accounted for as loans secured by transferred assets.

3.71 The JWG does not accept that the principles described in sub-paragraphs 3.63(d) and 3.63(e) are necessarily inconsistent with the adoption of a "pure" components approach. The components approach, just like the definition of an asset itself, depends on the existence of control. The principles in sub-paragraphs 3.63(d) and 3.63(e) have been developed *because* transfers of the type described in sub-paragraphs 3.69(a) and 3.69(b) make it so difficult to determine where control lies.

Transfers That Lack Substance Should Have No Accounting Effect

3.72 Although there can be little argument that a transfer has to have substance if it is to have an accounting effect, it is less clear what the characteristics are that give a transfer substance. Some argue that a transfer involving a financial asset will have substance only if it has a significant effect on the transferor's exposure to that asset. Others argue that a transfer has substance only if it results in the transferor being completely isolated in all circumstances from the transferred asset. The JWG is proposing that a transfer has substance only if the counter-party (the transferee) carries out substantial non-transferee business with parties other than the transferor or, if that is not the case, if the transferred components have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Substantial Non-transferee Business with Parties Other Than the Transferor

3.73 Essentially what the JWG is proposing is that, in order for a transfer to be more than a mere nominal bookkeeping entry, the transferee cannot be an enterprise that is the transferor's nominee. To ensure that that is the case, the JWG would require the enterprise to have a separate existence from the transferor and not to be dependent on it (i.e., it carries out substantial business with enterprises other than the transferor).

3.74 Some argue that the JWG has adopted too narrow a meaning of "dependence on the transferor" and, as a result, enterprises that are financed by the transferor will be treated as having substance when that might not be appropriate. They point out that subsidiaries, for example, are by definition at the beck-and-call of their parent, yet will be treated as having substance if they carry out substantial business with enterprises other than their parent. Such arguments raise complex consolidation issues and issues relating to accounting for related party transactions that the JWG believes are more appropriately covered in other accounting standards.

3.75 The Draft Standard also would require that, in considering whether the transferee carries out substantial business with enterprises other than the transferor, business that involves the transferee acting as a transferee of financial assets should not be taken into account. That is because the JWG does not believe that a transfer involving a financial asset can have substance simply because the transferee carries out many such transfers, some with other parties.

3.76 The JWG recognises, however, that it would be equally inappropriate to say that, just because the transferee only carries out transfers involving financial assets, those transfers lack substance. The JWG has therefore proposed that, if the transferee's main activity is to carry out transfers involving financial assets, one should look to the transfer itself to determine if it has substance. The JWG's proposal is that the test in these circumstances should be whether the transfer results in the transferred asset being isolated from the transferor in all circumstances (including bankruptcy). This notion is often referred to as “achieving legal isolation” and the test as a “bankruptcy remoteness test”.

3.77 The type of transactions that will probably be affected most by the inclusion of this will be securitisations, because the transferee in a securitisation is often a special purpose enterprise that has been set up solely for the purpose of this, and perhaps other similar, transactions. Under the Draft Standard’s proposals, if the transferee in a securitisation is such an enterprise, the securitisation will generally have no accounting effect unless the arrangements legally isolate the transferor from the securitised assets.

Isolation in Bankruptcy

3.78 An implication of paragraphs 35 and 36 of the Draft Standard is that a non-bankruptcy remote transfer (i.e., a transfer that does not achieve legal isolation) can still have an accounting effect (i.e., still result in derecognition of the transferred asset) if the transferee carries out substantial non-transferee business with enterprises other than the transferor.

3.79 Some believe that a transfer must be bankruptcy remote if it is to cause derecognition of an asset or component of an asset. They point out that this is a central plank of the approach adopted in FASB Statement 140. In their view it is misleading for a transferee to recognise a transferred financial asset on its balance sheet if, were the transferor to go into receivership, that asset would have to be returned and replaced with an unsecured claim on the financially weak transferor. Whether or not a transfer achieves bankruptcy remoteness is considered by the markets to be a not insignificant matter and it will affect the pricing of the transfer. In their view a derecognition framework that ignores the notion is not fully reflecting the economics of the market place.

3.80 The JWG has not accepted these arguments. It accepts that bankruptcy remoteness plays a role in the pricing of a transfer and that information about transfers that are not bankruptcy remote is important to a transferee if there is more than a remote possibility of the transferor going into receivership. It also accepts that the notion has a role to play in certain circumstances in determining whether a transfer should have an accounting effect, and it believes that some of the Draft Standard’s proposals implicitly give effect to the notion for some transactions in some jurisdictions. However, it has not been able to agree that the notion should be given a greater significance in its proposals. To some extent that is because bankruptcy remoteness is an unfamiliar and largely untested notion in some jurisdictions, but it is also because of concerns in some jurisdictions as to the accounting that would result from its application.

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party

3.81 As explained in sub-paragraph 3.50(c), the JWG has concluded that, if a transfer involving some or all of a financial asset takes place and, as a result of that transfer, the transferee is free and able to transfer the whole of that asset to a third party, it follows that the transferee must now have control of the whole of that asset. The Draft Standard expresses the notion of the transferee being "free and able" to transfer an asset by focusing on whether the transferee has the *practical ability* to transfer the financial asset in its entirety to a third party and is able to exercise that ability *unilaterally* and *without needing to impose additional restrictions* on the transfer. The key issue is therefore what the transferee is able to do in practice; not on what contractual rights the transferee has concerning what it can do with the asset or what contractual prohibitions exist. In particular:

(a) a contractual prohibition on disposing of an asset (or the absence of a contractual right to dispose of it) may have no effect on the transferee's practical ability to dispose of the asset if it is easy to obtain replacement assets (see paragraph 3.82-3.84);

(b) a contractual right to dispose of the asset is of little practical use if there is no market for the asset (see paragraph 3.85 and 3.86); and

(c) an ability to dispose of an asset is of little practical use if it cannot be exercised freely. For that reason:

   (i) the transferee's ability to dispose of the asset must be capable of being exercised independently of the actions of others (i.e., it must be a unilateral ability); and

   (ii) the transferee must be able to dispose of the asset without needing to attach restrictive conditions or "strings" to the transfer (for example, conditions as to how a loan asset is serviced or an option giving the transferee the right to repurchase the asset) (see paragraphs 3.87-3.91).

A Contractual Prohibition on Disposing of an Asset may have No Effect if it is Easy to Obtain Replacement Assets

3.82 It is quite common for an enterprise (the transferor) to transfer a security to another enterprise (the transferee) on terms that stipulate that the transferor will repurchase the security at some specified date and that, in the meantime, do not permit the transferee to dispose of the security. Yet, if the security is one in which an active market exists, the transferee will often sell the security to a third party, knowing that it will be easy to obtain a replacement asset prior to the repurchase date to fulfil its obligations under the repurchase arrangement. As the concern here is with what the transferee is able to do in practice, it is important that such market practice is taken into account. The JWG is therefore proposing that a contractual prohibition on disposing of an asset may have no effect on the transferee's practical ability to dispose of that asset if it is easy for the transferee to obtain replacement assets.

3.83 As most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one easily replaceable security in exchange for another easily replaceable security[25], an implication of the proposal explained in the preceding paragraph is that most repo transactions will, under the Draft Standard, be treated as involving the sale of both securities. That means that each party to the transaction will derecognise the security it had been recognising prior to the transaction and each will recognise the security received in return. In most jurisdictions around the world this will represent a fundamental change in accounting treatment because, to date, sale and repurchase agreements have generally been treated as secured borrowings, and stock lending transactions have generally not affected the assets and liabilities recognised in the balance sheet at all.

3.84 The JWG recognises that is a change that will have a major impact on the reported financial position of many enterprises. The JWG is also aware that FASB concluded, in FASB Statement 125, that the nature of the transactions was ambiguous and that a change in practice could not be justified. Nevertheless, for the reasons set out in paragraph 3.81 the JWG believes its proposal to be appropriate.

A Contractual Right to Dispose of an Asset is of Little Practical Use if there is No Market

3.85 As the objective is to establish whether a transferee is genuinely free and able to give control of the asset to another party, some argue that the existence or otherwise of a market is irrelevant.

(a) The purpose of the assessment is to establish where control lies. If an enterprise would be able to transfer the asset (i.e., would have control of the asset) had a market existed, it does not cease to have control merely because a market does not exist.

(b) The proposal, if taken to its logical conclusion, means that the creation of a market for an instrument that did not previously have one would be a recognition/derecognition event.

(c) A buyer can be found for most, if not all, financial assets if the price is right. The absence of a market for a financial instrument does not therefore mean that an enterprise is unable to sell the instrument. It merely means that, if it wants to sell the instrument, it might have to accept a price that is lower than its intrinsic value. The discount involved reflects the lack of liquidity and, perhaps, other uncertainties, but is not the cost of withholding control of the asset.

3.86 The JWG does not accept that argument. It believes that, unless an accessible market exists, whether or not the transferee has the ability to transfer the asset to a third party is of

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25 The same is true of most stock and securities lending transactions.

little practical significance, and things that are of little practical significance are not generally allowed to influence accounting treatments.

The Need to Impose Additional Restrictions on the Transfer

3.87 The JWG believes that a transferee is not genuinely free and able to transfer to a third party the *whole* of the asset that was previously recognised by the transferor if it risks being in default of its obligations to the transferor if it undertakes a transfer without attaching restrictions to protect its position. For example, a call option held by the transferor will constrain the transferee's ability to dispose of the asset unless either replacement assets are readily available or if it is virtually certain that the call option will not be exercised. Similarly, the JWG believes that, if a transferee has to attach additional restrictions on a transfer of a transferred asset to a third party in order to protect itself from losses that it would otherwise incur on the transfer, it is economically impeded from, and therefore not genuinely free and able to, transfer to a third party the *whole* of the asset that was previously recognised by the transferor. For example, a put option held by the transferee that is virtually certain to be exercised will constrain the transferee's ability to dispose of the asset unless replacement assets are readily available. The JWG has reached these conclusions for the following reasons.

(a) While a call option that is virtually certain not to be exercised will not have a significant effect on a transferee's actions (and is therefore unlikely to prevent it from transferring the asset to a third party should it wish to do so), all other call options are likely to constrain the transferee to some extent because it will be concerned about the possibility of defaulting on the option.

(b) Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option that is virtually certain to be exercised will convey benefits to the transferee that it is unlikely to be prepared to give up lightly, so its existence is likely to constrain the transferee.

3.88 The Draft Standard would require that the assessment by the transferor as to whether an option constrains a transferee should be made once only, at the date of transfer. That requirement reflects the JWG's view that, regardless of the merits that any alternative approach might have, it would be impractical to require the transferor to re-evaluate the option and, if necessary, change the accounting treatment of the transfer, on an ongoing basis throughout the life of the option. However, the Draft Standard treats the expiry unexercised of an option previously considered to be constraining as a recognition/derecognition event.

3.89 Some do not agree with these proposals, believing that by requiring enterprises to determine whether it is virtually certain that a put option will be exercised or whether it is virtually certain that a call option will not be exercised:

(a) the approach being proposed contradicts the comments made in paragraph 3.2 about probability having no role to play in the recognition and derecognition of financial instruments;

(b) the approach is placing unrealistic demands on preparers, who cannot be expected to predict the future. In their view, there is no clear way in knowing whether an option will be exercised at exercise date and, as a result, an option, no matter how much it is in the money at the date of issue, is not a forward contract and should not be treated as such. Circumstances may change which could result in the option being out-of-the money at exercise date. Conversely, an option that is out of the money at issue date can be deep in the money at exercise date; and

(c) the approach implicitly accepts that the transferor and transferee may not be adopting mirror image accounting in a wider range of circumstances that that envisaged by paragraph 3.67. This is because the transferor and the transferee may have different views as to whether the option will be exercised which will again lead to asymmetrical accounting.

Those who hold this view believe that the Draft Standard should adopt an approach to options that will ensure that transferors and transferees treat them consistently. They suggest that one way to achieve this might be to require that call options held by a transferor will always ensure that control is retained unless the transferred asset is easily replaceable.

3.90 The JWG accepts that an implication of its proposals in this area is that, because transferors and transferees may reach different conclusions about whether an option constrains the transferee's ability to dispose of a transferred asset, the decision the transferor takes about the recognition or derecognition of the transferred asset may not be consistent with the decision taken by the transferee. The JWG does not, furthermore, believe that the proposals in this area contradict its early comments on the role of probability in the recognition process or that they place unreasonable demands on preparers. The objective of the "virtually certain" test is to ensure that options that have no economic relevance are not treated as relevant for accounting purposes. If it is possible that a put option that is in the money at the date of issue might be out-of-the money at exercise date then it is not virtually certain that it will be exercised.

3.91 Paragraph 3.87 states in effect that, where a transferee has a put option over a transferred asset that it is virtually certain to exercise, it is economically impeded from transferring the asset without imposing additional restrictions on that second transfer. Some believe that this is not correct because the transferee would generally be able to sell the asset and put option together to another party and, in that circumstance, the put option would not represent an additional restriction imposed on the transfer. The JWG believes that there will be many circumstances in which the put option is not transferable in that way (a put option held by a factor to give effect to the recourse arrangements underlying a transfer of receivables with recourse is an example of a non-transferable put) and is not aware of any satisfactory way of differentiating the two types of option.

Clean-up call options

3.92 Sub-paragraph 50(b) explains that clean-up call options should be ignored when determining which contractual rights and contractual obligations to recognise and which to derecognise. That is because such options do not affect the control of the transferred assets—they are simply a means of bringing to an end a securitisation that has ceased to be economic to operate because almost all the securitised assets have matured and been paid out.

Transfers Where the Transferor has an Obligation To Repay Consideration Received

Determining the Amount of the Loan

3.93 As explained in sub-paragraph 3.63(d), the proposal is that, if following a transfer, the transferee is not free and able to transfer to a third party the whole of the asset previously recognised by the transferor, and the transferor has an obligation that could or will involve it repaying transfer consideration, the transfer is a loan to the extent of that obligation. That means that, where the transferor's obligation is conditional or for an uncertain amount, the amount of the transfer consideration that should be treated as a liability will be based on the maximum amount that the transferor might be required to repay under its obligation or, if lower, the amount of the transfer consideration received.

3.94 Some oppose basing the amount of the loan on the maximum amount that the transferor might be required to repay. They argue that an implication of the approach will be that the amount recognised as a loan will not reflect the amount likely to be repaid. In their view, the amount of liability recognised should be based on the amount likely to be paid to meet the obligation.

3.95 Under the approach proposed, a full recourse factoring, in which the transferor has guaranteed even the catastrophic losses that might be incurred on the factored receivables, is treated as involving no sale of a receivable. On the other hand, if the amount of the loan were to be calculated by reference to the amount that is likely to be repaid, a significant portion of the receivables would be treated as sold. In the JWG's view, "no sale" treatment is the appropriate treatment of such transactions, so it considers its approach preferable to the alternative suggested. Having said that, it is true that the difference between guaranteeing all losses including those arising from catastrophic risks and guaranteeing an amount of losses that comfortably exceeds the amount of losses that will be incurred in almost all circumstances is also not a major change in the transferor's economic position. However, the difference will have a substantial effect on the transferor's balance sheet. The

JWG believes that it is inevitable that, when one draws a "bright line" between fundamentally different types of accounting, small changes to situations close to the bright line can have a major accounting effect.

3.96 The JWG also notes that, if the amount of the loan was to be calculated by reference to the amount that is likely to be repaid, the effect would be to allow the transferor's assessment of its likely exposure under some transfers to determine the extent to which it derecognises those assets. The JWG sees that as a disadvantage that can be avoided by adopting its approach.

3.97 Others suggest that recognising a liability for an amount derived from the transferor's maximum exposure is not consistent with the JWG's overall conclusion that all financial instruments should be measured at fair value. A similar issue arises, they argue, with the asset that is recognised in such circumstances. For example, assume that a portfolio of receivables (fair value 100) has been factored with full recourse in exchange for a cash payment of 85. The recourse arrangements are achieved through a simple guarantee given by the transferor, who also retains a residual interest in the portfolio. Those who believe that recognising a liability of 85 conflicts with the fair value principle would argue that it cannot be right to recognise a liability of 85 when the fair value of the payments that are expected to be made under the guarantee is virtually nothing—because the fair value of the receivables to which the factor first looks for payment is 100.

3.98 The JWG believes that such a suggestion confuses the recognition process with the measurement process. In its view, the correct way to look at the position is to first of all apply the recognition and derecognition provisions, resulting in the conclusion that the transferor has a liability to repay 85 to the factor. This liability will be met initially from the cash collected on the receivables and then, if those monies are insufficient, from the transferor's other assets. The JWG believes that, although the principles summarised in sub-paragraph 3.63(d) have the effect of recognising greater amounts of assets and liabilities on the transferor's balance sheet than would the recognition of only a guarantee at its fair value, that better reflects the assets still under the transferors' control and the obligations that are to be satisfied from those assets.

Transfers Where the Transferor Has a Call Option over a Transferred Component

Removal of Accounts Provisions and Call Options over Assets

3.99 As explained in paragraph 3.63(e), the Draft Standard is proposing that control of a contractual right has not passed to the transferee if both the following criteria are met:

(a) the transferee does not have the practical ability to transfer to a third party, unilaterally and without imposing additional restrictions on the transfer, the whole of the asset previously recognised by the transferor that is the subject of the transfer; and

(b) the transferor has a call option over that specified transferred contractual right.

3.100 In some transfers of groups of contractual rights, the transferor will acquire a call option in respect of each and every transferred contractual right and is free to exercise as many or as few of those options as it wishes. In such circumstances, it is consistent with the analysis underlying paragraph 3.63(e) to conclude that control has been retained in respect of each and every transferred contractual right. However, the position is not as clear if the call option relates to a group of assets and the terms are such that only some, not all, of those assets can be reacquired through exercising the option.

3.101 Securitisations are sometimes carried out on terms that contain a provision that enables the transferor to call back some of the assets securitised at a subsequent date. Some of these "removal-of-accounts" provisions (or ROAPs) allow the transferor to determine the identity of the assets called back; others specify that the assets will be identified by other means (such as randomly or by the transferee). Such provisions are included for good business reasons. For example, credit card balance securitisations commonly have a ROAP that permits the transferor to specify the assets to be called back. The transferor may wish or need to transfer to another credit card issuer some of its credit card accounts, perhaps those for customers with a particular attribute or characteristic. In such a circumstance, the originator may prefer to be able to reclaim, from amongst the securitised assets, any uncollected balances relating to those credit card holders. A ROAP that permits the transferor to specify the assets to be called back would enable it to do that.

3.102 In deciding how to deal with such provisions, the JWG considered which, if any, ROAPs mean that the transferor has retained control over some or all of the transferred assets. The JWG decided the following.

(a) If the transferee does not have the practical ability to transfer the assets transferred to it to a third party (which is usually the case with securitisations), a ROAP that enables the transferor to choose which assets to reacquire from amongst a group of assets will mean that the transferor can reacquire, and thus has not relinquished control over, *any* of the transferred assets. This is the case even if the terms of the ROAP mean that it cannot reacquire that whole group of assets. The transferee's inability to dispose of the transferred assets means that all it can do with them is hold onto them until either all the cash flows due on them have been collected or the transferor calls them back, and it is the transferor that decides which it shall be. In such circumstances, the assets effectively remain at the transferor's command.

(b) Other types of ROAP do not maintain the transferor's control over any part of the group of assets. Even though the transferee is not able to dispose of any of the assets involved, the transferor's inability to specify the transferred assets to be reclaimed means, in the JWG's view, that the transferor has not retained control of the assets. That means that ROAPs that allow the transferor to remove randomly selected, transferred assets at its discretion will not fall within the scope of paragraph 60(b). Neither will ROAPs that involve the transferee selecting the transferred assets to be returned fall within the scope of paragraph 60(b), as long as such provisions do not have the practical effect of allowing the transferor to remove *specific* transferred assets.

Implications of the JWG's Recognition and Derecognition Proposals for Non-financial Items

3.103 The JWG's proposals on recognition and derecognition have been developed for application to assets and liabilities arising from instruments and other contracts falling within the scope of the Draft Standard. They have not been developed with non-financial items in mind. Financial instruments and non-financial items have significantly different characteristics, which means that what is appropriate for financial instruments may not be appropriate for non-financial items. Therefore, although the JWG's proposals may shed some light on the recognition and derecognition frameworks for non-financial items, they do not have any direct implications for those frameworks.

4. Fair Value Measurement

Defining Fair Value—the Exit Price Objective

4.1 Fair value has traditionally been defined in most jurisdictions as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's-length transaction. In practice there has been uncertainty as to whether fair value should be interpreted to be the current entry price (the amount that would be paid for an asset or the amount that would be received from the issuance of a liability at a measurement date) or the current exit price (the amount that would be received for an asset held or that would be paid to be relieved of a liability owed at a measurement date). In many cases, the two are the same or near enough to the same that there is no practical difference for accounting purposes. However, for instruments that are not frequently traded or that are usually traded as a part of portfolios, the entry price differs significantly from the exit price. One example involves financial institutions that make loans to individual customers, sell those loans in portfolios, and realise immediate gains or losses.

4.2 The JWG decided that exit price is the more relevant measure of the fair value of a financial instrument. The market exit price of an asset or liability that an enterprise currently holds or owes reflects the market's expectations of the amount that would be realised on the measurement date. In contrast, an entry price reflects what would be paid to acquire an asset, or received to assume a liability, which amount may be more or less than what would be realised at that date. An "asset" is defined in terms of the economic benefits that are expected to flow from it. The exit price of a financial asset is consistent with that definition because it is the market's estimate of the value of the benefits that are expected to flow to the enterprise from that asset on that date. Similarly, a "liability" is defined as a present obligation that is expected to require future outflows of enterprise resources. The exit price of a financial liability is the market's estimate of the current value of the future resources that the enterprise will have to sacrifice to be relieved of that liability.

4.3 The JWG's conclusion that the fair value measurement objective should be exit price only applies to financial instruments. The JWG has not addressed, and makes no judgement as to, the possible relevance of market entry price for non-financial assets and liabilities. As observed in paragraphs 2.16-2.19, non-financial assets and liabilities have distinctly different characteristics and functions from financial instruments, which may make different accounting appropriate.

Value-in-use, Recoverable Amount and Deprival Value

4.4 Some have advocated that, for the purposes of measuring financial instruments in financial statements, "fair value" should be taken to mean "value-in-use" or "recoverable amount" or "deprival value"[26].

4.5 An asset's value-in-use[27] to an enterprise should be management's best estimate of the net present value of the future cash flows expected to be obtained from the asset's use, and ultimate disposal, by the enterprise. Value-in-use is therefore an enterprise-specific measure that would take into account management's assessment of any ability an enterprise had to extract above-average net cash flows from a financial asset or any inability it had to extract even average net cash flows. In other words, it would reflect management's perception of the enterprise's private skills. It would also reflect any private information that the enterprise had about the likely performance of the asset.

4.6 A financial asset's value-in-use will tend to be either above or below its market exit price. Logically, if all other things are equal, an enterprise will hold on to a financial asset if its estimate of the asset's value-in-use is higher than its market exit price, but will sell the asset if its value-in-use is lower than its market exit price. That causes some to argue that the true reflection of the value of a financial asset is the higher of its value-in-use and net realisable value.[28] This is known as the asset's recoverable amount.

4.7 Others suggest that the true worth of a financial asset to an enterprise is the loss that the enterprise would suffer were it to be deprived of the asset; a notion known as deprival value. An asset's deprival value will depend on the circumstances involved.

(a) If an enterprise is putting the asset to profitable use, the asset's value in its most profitable use (i.e., its recoverable amount) will exceed the cost of replacing it (i.e., its current replacement cost, which is its market entry price inclusive of transaction costs). In such circumstances, the enterprise will, if deprived of the asset, replace it, so its deprival value will be its current replacement cost.

(b) However, a financial asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, if the enterprise is deprived of the asset its loss will be limited to its recoverable amount.

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[26] Deprival value is sometimes also referred to as "the value to the business". In some jurisdictions, the terms "current value" and "deprival value" are treated as synonymous.

[27] Although the discussion here is framed largely in terms of financial assets, the notions discussed and the arguments involved are the same for financial liabilities.

[28] The net realisable value of a financial asset is its market exit price adjusted for selling costs.

In other words, in simple terms, a financial asset's deprival value may be considered to be the lower of its current replacement cost and its recoverable amount; its recoverable amount being the higher of its net realisable value and value-in-use.

4.8 When people advocate the use of value-in-use, recoverable amount or deprival value, they are arguing that market entry prices (in the case of deprival value) and value-in-use can, in appropriate circumstances, be satisfactory measures of financial assets for external financial reporting purposes.

4.9 It has been explained in paragraphs 4.1-4.3 why the JWG does not accept that entry value is a satisfactory measure for financial assets except where it approximates exit value. The JWG does not accept value-in-use for measuring financial instruments because it is dependent upon internal estimates and assumptions even when market prices are available, and because it will not be comparable from enterprise to enterprise. Management may be forced to use its own assumptions in estimating the market exit price of a financial instrument if there are no observable market prices for identical or similar instruments. However, the objective is to replicate the assumptions that market participants would use. In contrast, the objective of value-in-use is to apply present value or other valuation techniques based on management's expectations about cash flows, market conditions, and other uncertainties. The JWG believes that the benchmark for measuring performance of financial instruments should be market expectations, not management's expectations.

4.10 The JWG does not make any judgements about the appropriateness or otherwise of these measures for non-financial items, because this is a subject that is outside its scope.

Direct Costs to Sell or Obtain Relief (Exit Costs)

4.11 Direct costs to sell an asset or obtain relief from a liability affect the net cash flows from a financial instrument, and consideration of those costs in determining fair value could be considered to be consistent with an exit price objective. The JWG decided against that treatment for a variety of reasons. Some believe that such costs should not be recognised until a transaction takes place because they are not, in their view, a liability of the enterprise until that time. Others believe that in concept such costs should be provided for under an exit value objective, but would not require that treatment for reasons of practical expediency. Exit costs will not be significant in many cases, and would be difficult to measure in other situations because they can vary significantly depending on the type of transaction. In addition, such costs have generally been considered costs of the period in which they occur, that is, as the cost of the decision to sell or obtain relief.

Hybrid Contracts

4.12 A financial instrument that is part of a hybrid contract is to be measured as if it were a free-standing instrument even though its value as a part of a hybrid contract may not be the same as if it were free-standing. The non-financial portion of the hybrid contract is not measured separately; its value is simply the difference between the total fair value of the hybrid contract and fair value of the financial instrument portion determined as if it were free-standing. In similar situations involving separate measurement of two or more portions of a single contract, international accounting standards and some national standards permit or require allocation of the entire fair value (or cost) of the whole instrument to its parts based on their relative fair values. The JWG acknowledges that there is no conceptual basis for measuring the financial instrument component as if it were free-standing and attributing any value arising from combining the components in the hybrid contract to the non-financial portion. Some believe that an allocation of such value should be made between the financial and non-financial components. However, any allocation basis will be arbitrary, and the Draft Standard approach is simpler.

4.13 An alternative view would be to measure both the financial and non-financial components at their respective fair values on initial recognition, with any difference between the sum of their fair values and the fair value of the hybrid instrument as a whole recognised as an immediate gain or loss in the income statement. It would seem, however, difficult to justify the recognition of a gain or loss on initial recognition solely as a result of the apparent effect of combining components into a hybrid contract.

4.14 The JWG believes that the requirements of paragraphs 4, 5 and 74-76 of this Draft Standard will ensure that items included in a hybrid contract that are economically equivalent to those measured at fair value in accordance with the Draft Standard will be accounted for in the same manner. At the same time the requirements will limit the circumstances in which non-financial items that are generally measured on another basis are measured at fair value. This approach is consistent with the risk management practices of many financial market participants that focus on individual financial risks within contracts.

4.15 The JWG acknowledges that, in some circumstances, an enterprise may not be able to reliably identify and measure the separate sets of rights and obligations in a hybrid contract that would fall within the scope of the Draft Standard. In these circumstances, the JWG believes that the entire contract should be accounted for as if it were a single financial instrument, primarily to preclude any possibility that the Draft Standard requirements could be avoided for a financial instrument by embedding it in a hybrid contract. Some may be concerned that this requirement could result in a contract with only a minor financial instrument element being accounted for on a fair value basis. The JWG believes that it would rarely be the case that the financial instrument element will not be capable of reliable identification and measurement, and that it is not practicable to develop criteria for determining when a financial instrument element is minor.

4.16 If an enterprise determines that it can no longer reliably identify and measure the separate components of a hybrid contract, then the JWG believes that the enterprise should measure the entire contract at its fair value throughout its remaining period. It does not believe that an enterprise should be permitted to determine in one period that it could not reliably identify and measure the separate sets of rights and obligations and in a later period revert to separately accounting for those sets of rights and obligations. The JWG considered whether to require an enterprise to make this assessment only at the inception of the contract. However, it decided that it is conceivable that an enterprise would determine part way through the life of a contract that, as a result of a change in circumstances, it could no longer reliably identify and measure the separate sets of rights and obligations if circumstances were to change.

Differences Between Bid and Asked Prices (Bid-asked Spreads)

4.17 Some have advocated that the mid-point price should always be used for financial instruments for which there are quoted bid and asked prices. They argue that the difference between bid and asked prices in an active dealer market represents an exit cost that is included in the quoted price. If so, the requirement to exclude exit costs could be extended to require that the dealer's profit is estimated and the bid or asked price adjusted accordingly. However, because removing exit costs presumed to be included in bid or asked prices could be difficult if not impossible, the JWG decided to permit the use of the mid-point between quoted bid and asked prices for instruments traded in active markets where the differences between the bid and asked prices are small. The JWG can see no justification for using a mid-point price in other situations—that is, where the difference between the quoted bid and asked prices is large enough to make a significant difference in the fair value of a financial instrument—because the mid-point price cannot be relied upon to represent the price at which a market transaction would occur. In these cases, enterprises should estimate the price they would expect to receive for assets or pay to be relieved of liabilities whether it is the bid price, the asked price, or another price within the range.

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument

4.18 The Draft Standard adopts the principle that the fair value of a financial instrument should be derived directly from its contractual rights and obligations, even if the only observable prices regarding a particular financial instrument take into account cash flows that do not result directly from those rights and obligations. The JWG believes that any expected benefits, or sacrifices, that are not directly attributable to the rights or obligations under the financial instrument contract should not enter into the estimation of its fair value (see Draft Standard paragraphs 92 to 94).

4.19 Some assert that in certain circumstances this principle is in conflict with the principle that fair value should be based on observed market exit prices whenever they are available. They believe that this conflict exists particularly in respect of financial instruments that are traded only in combination with closely related non-contractual benefits. Two examples are credit card contracts and demand deposit liabilities. Observable prices may exist for the entire credit card and demand deposit relationships. For example, a portion of the observable market exit price for a portfolio of demand deposit liabilities is attributable to expected future benefits from the relationship with the depositors apart from their existing balances. It is not likely to be possible to determine by reference to observable market evidence the portion of the total observed market price that is attributable to the existing balances. Some believe that the observable price of the total relationship should be used in these situations—that the principle of using observable market prices whenever available should be given priority over the principle of estimating the fair value of only the financial instrument contract.

4.20 The primary principle, in the view of the JWG, is to estimate the fair value of the financial instrument. The JWG believes that a market exit price that includes the value of expected customer relationships that are traded with the financial instrument does not fairly represent the fair value of the financial instrument. The fair value of the customer relationships represents the value of an intangible asset to the enterprise that should be treated as such, not as part of the value of the financial instrument. For example, an observed market exit price for a portfolio of credit cards would include the fair value of expected future benefits to result from future business with those cardholders, as well as the fair value of the existing receivable balances and lines of credit extended to those cardholders. The acquisition of such a portfolio may be regarded as equivalent to the acquisition of a credit card business, requiring allocation of the purchase consideration between the identifiable assets acquired and liabilities assumed (that is, allocation on the basis of the fair values of the financial asset receivables, financial liabilities for the lines of credit, and the intangible assets representing customer lists and/or "goodwill").

4.21 Those who advocate using the observed market exit price for the package in these situations because it is a reliable market price point out that the estimation of the fair value of the financial instrument elements is likely to require certain assumptions for which there may be no available market information because there are no transactions involving the financial instruments alone. The JWG does not believe it is appropriate to use the observed market exit price without adjustment simply because it is available, if it represents an asset or liability that is different from the one being measured. The JWG agrees that it probably will be necessary to use internal valuation techniques for credit card receivables and borrowing options, and for demand deposit liabilities. However, it believes that reasonable techniques and assumptions can be developed in respect of these financial instruments, and the Application Supplement provides some implementation guidance (see paragraphs 332-339) with respect to the nature of such techniques. Further, the JWG expects that the alternative approach of pricing the packages would also have to make use of internal valuation techniques in many situations because transactions in these packages are likely to be infrequent in many jurisdictions.

4.22 Some have expressed the view that the expected benefits to result from credit card and demand deposit relationships that are evidenced by prices of observed market transactions should be recognised as intangible assets. This Draft Standard does not address questions relating to the possible recognition of intangible assets because they involve issues that go well beyond those that are relevant to financial instruments.

Written Options That Are Not Embedded in Other Financial Instruments

4.23 Some difficult issues arise in determining the projected cash flows that should be considered to be directly attributable to certain written options that give rise to expectations of future benefits to the writers of such options.

4.24 Generally an option is priced on the expectation that it will be exercised when it is “in the money”, that is, when the value of the option to the holder exceeds its strike price. However, some types of options are issued with the expectation—supported by historical evidence and current market exit prices—that holders will be influenced by factors other than the values of the options in relation to their strike prices in deciding to exercise or not exercise them. That is, a proportion of holders probably will exercise these options when they are “out of the money”, or not exercise them when they are “in the money”, as assessed in terms of the strike prices. The result is that such options can give rise to expected positive value to the writer. A prominent example is credit card borrowing options.

4.25 Some believe that the writer should estimate the market exit price of these options on the basis of including the expected benefits. This would result in the writer reporting these options as assets. The JWG believes that a written option can only be a liability of the writer. It cannot have an asset value. The JWG believes that any expected future asset value associated with a written option relates to expected future business with the option holders, which is an intangible asset and not directly attributable to the option contract.

4.26 It would be inappropriate, in the JWG’s view, for an enterprise to record as an existing financial asset an option that enables customers to borrow money in future periods at or above existing market interest rates for equivalent risk. It may be assumed that the enterprise will extend loans on these terms to all qualified customers whether or not they hold this option. In both cases there may be considerable expected future benefits to result from future loans to customers. To ascribe financial asset value to such an option would open up the opportunity for enterprises to create financial income and financial assets simply by writing at-the-money options.

4.27 In other words, the expectation of a future benefit is a necessary, but not a sufficient, condition for the recognition of a financial asset. To be recognised as a financial asset requires that there be an existing contractual right as a result of a past transaction. In the JWG’s view a written option carries with it no contractual rights to future benefits because the writer cannot compel the holder to exercise the option when it is out of the money or to not exercise it when it is in the money. An option to lend money at or above current market rate of interest may have a small fair value as an obligation. However, it would be expected to have some value to the extent that it could move to be in the money before it expires (for example, if interest rates were to rise or an option holder's credit worthiness were to deteriorate).

Financial Instruments That Contain Options

4.28 In contrast, the JWG believes that the fair value of an existing financial instrument that contains a written option, such as a prepayment option contained within a loan contract, should be estimated taking into account market expectations of the probability of the exercise of the option.[29] The JWG recognises that this position can be considered to be inconsistent with that in respect of free-standing written options discussed in the immediately preceding paragraphs. The fair value of the expectations for out-of-the money behaviour by holders of prepayment options embedded in loans can be considered to be just as much an intangible, rather than a financial, asset to the issuer as the value of expected benefits to result from a free-standing option. However, the JWG believes that there are important differences that warrant the options contained within another financial instrument being treated differently.

(a) A financial option that is contained in another financial instrument enters into defining the contractual rights or obligations of that financial instrument. For example, the prepayment option in a mortgage is an integral and inseparable part of the mortgage contract, which, along with the other provisions of the contract, defines the obligation and rights of the borrower and the lender. The lender (who is the writer of the option) has a contractual right to specified interest and principal amounts that is constrained by the expected effects of the prepayment option. The probability of prepayment will enter into the determination of the interest rate and cash flow expectations that market participants will build into the estimation of the fair value of the mortgage (which is the present value of its expected cash flows at a market rate of return adjusted for prepayment expectations and risk, along with other risks).

(b) The fair value of an option embedded within a loan contract reflecting the market expectations of the probability of prepayment is not conditional on anticipating benefits from expected future loans or other future relationships with customers. It relates only to estimating the future cash flows to be received from the particular existing loan contract. It is therefore not as open to being used to create financial income and financial assets as a free-standing option.

[29] This is subject to the condition set out in paragraph 100 of the Draft Standard.

Application to Demand Deposit Liabilities

4.29 In accordance with the principles explained in the preceding paragraphs, the fair value of demand deposit liabilities will reflect the market's expectations of the timing of withdrawals of existing deposit balances, the level of interest rates on borrowings of equivalent term and risk, and the costs of servicing those deposits. Benefits expected to result from future deposits from existing or new depositors, or from other relationships with depositors, will not enter into the determination of their fair value.

4.30 It is recognised that deposit-taking institutions manage existing financial assets and liabilities in relation to cash flows and risks expected to result from future deposits. Such institutions base the maturities and risks of their investments in loans and other financial assets on the expected timings and amounts of future deposits. The JWG does not believe that there is any conflict between this management objective and the Draft Standard requirements for the fair value measurement of existing deposit liability balances. The objective is to fairly reflect the financial assets and financial liabilities of an enterprise that exist on the reporting date. This, in turn, is based on the premise that a clear picture of existing financial assets and financial liabilities is the essential reference point for evaluating future plans and expectations. The exclusion of expected benefits to result from future deposits in measuring the fair value of existing demand deposit liabilities is consistent with this objective.

4.31 The JWG believes that the link between financial assets and financial liabilities existing at the end of a reporting period and their use in managing expectations with respect to future transactions is appropriately provided by supporting disclosures about an enterprise's financial risk management objectives and policies. Accordingly, the Draft Standard would require the disclosures set out in paragraphs 156-163.

4.32 The JWG understands that most deposit-taking institutions have not addressed the fair value measurement of demand deposit liabilities within a context that is consistent with the principles of the Draft Standard—so that a transition period will be necessary to enable the development of valuation techniques and supporting systems, and the testing of these systems. The Application Supplement, paragraphs 336-339, sets out some basic considerations related to estimating the fair value of demand deposit liabilities. The process of developing fair valuation techniques for demand deposit liabilities may enable more in-depth guidance to be provided.

Prices from More than One Market for the Same Instrument

4.33 The Draft Standard (paragraph 96) would require that, if an enterprise has access to more than one exit market for a financial instrument, the determination of the most advantageous market exit price would take into account any significant difference in the costs that would have to be incurred to realise that price. The JWG believes that this requirement is necessary, even though these costs would not be recognised in measuring the fair value of the financial instrument. Otherwise, it is possible that the observed, most advantageous, market exit price would not be the most advantageous net amount that would be realised on the measurement date. The JWG is concerned that this might lead to efforts to create different markets for the same financial instruments with the only difference being whether certain costs are included in or excluded from the quoted market exit price.

Large Blocks of Instruments and Control Premiums

4.34 It may be contended that the requirement in Draft Standard paragraph 102 for holdings of large blocks of financial instruments will not accurately reflect the expected exit price of an enterprise that holds so many units of a financial instrument that the market could not be expected to absorb them immediately at the prevailing price. One might expect that some adjustment should be made for the expected effects, if information necessary to estimate them is available. The primary reason for the Draft Standard requirement is that market information necessary to estimate the adjustment is not likely to be available. In fact, it is not even clear from market evidence whether or when the adjustment for some equity securities would be positive or negative. The result depends on what weighting might be given to possible positive effects of having a "control premium" versus possible negative effects of the supply exceeding demand at the current market price. Thus the JWG concludes that the most useful representation of exit price is the observable market exit price for smaller quantities if an observable market exit price for a large block is not available. Enterprises are required to disclose the existence of large blocks and the fact that they may not be capable of liquidation immediately at their quoted market prices.

4.35 However, the JWG acknowledges that, if agreed-upon methods were developed for reliably estimating the fair value of large blocks, there would be merit in requiring an adjustment to the price of the security sold individually or in small blocks. In this eventuality, the JWG believes that the requirement of paragraph 102 should be reconsidered.

Estimating Fair Value without Observable Market Exit Prices

Loan Assets and Credit Risk

4.36 Few observable market transactions occur for some types of loan assets in some jurisdictions. In that situation, an enterprise will have to estimate fair value using a valuation technique. The credit quality of loan assets is a key price-determining variable in such a valuation technique. The estimation of the fair value effects of credit quality and changes in credit quality depend on two basic factors: (a) a reliable on-going loan asset credit grading system which is used in extending loans and in continuously evaluating the credit quality of loan assets and (b) a reliable basis for translating the credit grades assigned to loan assets into their estimated fair values at measurement dates. The Application

Supplement to the Draft Standard (paragraphs 359-363) indicates how these factors could be generally incorporated into a loan asset valuation technique.

4.37 The JWG understands that credit risk grading systems with the basic attributes outlined in the Application Supplement are in place in many major lending institutions. It notes that the Basel Committee on Banking Supervision has been urging banks to develop internal risk rating systems that include policies and procedures for identifying, measuring, monitoring and controlling credit risk exposures that are appropriate to the nature, size and complexity of an enterprise's lending activities.[30] An effective credit grading system enables an enterprise to identify and monitor changes in the credit standing of its loan portfolio as changes occur. This in turn facilitates the institution of timely controls over the enterprise's exposure to credit risk. Traditional accounting is based on carrying loans at cost without adjustment for credit deterioration until there is evidence that specific loans are impaired. Some consider that accounting to be deficient in presenting relevant information about lending activities because credit deterioration is not recognised in the periods in which the value of the loan is affected.

4.38 A valuation technique based on an enterprise's internal credit grading system may not be entirely consistent with the exit price objective of fair value measurement because it estimates the current market entry prices between the lender enterprise and borrowers. These entry prices may differ from the prices that the lender would realise if it sold its loan assets on the measurement date in arm's-length transactions in the market place. However, such an internal model would, if based on sound lending practices and consistent policies and procedures, result in an estimate of the fair value of loan assets that consistently reflects the effects of changes in lending market prices for credit standing. The JWG believes that, in the absence of observable market exit prices, such credit grading-based models will provide an acceptable approximation of fair value.

4.39 Some have advocated that accounting standards should specify detailed policies and procedures for estimating the fair value of loan assets. The JWG believes that the determination of appropriate implementation policies and procedures are best left to the enterprise. The enterprise then has the ability to develop a system that is appropriate to its circumstances and the nature, size, and complexity of its lending activities. To help compensate for potential differences in estimation techniques from enterprise to enterprise, the Draft Standard would require certain disclosures of an enterprise's fair value estimation policies, key assumptions and measurement uncertainties (see paragraph 183).

4.40 Some are concerned that the fair values of loans that are estimated on the basis of internal credit grading models may not be comparable between enterprises. The JWG expects some degree of measurement variability between enterprises that have different credit granting

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[30] See, Basel Committee on Banking Supervision, Principles for the Management of Credit Risk, Consultative Paper, Basel, July 1999.

policies and grading systems. This could result in loans of similar credit quality being made at somewhat different interest rates by different lenders, with resulting differences in subsequent credit grading and fair value estimates of these loans. Similar differences would occur within cost-based accounting in circumstances where initial amounts loaned on the same contractual repayment terms with the same credit risk differ as a result of different credit grading policies. The JWG expects that differences in estimated fair values between enterprises will be contained within limits that are reasonable for financial accounting purposes because lending enterprises should normally be expected to be pricing contracted cash flows at interest rates that are consistent with competitive lending rates in open and competitive lending markets.

4.41 In some countries government closely regulates loan rates and terms. Such regulations may include requirements for loans to certain classes of individuals or enterprises that may be linked to the amounts of deposit balances and the interest rates to be paid on the deposits of these individuals and enterprises. Government imposed lending and deposit terms could become uneconomic if economic conditions change, and there may be questions about whether or when changes in government regulation could be anticipated to adapt the regulations to current conditions. Some are concerned that it may be difficult in these situations to determine the fair value of these instruments, that is, how the market may be expected to value them (evaluate future expectations) when there are no observable market prices for these instruments. The JWG expects that the implications of government regulation of the terms of loans and deposits for the estimation of fair value will need to be addressed on the basis of the particular situations in specific countries—within the context of the requirements of this Draft Standard. The JWG believes that guidance on the application of the Draft Standard to these situations is best developed by the accounting standard setting bodies in consultation with the appropriate government bodies and the affected enterprises in these countries.

Impaired Loan Assets

4.42 All loan assets, whether fully performing or in default, would be measured on the basis of the same principles for estimating current market expectations of future cash flows and the interest return that market participants will charge.

4.43 Some believe that there is no need to distinguish loans that may be considered to be impaired. They note that the fair values of all loans reflect some expected incidence of default, and that what may be considered to be an impaired loan is open to a wide range of possible definition. Traditional accounting practices based on identifying impaired loans have been the subject of significant criticism and concern.

4.44 On the other hand, the JWG understands that many users want to know what portion of an enterprise's portfolio is considered to be impaired and what the income statement effect has been in the period, in part as an indication of management performance. The JWG believes that the separate identification and disclosure of impaired loans on the basis provided for in the Draft Standard can provide useful information within the context of the fair value measurement of loan assets.

Identification of Impaired Loans

4.45 The first issue is how to distinguish impaired from unimpaired or performing loans. Traditional definitions that focus on loans for which there is no longer "reasonable assurance" of timely collection of contracted cash flows beg the question: What level of probability should be considered to be "reasonable assurance"? In practice this has been open to a wide range of interpretations. The definition of "impaired loans" might be left to individual enterprise judgement, in which case it is open to a high degree of variability. Alternatively, a rigid definition (such as any breach of loan covenants or repayment terms, or where contracted payments are more than 60 or 90 days overdue) would be artificial and arbitrary in some degree.

4.46 The Draft Standard defines impaired loan assets as individually identifiable loan assets whose credit quality has deteriorated to the extent that it is more likely than not that the lender will fail to receive the full amounts owed in accordance with the terms of the loan contracts. The JWG believes that the "more likely than not" criterion should result in a more consistent identification of impaired loans than under traditional practice. This criterion is already used in accounting standards for the recognition of provisions and deferred tax assets in a number of jurisdictions.

Fair Value Measurement of Impaired Loans

4.47 An enterprise may not be able to apply its normal credit grading system to estimate values of loans with credit quality that has declined below levels at which it would be prepared to grant new loans. But the difficulties of estimating future cash flows are no greater under a fair value system than under traditional approaches. Further, the basic present value methodology for valuing impaired loans is well established and in place in some jurisdictions.[31]

Financial Liabilities

4.48 The benefits of measuring financial instruments at fair value, outlined in paragraphs 1.6-1.13, apply to both financial assets and financial liabilities. Fair value represents the estimated market exit price of the current economic benefits of a financial asset and of the current economic burden of a financial liability. However, some believe additional considerations warrant exceptions to full fair value measurement for certain liabilities. These considerations are addressed in the following paragraphs.

[31] These jurisdictions include Canada and the U.S. See also paragraph 115 of IAS 39.

Non-financial Assets Financed by Debt

4.49 Some hold the view that it is inconsistent to measure fixed coupon debt at fair value while carrying non-financial assets that are financed by that debt at amortised cost because the result yields non-comparable figures for the debt and non-financial assets. They advocate cost-based accounting for this debt, to achieve consistency and comparability with the accounting for the non-financial assets. The JWG believes that requiring cost-based accounting for debt would not enhance comparability or consistency with non-financial assets financed by that debt. It would only result in a less relevant measure of debt. Fixed coupon debt has a direct and immediate exposure to changes in interest rates, the effects of which are measured by the debt's fair value. On the other hand, any effect of changes in interest rates on the value of non-financial assets generally is indirect and uncertain. Thus the JWG believes that the measure of financial liabilities should not depend on whether they could be considered to be financing non-financial assets carried on a cost basis. In addition, any effort to make that link would necessitate requirements for designation and create other problems similar to those created by hedge accounting.

The Implications of an Enterprise's Credit Risk

4.50 The fair value of debt is its estimated market exit price, which reflects the credit risk inherent in the liability. It would take into account the credit standing of the enterprise that is obligated to pay and any collateral or other security provided. Many question whether an enterprise's credit risk, or changes in its credit risk, should enter into the measurement of its financial liabilities.

Measurement on initial recognition

4.51 When an enterprise incurs an unsecured liability in exchange for cash, the effect of its credit risk is clearly observable. An enterprise with a strong credit standing will receive more cash in return for a promise to pay a fixed amount than an enterprise with a weak credit standing. For example, suppose two enterprises both promise to pay 500 in five years. One enterprise with a strong credit standing can borrow at 6 percent. It would receive about 374. The other enterprise with a weak credit standing must pay 12 percent. It would receive about 284. Each initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates each enterprise's credit standing.

4.52 Few dispute this fair value determination on initial recognition of financial liabilities exchanged for cash. However, liabilities issued in exchange for other consideration, such as non-financial assets or services, have often been measured without recognising any effect for the credit risk of the enterprise obligated to pay. The JWG sees no convincing case for excluding the effects of credit risk from measurement of these financial liabilities. It concludes that the same principles should apply to all financial liabilities without regard to how they arose or the nature of consideration that was received in exchange.

Separation of the liability default option

4.53 The risk that an enterprise will fail to pay its liability has been described as an implicit option on the part of the debtor to "put" its assets to the creditor instead of settling the liability according to its contractual terms. An enterprise would be motivated, or forced, to exercise this option if its future cash generating prospects are poor and the enterprise cannot meet its obligations from its own resources. Theoretically, it would be possible to separate from a liability the value of that implicit "put" option. Separation would result in the liability being valued at the present value of its contracted cash flows discounted at the current basic (risk-free) interest rate. The option could presumably be separately accounted for as an asset of the enterprise, although some might argue for it to be treated as a charge against the equity of the enterprise. Some support separation of the option from the liability on the grounds that it results in measuring the liability at the amount that the enterprise is obligated to pay without any reduction for the market's evaluation of the statistical probability that the enterprise will not meet its obligation.

4.54 The JWG concluded that, while the approach may have some theoretical merit, it would be difficult for users to understand and would introduce complexity and practical computational issues that the JWG believes would outweigh its possible benefits.

Measurement subsequent to initial recognition

4.55 The fair value of a financial liability changes as the market's assessment of the risk it will not be paid changes. This is clearly evident from market prices for traded corporate debt. If a borrower's credit risk improves (deteriorates), the observable market exit price of its traded debt will increase (decrease). Some believe that the change in fair value of liabilities caused by changes in credit risk is not relevant to users of the debtor's financial statements. In their view the results are confusing and counterintuitive. In particular, if an enterprise's credit risk worsens, the fair value of its liabilities declines and the enterprise records a gain. They do not believe that a decline in credit worthiness could be considered to create a gain for an enterprise. Although this is an unfamiliar result, the JWG has concluded that the effect has a sound, explainable economic basis. It reflects the consequences of an important source of changes in economic conditions that affect the financial liabilities. The following considerations support this conclusion.

(a) The recognition of the effect of changes in credit risk on the fair value of an enterprise's liabilities is necessary to reflect the current economic burden of those liabilities. The enterprise's financial position changes as a result of changes in its credit risk if its contracted debt payments are not affected by its credit risk. It is better off if it has outstanding debt that bears a contractual rate of interest that is less than what the market would currently demand. Conversely, it is worse off if it has locked itself into long-term debt at a higher cost than it would now have to pay because its credit rating has improved. The effect on the enterprise is the same whether a change in the interest rates the market would demand is due to a change in the basic interest rate or a change in the enterprise's credit rating.

(b) A change in credit standing results in a change in the relative status of shareholders' and creditors' claims to an enterprise's assets. If the enterprise's credit risk worsens, the fair value of the creditors' claims diminishes. The amount of the shareholders' residual claim may appear to increase as a result, but in most cases an apparent gain from a decline in credit standing will be offset by the effects of losses and asset write-downs that have caused the decline in credit standing (although see paragraph 4.57). Because shareholders usually cannot be called upon to pay an enterprise's liabilities, the amount of their residual claim approaches, and is limited to, zero.

(c) A failure to include the effects of changes in enterprise credit risk in the measurement of its liabilities ignores economic differences between liabilities. Consider the case of an enterprise that has borrowed at two different times. The first borrowing occurred when the enterprise had a strong credit standing and a correspondingly low interest rate. The second occurred later when the enterprise had a lower credit standing. Failure to include credit changes in the enterprise's credit risk makes the two borrowings seem to be different, even though the market place evaluates the quality of their respective cash flows as similar to one another.

4.56 Some have suggested that the effects on the fair value of liabilities of changes in credit risk should not be included in the measures of those liabilities because they reflect changes in the internal conditions of the enterprise, rather than changes in external conditions. The JWG believes that, while the effect may seem unfamiliar, it validly reflects how market participants evaluate the interest rate to be charged on a loan. A debt issuer's credit worthiness is affected by its own operating results, but the effect on the fair value of the debt is externally imposed. It reflects the estimate of the market's evaluation of the enterprise's ability to pay.

4.57 Changes in the credit standing of an enterprise may reflect, in part, changes in its internally generated intangible assets, which are generally not recorded under existing accounting standards. Some believe that there is a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's liabilities, while not reporting potential offsetting effects of changes in unrecognised intangible assets. It is beyond the scope of the JWG project to examine accounting for intangibles. However, the JWG does not believe that what some might regard as a shortcoming in accounting for intangibles should be used to compromise appropriate accounting for financial liabilities.

4.58 If an enterprise is in serious financial difficulties, the fair value of the enterprise's debt may reflect the market's expectation that the enterprise probably will not continue as a going concern. (In other words, the market may evaluate the enterprise on the basis of its expected break up value.) That may create a discontinuity in accounting if the enterprise continues to account for its assets on a going concern assumption while the fair value of liabilities is determined on the expectation that it will not continue as a going concern. The JWG concluded that it was not appropriate to try to adjust the fair value measurement of financial liabilities, or require any special income statement adjustments, in such situations. It reached this conclusion in large part because of practical problems in assessing when these situations should be considered to exist and how to determine appropriate adjustments. However, the JWG believes that disclosures required by the Draft Standard (in particular of contractual terms of financial liabilities and any net gain due to the increase in the credit risk of an enterprise's liabilities) will be useful to users in evaluating the extent of potential going concern uncertainty.

4.59 The JWG considered whether the conceptual merits of including changes in credit risk in measuring financial liabilities could be outweighed by practical difficulties of users understanding the effects. The IASC Discussion Paper[32] suggested that making an exception for fair valuing debt for changes in credit worthiness might not undermine the essential elements of the fair value objective, if it is not a financial risk that can be expected to be actively managed by an enterprise, and if excluding it would not give rise to any measurement mis-matching problems with other financial instruments, or require hedge accounting adjustments. However, the JWG concluded that there would be complexities in removing the effects of changes in credit risk from the observable price of publicly traded debt and in explaining the resulting figures (which would represent neither fair value nor cost). Furthermore, some enterprises manage the credit risk of their debt by utilising derivatives, so that failure to measure the effects on fair value of changes in the credit risk of such debt would result in measurement mis-matches with the fair value of these derivatives.

4.60 In summary, the JWG concluded that a change in the credit risk of an enterprise's financial liabilities constitutes a vital element of their fair value, reflecting significant and relevant economic consequences. It believes that the fair value measurement and disclosure of these effects should have significant information value for users once they become familiar with its measurement basis and implications.

4.61 The Draft Standard would require disclosure of the net gain or loss resulting from changes in the credit risk of an enterprise's interest-bearing liabilities, both in the reporting period and cumulatively, so that users will have the basic information necessary to judge its significance for themselves.

[32] See sub-paragraph 6.8(d) of IASC, Accounting for Financial Assets and Financial Liabilities, Discussion Paper, March 1997, chapter 5.

4.62 The JWG considered how the estimation of the current credit risk element of financial liabilities might be simplified where there is no observable market exit price for identical instruments. It decided to permit an enterprise to presume that there has been no significant change in the credit risk related to its non-traded financial liabilities unless available information indicates that one or more specified events that are likely to have affected credit risk have occurred (see Application Supplement paragraphs 370-372).

Financial Guarantees of an Enterprise's Financial Liabilities

4.63 Application Supplement paragraphs 373-375 set out and explain the JWG's position on government insurance of deposit liabilities of regulated financial institutions, and how that may be considered to differ from commercial guarantees. The JWG considered whether insurance provided by government, or possibly in some situations by industry sponsored funds, might effectively provide a blanket guarantee of repayment of some other types of liabilities and that, as a result, such insurance should enter into the measurement of the fair value of these liabilities. It concluded, however, that an informed position on this possibility would require study of the facts and circumstances of particular situations, and accordingly the Application Supplement does not address it.

Exception for Certain Private Equity Investments

4.64 The JWG believes that certain private equity investments may not be practicable of reliable fair value estimation, and accordingly the Draft Standard, paragraph 122, provides for an exception. The basis for concluding on the need for this exception is discussed in the context of the JWG's overall evaluation of the reliability of fair value measurement of financial instruments (see in particular paragraphs 1.20-1.21). The Draft Standard would require that certain information be given about these investments so that readers will be in a position to evaluate their overall significance to the enterprise's financial position and results of operations.

4.65 Such an investment is to be reported at its carrying amount at the time that its fair value was determined to be not practicable of reliable estimation or at a lower amount if there is evidence that the full carrying amount cannot be recovered. The Draft Standard does not provide any guidance on how to determine whether such an investment's carrying amount cannot be fully recovered and its lower recoverable amount if this is this case. The JWG believes that such determinations would be made on the basis of existing standards and practice for identifying and accounting for impaired assets carried on a cost basis.[33]

4.66 Some believe that, if there is evidence that the carrying amount of an equity investment to which paragraph 122 applies cannot be fully recovered, it should be required to be written down to zero. They reason that, since fair value is not practicable of reliable estimate, its

[33] See, for example, IAS 36, Impairment of Assets.

recoverable amount on impairment cannot be expected to be reliably measured. However, the JWG concluded that the Draft Standard should not rule out the possibility that an enterprise might be able to ascertain that, for example, the minimum liquidation value of such an investment is an amount that is greater than zero.

4.67 The Draft Standard would require that such recoverable amount not be subsequently adjusted upward, even if there is compelling evidence that a higher amount up to its original carrying amount could be recovered, unless it is determined that it is now practicable to measure the investment at fair value on an ongoing basis. The JWG believes that this requirement is necessary to avoid the possibility of potentially unreliable adjustments.

Establishing Fair Value Estimation Policies and Procedures

4.68 Draft Standard paragraphs 129 and 130 require that an enterprise establish appropriate policies and procedures for estimating the fair value of its financial instruments. Application Supplement paragraph 376 stresses the need for appropriate supervision and control over the fair valuation process. The critical importance of establishing and maintaining a fair value estimation process based on clearly defined policies and procedures is well recognised for investment enterprises (such as mutual funds) that regularly measure their investments on a fair value basis, and regulators have set out some requirements in some jurisdictions.

4.69 Some believe that it is inappropriate and unnecessary for an accounting standard to set out any requirements for the procedures an enterprise should put in place to implement the standard. They point out that an enterprise must, of course, adopt appropriate procedures to be able to properly implement any accounting standard, and that other accounting standards do not contain requirements for such procedures. The JWG believes that it is important to make the requirement for establishing appropriate policies and procedures explicit in the Draft Standard because fair value estimation represents, for many enterprises, a very significant extension beyond policies and procedures generally necessary to support traditional historical cost-based accounting systems. Furthermore, the reliability of fair value measurements of financial instruments will depend significantly in many situations upon the application by enterprises of rigorous fair value estimation processes. The requirement for enterprises to have appropriate policies and procedures in place enables the fair value estimation requirements of the Draft Standard to be based for the most part on principles, rather than detailed rules, and it enables enterprises to have some degree of flexibility in developing and improving their estimation processes. The JWG believes that, ultimately, the cost to establish and maintain appropriate policies and procedures for financial instrument fair value estimation will be exceeded by the benefits because reliable fair value measurement of financial instruments is fundamental to effectively monitoring and managing fair value financial risks within an enterprise.

5. Balance Sheet Presentation

5.1 The JWG's approach to balance sheet presentation has been to specify primary groupings of financial assets and financial liabilities to provide an overall indication of the nature and significance of an enterprise's financial instruments by type.

5.2 Separate presentation of cash and cash equivalents and equity instruments held by an enterprise is commonly required in current best practice. This presentation has been retained.

5.3 The JWG believes that a distinction between straightforward unconditional financial instruments, and conditional and other more complex instruments, is helpful to an understanding of the basic nature of an enterprise's financial instrument positions. Such a distinction provides an initial indication of the certainty of the cash flows from financial instruments, as well as separately presenting those financial instruments whose fair value is dependent upon more highly leveraged risk positions.

5.4 The JWG considered a classification dependent upon whether a financial instrument is a delivery or exchange contract, in accordance with parts (c) and (d), respectively, of the definition of a financial instrument in Draft Standard, paragraph 7. However, the JWG believes that, while this distinction is useful to explain the definition of a financial instrument, it does not provide a clear, useful distinction for balance sheet presentation purposes. Indeed, some financial instruments, such as a swap contract, might fall partly within one classification and partly within another (for example, the next payment on an interest rate swap is an unconditional right of one party and an unconditional obligation of the other party to deliver, but the interest rate swap contract itself is an exchange contract). The JWG decided that it is more useful to distinguish the most straightforward unconditional delivery contracts in one classification, and to group other more complex financial assets or financial liabilities with conditional financial assets and financial liabilities in another classification.

5.5 The JWG considered whether an enterprise should disaggregate the fair value of financial instruments and hybrid contracts that contain more than one type of instrument for balance sheet presentation. Except in a few cases when disaggregation might be necessary to determine fair values, or might be done to manage individual risks in an instrument, enterprises would have no other need to disaggregate such financial instruments. Therefore, the JWG concluded that a requirement to disaggregate would be unduly burdensome and complicated. The Draft Standard instead focuses on requiring disclosures of key information about the significant terms and conditions and risk positions of an enterprise's financial instruments (see paragraphs 164-182).

6. Income Statement Presentation

6.1 The income statement presentation requirements are reasoned from two fundamental conclusions of the JWG.

(a) Changes in the fair value of financial instruments, after adjustment for receipts and payments, represent income that should be recognised in the income statement in the reporting periods in which they arise.[34]

(b) Fair value income from financial instruments should be disaggregated on a basis that facilitates analysis of the income statement effects of the significant financial risks assumed by an enterprise during a reporting period. The JWG believes that this income statement information complements disclosures about the enterprise's financial risk positions (required by Draft Standard paragraphs 170-180) and its financial risk management objectives and policies (required by Draft Standard paragraphs 156-163).

The bases for these conclusions are set out in the following paragraphs.

Fair Value Changes as Income

6.2 There are several dimensions to the assessment of the usefulness of income determined on a fair value basis for financial instruments.

(a) First, there are conceptual and practical considerations relating to (i) the economic (capital maintenance) properties of fair value income and (ii) the cause and effect relationships (of recognising income in the period that the events that gave rise to income took place).

(b) Second, there are practical considerations relating to whether fair value income (i) can help users in predicting the ability of the enterprise to generate cash and cash equivalents in the future, and (ii) can facilitate the stewardship or accountability of management for the resources entrusted to it.[35]

Each of these areas of consideration is addressed under separate headings in the immediately following paragraphs.

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[34] The Draft Standard makes one exception, for foreign currency exchange gains and losses arising in translating financial instruments from functional currencies to the reporting currency. The reasons for this exception are discussed in paragraphs 6.27-6.29.

[35] These are the fundamental purposes commonly cited in accounting conceptual frameworks (see, for example, IASC Framework, paragraphs 14-16).

The Concept of Fair Value Income

6.3 The economic concept of income is founded on the maintenance of an enterprise's capital. Specifically, income is defined as the amount that can be distributed to equity owners of an enterprise while maintaining its capital, after adjustment for owners' contributions and withdrawals. Accounting conceptual frameworks generally accept that this should be the objective for income determination. For example, the IASC Framework states that:

> ... only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. (paragraph 105)

6.4 From a capital market perspective, an increase in the fair value of a financial asset is income in the important sense that it represents the amount that can be distributed to owners while maintaining the value of the capital invested in the financial asset to earn the current market rate of return.[36] In other words, on a fair value basis capital is maintained in terms of the present value of the market's expectation of future cash flows to be generated by the asset discounted at the current available market rate of return adjusted for commensurate risk.

6.5 For example, suppose Company A bought a zero coupon bond of 10,000 due in three years, for which it pays its fair value of 7,938 (which is its present value at an effective annual yield of eight per cent). At the end of one year, this bond would have increased in value to 8,573 if future rates of return for a two-year bond were expected to be eight percent. Suppose the market rate of interest for bonds of this risk changed at the end of year one to ten percent. If Company A recognised a profit of 635 (i.e., 8,573 minus 7,938), it would not have maintained its capital in terms of its ability to earn the current market rate of return because, at 8,573, its investment can expect to earn only eight percent. Rational investors would not accept an eight percent rate of return at the end of year one when ten percent is available in the market place. To maintain its capital in terms of its capacity to earn the rate of return currently available in the market place, Company A would have to write down its investment to the present value of the expected future cash flows at ten percent (which is 8,264)—i.e., to its fair value. Its income for the period could be represented as interest income of 635 (at eight percent, which was the market rate prevailing during the year) less a loss of 309 (8,573 minus 8,264) due to the increase in the market rate of interest at the end of the year.

6.6 Historical cost income for financial instruments does not have this capital maintenance property, because income on a historical cost basis is recognised when it is realised, rather than when economic events change market prices. Thus the cost of a financial asset may be

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[36] It is important to distinguish the measurement of income (as the amount that can be distributed while maintaining the wealth of an enterprise) from considerations relating to whether the additional resources represented by that income should be distributed to shareholders or retained as additional capital of the enterprise. See further discussion of this point in paragraph 6.23.

relied upon to represent the present value of expected cash flows at the rate of return for commensurate risk demanded in the capital market place *only* at the moment when it was acquired or issued.

Reflecting the Effects of Events in the Periods they Occur

6.7 The practical result of recognising income on the basis of fair value rather than cost is that the fair value consequences of events are reflected when those events take place. Recognising the income statement effects of changes in economic conditions when they occur, rather than when they happen to be realised, enables analysis of economic causes (changes in market rates of interest, for example) and their income statement effects.

Basis for Prediction

6.8 A fundamental purpose of financial accounting information is to aid in evaluating the ability of an enterprise to earn income and generate cash flows in the future. For example, the IASC Framework states:

> The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. (paragraph 15).

6.9 Sub-paragraph 1.8(b) of this Basis for Conclusions notes the usefulness of fair value measures of financial instruments for predictive purposes. Some contend that, while fair value balance sheet figures have predictive value, income on a fair value basis has little or no usefulness for predictive purposes. They believe that gains and losses resulting from changes in the fair value of financial instruments are likely to be volatile and non-recurring results of unexpected, and often temporary, fluctuations in market conditions. They conclude that such gains and losses can provide no basis for predictions of future income and cash flows. Some express the concern that such gains and losses may actually serve to inhibit the ability of users to evaluate the sustainable earnings of an enterprise, which is considered to be a primary objective of financial analysis.

6.10 This concern would seem to presume that the objective of reporting income should be to facilitate forecasts of future income and cash flow streams based on simple projections of past periods' reported income. The JWG does not accept this objective as being either desirable or feasible. Certainly, reliable forecasts of the future income statement effects of a financial instrument are unlikely to be possible from simple extrapolations of past gains and losses. The potential implications of past gains and losses for the future are likely to be less direct. Investors and analysts can be expected to want to evaluate past gains and losses in assessing the potential variability of future returns, as well as in assessing future income expectations. As an example, past gain and loss experience on loans is an important input in evaluating future expected cash flows to result from loan assets and the variability (risk) of those cash flows.

6.11 More specifically, the market's expectations for future income to result from an enterprise's investment in a fixed-coupon loan portfolio may be deduced from its fair value and the current market rate of return for loan assets of commensurate risk. This return is subject to significant variability, depending on the potential for changes in the general level of interest rates and in the range of potential default experience. Estimation of this variability would be based in significant part on past experience with interest rates and loan defaults, taking into account current conditions. Models have been developed to utilise statistical data on past experience to aid in this analysis.

6.12 Some have claimed that income determined on a fair value basis is inferior to that determined on the cost basis for predicting future income and cash flows of, in particular, fixed-coupon, loan-type financial instruments. Certainly, the amortised cost basis can enable a reliable prediction of future historical cost interest to result from such instruments, if they are held to maturity and do not default. This predictability results because interest on the amortised cost basis is calculated as the average annual rate inherent in the difference between the acquisition cost and the future contracted cash flows. It is simply "predicting" an accounting allocation that is determined solely by a past transaction. One can easily project future income if it is simply the result of amortising a past cost. Fair value-based income provides a richer basis for prediction, because it reflects the effects of changes in conditions and events occurring during the reporting period. Recognising income effects of changes in economic conditions and events when they occur is essential to analyses of causes and effects that are at the basis of informed predictions.

Accountability for Income Performance

6.13 Recognising gains and losses as income when they occur also facilitates accountability and assessment of management performance because it attributes gains and losses to management in place when such gains and losses occur rather than possibly to a different management team who may realise them later. Fair value income effectively holds management accountable for the income statement effects of its decisions to hold and owe financial assets and liabilities.

Concerns with Respect to Recognising All Fair Value Gains and Losses Immediately in the Income Statement

6.14 The JWG considered the following areas of concern that have been raised with respect to recognising all gains and losses arising from measuring financial assets and liabilities at fair value in the income statement in the periods in which they arise.

Relationship to Accounting for Non-financial Operating Activities

6.15 Some believe that recognising unrealised gains and losses resulting from changes in the fair value of financial instruments in the income statement is inconsistent with the well accepted income recognition principles for accounting for non-financial operating activities. Revenues of a manufacturing activity, for example, are generally not recognised until they are realised as a result of sales transactions. They argue that, until such time, if any, that the accounting standards for manufacturing and other revenue-generating activities are changed to recognise unrealised gains and losses, unrealised gains and losses arising on financial instruments should not be recognised within the income statement. Rather, unrealised gains and losses resulting from changes in the fair value of financial instruments should be presented outside the income statement, to be recognised in the income statement when they are realised.

6.16 The JWG does not accept this view for the following reasons.

(a) Non-financial assets held for use in productive revenue-generating activities give rise to different accounting considerations than those appropriate to financial assets and liabilities (see discussion in paragraphs 2.16-2.19). Further, the JWG does not believe that standards that improve the presentation of income from financial instruments should be precluded until such time, if any, that it might be determined that similar accounting should be adopted for productive revenue-generating activities.

(b) The recognition of unrealised gains and losses on financial instruments is well accepted when the financial instruments are intended for trading purposes. The JWG believes that it *is* inconsistent to recognise unrealised gains and losses on potentially identical financial instruments within or outside the income statement depending on management's intentions to hold or trade those instruments.

Presenting some or all Financial Instrument Gains and Losses outside the Income Statement

6.17 Some believe that certain gains and losses arising upon the fair valuation of financial instruments are of such a different quality or significance that they should be presented outside the income statement (that is, be presented in a separate section of the statement of equity, or in another performance statement). Furthermore, some have expressed concern about the consequences of abruptly changing long established income recognition conventions. They advocate presenting gains and losses that are not consistent with conventional income reporting outside the income statement, with full disclosure so that users can decide for themselves on their relevance to the income of an enterprise in a reporting period.

6.18 The JWG has two general reservations with respect to this recommendation.

(a) It is concerned that presenting some financial instrument gains and losses outside the income statement would obscure the economic significance of fair value income, and thereby diminish its usefulness as a basis for prediction and accountability.

(b) It is far from clear what the "conventional" cost or mixed income model for financial instruments is, and what it represents. The objective of transparency could be met by highlighting particular gains and losses on financial instruments <u>within</u> a single income statement without the complexity, and the potential for confusion, of placing some gains and losses in a separate equity section or performance statement.

6.19 Despite these general reservations, the JWG agrees that it is important to consider practical issues relating to certain types of gains and losses. It considered the following possibilities for the presentation of gains and losses outside the income statement.

(a) All unrealised gains and losses.

(b) Certain unrealised gains and losses.

(c) Gains and losses on financial instruments designated as hedges of existing unrecognised and expected future risk positions.

All Unrealised Gains and Losses

6.20 The conventional cost-realisation model generally does not recognise income until it has been confirmed by realisation as a result of sale or settlement. Some advocate that it would be helpful for users familiar with this model if all unrealised gains and losses on financial instruments were presented outside the income statement. The difficulty with the resulting presentation of income is that realisation is not an event that results in any increase or decrease in the economic value of a financial instrument to the enterprise. The JWG is concerned that recognition of only realised gains and losses in the income statement would perpetuate the shortcomings of the cost basis of accounting for financial instruments. Gains and losses would not be recognised in the income statement in the period that the underlying causal events occurred.

6.21 The JWG recognises that there could be information value in distinguishing realised and unrealised gains and losses, particularly if they trigger tax consequences or indicate something of management’s investment strategies. However, these would not seem to be sufficient reasons for excluding unrealised gains and losses from the income statement. Consideration of disclosing the amounts of realised and unrealised gains and losses recognised in the income statement is discussed in paragraph 6.44.

6.22 Presentation of unrealised gains and losses outside the income statement has also been advocated on the grounds of alleviating the potential for unrepresentative volatility in reported income. The JWG believes that the volatility of changes in the fair value of financial instruments is unrepresentative only if fair value estimates are not reliable, that is, do not reasonably reflect market-equivalent value at a measurement date. (Considerations relating to presenting unrealised gains and losses resulting from subjective fair value estimates are addressed in paragraph 6.25.) Otherwise, where reliability is not a consideration, how is one to judge whether a change in fair value is unrepresentative, for example, whether a change in a quoted market price is not representative of the real economics of the situation? What decision basis can be used for second guessing the market and judging which gains and losses are real and will be sustained, and which are not? The JWG believes that recognition on the basis of realisation of gains and losses is a less appropriate basis, because it replaces the market's unbiased measure of the effects of economic events with management's timing of realisation, which timing has no necessary relationship to any income earning activity or events.

6.23 The JWG understands that the concerns of many about the potential volatility of fair value income are concerns about risk—concerns that unrealised gains recognised in the income statement in one period may reverse to become losses in future periods. A possible response to this concern may be for an enterprise to set aside an amount to be held as capital as a buffer against risk, rather than modifying the recognition of income for financial instruments. Various models for quantifying the market risk of financial instruments now exist, and a number of regulators of financial institutions are actively considering whether certain of these models may be helpful in determining minimum capital requirements for these institutions.

Certain Unrealised Gains and Losses

6.24 Few now believe that *all* unrealised gains and losses on financial instruments should be excluded from the income statement. Most enterprises would recognise unrealised gains and losses on trading activities in the income statement, but they would exclude unrealised gains and losses on financial instruments that are intended to be held for the long-term. The JWG accepts that it may be useful to distinguish the income statement results of trading and non-trading financial activities, especially where the two activities are managed with different strategies by different managers in separate segments. It does not believe, however, that this warrants different measurement bases or presenting unrealised gains and losses of non-trading activities outside the income statement.

Distinguish Gains and Losses Where Fair Value Estimates Are Highly Subjective

6.25 Some advocate that unrealised gains and losses on financial instruments should be separately presented outside the income statement where fair value is subject to significant estimation variability, until they are realised or until the estimation uncertainty has been resolved. Some believe that unrealised gains and losses that are subject to significant measurement uncertainty should be amortised to the income statement over some period of time, as are, generally, "experience gains and losses" arising on estimates of defined benefit employee benefit plan obligations in employer financial statements. The JWG believes that issues of reliability are appropriately addressed in relation to measurement on the balance sheet, and that there need be no additional tests for the income statement recognition of gains and losses.

Gains and Losses on Financial Instruments Held for Hedging Purposes

6.26 Many believe that gains and losses on financial instruments held as hedges of items that are not recognised or measured at fair value on the balance sheet, or as hedges of future transactions, should be deferred on the balance sheet or separately presented outside the income statement, possibly to be transferred to the income statement as the hedged items are presented in the income statement. The JWG has given separate, extended consideration to these issues (see paragraphs 7.17-7.20 of this Basis for Conclusions).

Exemption of Certain Foreign Currency Translation Gains and Losses

6.27 The Draft Standard, paragraph 136, makes one exception to the requirement for the recognition of all gains and losses on financial instruments in the income statement when they arise. Accounting standards and accepted practices in most of the world require that gains and losses arising on translating assets and liabilities of certain foreign operations from their functional currencies to the reporting currency be presented outside the income statement. The exclusion of these gains and losses from the income statement is premised on the assumption that an enterprise is exposed to foreign currency risk in respect of changes in exchange rates with the functional currencies of the foreign operations, rather than with the reporting currency of the enterprise.

6.28 Despite certain reservations on this point, the JWG has concluded that an exemption is necessary pending a comprehensive reconsideration of accounting for the translation of the assets and liabilities of foreign operations. The JWG's conclusion is based on its understanding that an amendment to foreign currency translation standards to require all translation gains and losses on financial instruments to be recognised in the income statement would necessitate a fundamental revision of these standards, and that this, in turn, would require reconsideration of underlying principles for foreign currency translation that go beyond accounting for financial instruments.

6.29 The Draft Standard would require enterprises to disclose the amount of any net exchange gain or loss on financial instruments that has been presented outside the income statement, so that the effect of this exception will be transparent.

Disaggregation of Fair Value Income

The Need for Fair Value Income Disaggregation

6.30 The first question is whether there is any need for disaggregating changes in the fair value of financial instruments at all. The JWG believes that a one-line presentation of changes in fair value of financial instruments is not sufficient—and that the information value of the reported fair value income of an enterprise can be much enhanced by reporting the significant types of revenue, expense, gains and losses that make up that income.

6.31 Having arrived at this conclusion, the JWG then considered whether particular income presentation information should be required by the Draft Standard, or whether this might be left to the discretion of reporting enterprises. The JWG concluded that the Draft Standard should specify certain items to be presented and, in some cases, the methods for their determination, so as to improve the relevance and comparability of fair value income information.

JWG Approach

6.32 There are many possibilities for presenting items within an income statement. These include reporting by activity centres or functions, by types of financial instruments, by types of financial risks, by realised and unrealised income, by distinguishing expected from unexpected income, unusual from non-recurring income, and sustainable from non-sustainable income. The classification possibilities overlap in some respects, and a number of them present difficulties because their bases for distinction are necessarily highly subjective.

6.33 In order to identify and assess possibilities, the JWG:

(a) looked to existing financial income presentation standards, and how they have been evolving to meet perceived user needs and expectations in light of developments in capital markets, and in financial risk management and investment practices;

(b) examined the implications of the fair value model itself and the extent to which the income statement presentation standards can be reasoned from fair value concepts and principles that can be discerned from the rational information needs of financial capital markets; and

(c) considered practical issues of computation involved in determining fair value income breakdowns.

Existing Standards

6.34 Accounting standards typically require the disclosure of certain revenue and expense items, and the distinction of income or loss from unusual, "extraordinary", and discontinued operations. However, beyond this, income statement presentation standards have generally avoided being narrowly prescriptive and have permitted considerable flexibility of presentation.

6.35 Most accounting standards require disclosure of interest revenue and interest expense (determined on an historical cost "effective interest" basis) and other income from investments, and some disclosures about losses from loan assets that are considered to be impaired. In addition, several standards require some information on the income statement effects of financial instruments used in designated hedging relationships.

6.36 In recent years, some standards have been developed for disclosure of certain of an enterprise's financial risk exposures at the reporting date, and its financial risk management purposes, policies and strategies, including policies for hedging major types of anticipated future transactions. These disclosures have resulted from concerns of users to better understand an enterprise's exposure to financial risks, how they are managed, and the performance of an enterprise in managing these financial risks. Today's standards for disclosure of financial risks and the income statement effects provide an incomplete picture, however. For example, IAS 32 and IAS 39 require information related to interest and credit risk exposures, but nothing on foreign currency, commodity and other market risks.

Implications of the Fair Value Model and Financial Markets

6.37 One of the major advantages of fair value income for financial instruments is that it directly reflects gains and losses from assuming particular financial risks (including interest rate risk, credit risk, risks of changes in commodity and equity instrument prices, and currency exchange risks) when the underlying market conditions change. The JWG believes that it follows from this that a primary objective of the income statement presentation for financial instruments should be to provide information about the gains and losses for each of the significant financial risks that is inherent in an enterprise's financial activities.

Computational Issues

6.38 The disaggregation of fair value income on a basis that facilitates analysis of each significant financial risk inherent in an enterprise's financial activities gives rise to a number of issues that have not previously been addressed in accounting literature. These issues arise because the fair value model for financial instruments is reasoned in part from concepts outside conventional accounting—in particular, from finance and capital markets pricing theories and practices. Furthermore, there are questions relating to whether it is possible to reasonably allocate fair value income effects by types of risk where these effects are the joint result of changes in underlying conditions. For example, calculations of gains and losses resulting from changes in basic interest rates and credit risk are affected by the order in which the calculations are performed when changes in underlying conditions are interdependent or occur more or less simultaneously during a reporting period.

6.39 Based on its work, the JWG does not believe that these problems are insurmountable. It observes, for example, that enterprises commonly manage basic interest, credit, foreign exchange, and specific commodity and equity price risks separately, and may, therefore, be expected to have reasonable bases for assessing the income statement results of assuming these risks. However, the JWG believes it is important not to place too great a burden on enterprises by requiring detailed breakdowns of gains and losses by specific types of risk at this time, pending further study of alternatives, and a period to enable field testing and experience with the application of less detailed requirements.

6.40 The Draft Standard tries to strike a reasonable balance in prescribing items of income and bases of calculation where they can be derived from accepted accounting or finance concepts or capital market practices, and allowing an enterprise some flexibility to choose approaches that are consistent with the ways in which it is managing risks where no one approach is demonstrably superior.

6.41 The Draft Standard also provides for approximations and simplifying assumptions with respect to certain calculations (notably in respect of interest and foreign exchange calculations). At the same time it encourages enterprises to develop more sophisticated methodologies and presentations that are consistent with the required standards.

Other Possible Bases of Income Statement Presentation

6.42 The JWG considered a number of other possible bases of income statement presentation, and reached the general conclusions in paragraphs 6.43-6.45, below.

Trading and Non-trading Classification

6.43 The JWG considered whether enterprises should be required to distinguish between financial income (and financial assets and liabilities) of its trading and long-term financial investment and financing activities. It concluded not to put in place any specific requirements in this regard. However, it notes that such activities could require separate disclosure under segment disclosure standards in some jurisdictions if they are managed as separate business segments. It may also be necessary to provide some separate information on trading and long-term investment portfolios if they are subject to different management objectives and policies (see Draft Standard, paragraphs 156-159).

Unrealised Gains and Losses

6.44 The JWG accepts that the disclosure of unrealised gains and losses on financial instruments may be useful supplementary information. It concluded that this disclosure should not be required, but left optional, because it is not fundamental to the analysis of fair value income.

Operating, Financing, Investing Classification

6.45 The JWG considered whether the Draft Standard should set out requirements or guidance for the presentation of items of financial income under "operating", "financing", "investing" or other headings within the income statement. Some believe, for example, that all revenue, expense, gains and losses from financial instruments should be presented outside the “operating income” section of the income statement, at least for an organisation that is not a financial institution. The JWG believes it is not appropriate at this time for it to dictate how an enterprise should present items of financial instrument income within the income statement.[37]

Interest Revenue and Expense

6.46 Accounting standards in most jurisdictions require disclosure of interest income or revenue and interest expense. Interest is considered to represent a distinct source of revenue and expense. The JWG agrees that interest revenue and expense should be separately disclosed.

6.47 While the general concept of interest is well recognised, the term is not precisely defined in accounting standards or supporting literature. In order to determine "interest" on a consistent and relevant basis a clear definition is needed. The development of the definition provided in the Draft Standard required that two fundamental issues be addressed: (i) What are the appropriate elements to be included in an interest rate? (ii) What should be considered to be interest-bearing financial instruments on which interest should be determined?

Elements of an Interest Rate

6.48 Paragraphs 347-354 of the Application Supplement discuss the relationship between discount rates and projected cash flows in present value determinations. They compare the discount rate adjustment and cash flow adjustment approaches. The Draft Standard does not prescribe whether or when either basis (or a basis that has elements of both) should be used in a present value model for estimating fair value. Properly applied, they will arrive at the same estimate of fair value. The two approaches, however, will result in very different determinations of interest revenue and interest expense.

6.49 The JWG believes that one concept of interest revenue and expense should be specified in the Draft Standard to facilitate comparability. The Draft Standard specifies a definition of interest revenue and expense that is generally consistent with the discount rate adjustment approach. This approach is also consistent with how interest is defined in practice, and in the market place, where interest rates are usually quoted in terms of rates that equate contracted cash flows with fair values.

What Are "Interest-bearing Financial Instruments”?

6.50 Traditionally, interest revenue and expense have been determined and disclosed with respect to all forms of loans, and bond and mortgage securities, that is, where cash has been loaned in return for a contractual promise to pay. However, there is no clear definition of interest-bearing financial instruments in authoritative accounting literature. There are some

[37] A number of accounting standard setters have been considering issues of reporting financial performance. See, G4+1 Position Paper: Reporting Financial Performance, August 1999. The IASC has established a Steering Committee to consider the issues.

significant questions with respect, for example, to whether some or all forms of derivative financial instruments should be considered to be interest bearing. These questions have not been given significant consideration in accounting literature to date.

Derivative financial instruments

6.51 On the one hand, derivative financial instruments may be considered to be interest bearing, because they comprise contractual rights and obligations to deliver or exchange financial instruments in future periods, and their fair values can be expected to be affected by the time value of money. It may be claimed, then, that an interest revenue or expense figure will be incomplete if it does not include the time-value-of-money income effect on the fair value balances of derivatives during a reporting period.

6.52 On the other hand, “interest” (time value of money) effects in respect of certain types of derivatives would seem to have a rather indirect and complex relationship to their fair values. For example, the time value of money effects on the fair value of an option that can be exercised at any time during its life will depend in some part on the value of its volatility and the ability of the holder to delay payment of the exercise price, rather than being a direct function of the market interest rate accruing on its fair value. It may also be questioned whether a derivative should be considered to be interest bearing if its underlying variable is not based on interest rates, particularly if it is based on a variable that is tied to some measure of an equity or similar return.

6.53 The JWG has not been able to resolve these questions to its satisfaction. The JWG considered whether interest should be required to be determined on the fair value balances of all derivatives, except those based on equity instruments, without specifying the basis for determination—or whether enterprises might be allowed to determine for themselves whether derivatives should be included and, if so, on what basis. It was concerned that these alternatives could be too burdensome and lead to inconsistencies between enterprises. It concluded that, pending further study of defensible conceptual and practical bases for inclusion of some or all derivatives as interest-bearing financial instruments, all derivatives should be excluded from the definition of interest-bearing financial instruments. The JWG believes that, while the resulting definition of interest-bearing financial instruments is not complete, (a) it will capture the large proportion of the interest generating base for the large majority of enterprises, and (b) it avoids the additional complexities and potential for differences in calculating interest.

6.54 The fair value of certain derivative financial instruments, such as interest rate swaps and forward contracts, is a direct function of changes in interest rates. For the reasons noted above, no interest is to be accrued on these fair value balances under the Draft Standard definition of interest-bearing financial instruments. Rather, the full income effect of changes in the fair value of such derivative financial instruments (that is, derivative financial instruments with underlying variables that are based on interest rates or credit risk) is to be presented together with the amount of the net gain or loss arising from interest-bearing financial instruments (see sub-paragraph 137(e)).

Income statement information on impaired loans

6.55 Some believe that impaired loan assets are not interest-bearing financial instruments, and that the discount accrual effect should be considered to be part of the net gain or loss on impaired loans in a reporting period. The JWG believes that whether a financial instrument is interest-bearing should be determined by the nature of the financial instrument contract, not by its performing or impaired status. Further, the JWG believes that useful information is provided in determining gains and losses on impaired loans after the determination of interest accruing on those loans. The Draft Standard would require separate disclosure of interest revenue on impaired loans, as well as the net gain or loss on impaired loans after interest, so as to enable users to determine the net income statement effect of impaired loans in the reporting period.

Trading portfolios

6.56 Some believe that interest-bearing financial instruments that are held in a trading portfolio should be excluded in determining interest. They note that many enterprises have separate trading and long-term portfolios of financial assets, which are typically managed by different departments on different bases with different objectives. Some believe that the distinction of interest revenue and interest expense is not relevant to the management of a trading portfolio, and that its distinction would require complex computations and costly record keeping for little benefit. Others believe that an enterprise should be accountable for the income statement effects of changes in basic interest rates whether or not an interest-bearing asset or liability is designated by management for trading purposes. They also note that an enterprise must determine interest on an interest-bearing instrument on an appropriate basis in order to be able to compute gains and losses that have resulted from changes in interest rates, that is, to be able to evaluate the income statement results of taking basic interest rate risks. The JWG agrees with this latter view—that interest revenue and expense should be defined to include interest on all interest-bearing instruments including those designated as trading.

6.57 The JWG recognises concerns that the bookkeeping costs to calculate interest on interest-bearing financial instruments that are turning over on a short-term basis could be onerous. Accordingly, the Application Supplement provides for approximate calculations based, for example, on average fair value quarterly balances. The JWG believes that such calculations should generally be practicable and enable determinations that will be sufficiently reliable for financial reporting purposes (see paragraphs 386-389).

Determining Interest Revenue and Interest Expense within a Fair Value Model

The historical cost method

6.58 Some believe that interest on interest-bearing financial instruments measured at fair value should continue to be determined on the historical cost “effective interest” basis. They point out that this basis is familiar to users. It may also be claimed that this method has important information value because it reflects the contracted interest rate inherent in an interest-bearing financial instrument. Further, some express concern that requiring a "fair value" determination of interest would be confusing.

6.59 While the historical cost "effective interest" basis is well accepted, it is within the context of the historical cost rather than fair value measurement model. It is not an appropriate basis for determining interest revenue and interest expense within the fair value model. Using the historical cost “effective interest” method to determine interest when the interest-bearing assets and liabilities are measured at fair value would result in misrepresenting the current economic interest return/cost and is not compatible with fair value measurement. The effect would be to distort the reported amounts of gains and losses resulting from changes in market interest rates. This, in turn, would seriously detract from the information value of fair value income figures for prediction and accountability purposes. The basis for the JWG’s conclusion may be illustrated by a simple example:

Suppose an enterprise pays 1,000 for a three-year bond with fixed coupon payments to yield an average annual 10 percent rate of return. Its contracted cash flows would therefore be as follows:

	Year ends			
	0	1	2	3
Contracted future cash flows		100	100	1,100
Fair value (present value at 10%)	1,000			

6.60 Suppose that at the end of year 1, the interest rate on two-year money changes to 8%, so that the bond now has a fair value (present value of contracted cash flows discounted at 8 percent) of 1,035.67. Thus there would be a reported gain of 35.67. For simplicity, assume that the yield curve is flat, and that the market rate of interest at the end of year 2 is still 8 percent. The disaggregation of income on this loan using the historical cost effective interest method would be as follows:

	Years		
	1	2	3
Historical cost interest income (at 10%)	100.00	100.00	100.00
Gains (losses)	35.67	(17.15)	(18.52)
Aggregate income return	135.67	82.85	81.48

6.61 The above calculation makes it appear as though the enterprise has incurred losses on a fair value basis in years 2 and 3, offsetting the gain in year 1. If these losses were expected at the end of year 1, should there not have been an impairment write down offsetting the gain? This strange looking result is the product of continuing to show historical cost interest income at 10 percent of historical cost balances in years 2 and 3, when the current economic interest rate determined on a fair value basis is 8 percent. If there has been no change in the 8 percent rate through years 2 and 3, there should be no gain or loss reported on a fair value basis in those years.

6.62 The disaggregation of income with interest measured on a fair value basis in this situation would be as follows:

	Years		
	1	2	3
Fair value interest income	100.00	82.85	81.48
	(10%)	(8%)	(8%)
Gain	35.67	0	0
Aggregate income return	135.67	82.85	81.48

6.63 Some are also critical of the historical cost effective interest method because it is based on the assumption that there is no yield curve, or that the yield curve is flat—because the method reflects the average rate for each period. Thus, it may be said that the historical cost effective interest method misstates even historical cost interest on a period by period basis over the term of a loan.

6.64 Some may wish to provide supplementary information on the historical cost effective interest rates (which some refer to as the “contracted rates”), and perhaps the amortised cost of interest-bearing instruments at the end of the reporting period. Some may also wish to disclose historical cost interest revenue and expense, particularly where such historical cost determinations comprise the basis for determining interest rate coverage or compliance with provisions of bond indentures, etc. The JWG accepts that such disclosures may be useful in some situations. However, the above example demonstrates that historical cost based calculations should <u>not</u> be used in disaggregating fair value change figures.

The computation of fair value interest

6.65 At any point in time market interest rates are represented by a term structure, or “yield curve”, that indicates the current spot rates of interest for increasing terms. The interest rates along the yield curve change as economic conditions, government policies and market expectations as to future conditions (in particular inflation) change. Usually, but not always, the yield curve will be upward sloping, that is, rates increase as term is lengthened so that the market demands a higher rate of interest the longer the term of a loan. There are fundamental questions with respect to whether or how the yield curve should be factored into the determination of interest revenue and expense. These questions have not been addressed by accounting standard setters to date, and there is little accounting literature on the subject. The JWG has given consideration to finance theories of interest in identifying and assessing alternatives for the determination of fair value interest.

6.66 Some may favour the “liquidity preference” interpretation. It presumes that the yield curve represents the greater risk of longer term loans, and that the market generally requires a higher rate of interest to commit money for a long term than it does for a short term. Under the liquidity preference assumption the interest revenue and expense for a period would be based on the prevailing rate for the final year of an interest-bearing financial asset or liability, and the rate would be expected to reduce (assuming a rising yield curve) as the remaining term to its maturity reduces. This method might be favoured because it may be reasoned that it factually represents the effects of changes in rates along the yield curve. If rates along the yield curve do not change during a period, no gain or loss will be reported. A criticism of this method is that the market prices financial instruments on the expectation that interest rates will change, which is the “market expectations” assumption.

6.67 Some may favour the “market expectations” interpretation, which presumes that the yield curve reflects expected future period interest rates. To illustrate, it would be assumed that the existing two-year and three-year rates at the beginning of year one will be the one-year and two-year rates at the end of year one. A primary reason for a rising yield curve within the market expectations assumption may be that the market expects that the rate of inflation will increase over future periods. The effect of using this assumption is that interest revenue and expense for a period would be based on the short-term rate prevailing during the reporting period, regardless of whether the remaining term of an interest-bearing financial asset or liability is one or twenty years. Some may not believe that this result is a reasonable reflection of the effect of the term of a loan on its interest rate. However, forward interest contracts and interest swaps are priced and traded in the market place on the basis of the market expectations assumption.

6.68 Alternatively, it might be expected that, at different times, the yield curve reflects different mixes of these two effects, or some other effects. Thus some may believe that fair value interest should be determined on a basis that yields results between those resulting from the liquidity preference and market expectations assumptions.

6.69 The Draft Standard would require that fair value interest be determined on the current yield to maturity method—with the exception that it allows an enterprise to elect to use the market expectations basis if the chief operating decision maker relies primarily on this basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk.

6.70 The current yield to maturity basis is the fair value equivalent of the historical cost effective interest method. This method largely overcomes the major problem with the historical cost method illustrated in paragraphs 6.58-6.64 above. However, as with the historical cost method, it ignores the effects of a rising or falling yield curve. As a consequence, as the term to maturity of an interest-bearing financial instrument reduces, the current yield to maturity can be expected to change (as it reflects a different average rate for the reduced term) even if there has been no change in the rates along the yield curve. Nevertheless, this method is a substantial improvement over the historical cost method within a fair value measurement system, and the JWG believes that it will provide a reasonable determination of fair value interest revenue and expense in most circumstances.

6.71 However, the JWG concluded that some flexibility should be permitted at this stage of the development of fair value interest determinations. It concluded that the market expectations basis should be permitted on the conditions set out in the Draft Standard because it is the only method that can claim to be fully consistent with the objective of measuring fair value and its income effects against market expectations.

Computational issues

6.72 The JWG is concerned that the determination of fair value interest, and gains and losses relating to changes in market interest rates, not be unduly complex and costly to determine on an ongoing basis. The Application Supplement provides for approximations based on accruing interest on average quarterly fair value balances of groups of similar interest-bearing financial instruments, adjusted where major transactions or changes in market rates have taken place near the beginning or end of a quarter. The JWG believes that the effectiveness and practicality of such approximate calculations can only be thoroughly evaluated on the basis of experience and field tests.

The information value and difficulties of determining interest on a fair value basis

6.73 Some are not convinced that interest determined on a fair value basis is of sufficient conceptual and practical merit to warrant it being required by the Draft Standard. Some believe that "fair value interest" is of doubtful relevance. Some argue that the uncertainties and unresolved issues relating to its basis of determination (discussed in paragraphs 6.65-6.72) and to defining "interest-bearing financial instruments" (discussed in paragraphs 6.50-6.57) may nullify any usefulness that it might have. Further, some believe that the complexity and cost of the computations necessary to determine fair value interest with an acceptable degree of precision are likely to exceed possible benefits.

6.74 The determination of interest on a fair value basis is, as noted earlier, a new concept for financial reporting that has not been seriously examined or tested before. The JWG has considered the conceptual and practical difficulties and uncertainties relating to its determination. The Draft Standard provides that a degree of flexibility and approximation be permitted in its calculation, pending further study and experience.

6.75 The JWG is concerned that, if no requirement for the presentation of fair value interest is put in place, a significant source of information about interest and gains and losses would be missing, and there would be no basis from which to develop knowledge and experience on its usefulness and on the conceptual and practical calculation issues. It concludes that, although imperfect, the interest revenue and expense determinations required in the Draft Standard should provide a basis for analysis that is superior to (a) no requirement (which could result in no information, or information on possibly widely different bases), or (b) historical cost interest (which, as demonstrated in paragraphs 6.58-6.64, is not appropriate within a fair value model). Many enterprises and investors believe it important to manage fair value interest rate risk, and in order to do so they must develop reasonable bases for determining the gain or loss effects of changes in interest rates in order to be able to assess the effectiveness of their management efforts.

6.76 The JWG believes that fair value interest is important and that it is also important that the JWG's proposals for its computation, and possibly other alternatives, be extensively field tested to enable a full assessment of its usefulness and practicality.

Application of Fair Value Interest Determinations in Some Countries

6.77 In some countries there may be no readily observable basic ("risk-free") interest rate, because government bonds may carry a significant credit risk. Some enterprises in these countries may have better credit standings than the government, and thus be able to command a lower borrowing rate than can the government. In such a case, government borrowing rates may not provide a useful, stable benchmark. Nevertheless, interest is still comprised of the elements set out in the Draft Standard definition of "interest revenue (expense)"—that is, the basic interest rate, a credit rate premium, and any premiums for liquidity risk and risks of adverse variability of expected cash flows apart from credit risk. Fair value interest is still determined by equating the contracted cash flows of an interest-bearing financial asset or liability with its fair value. The problem is that there may be no observable market rate of basic interest for enterprises reporting in that currency. Sub-paragraph 346(a) of the Application Supplement provides that in such a case observable market interest rates for the highest rated corporate bonds issued in the currency may be used as the benchmark rate.

Disclosure of the Fair Value Effects of Changes in the Issuer's Credit Risk on Financial Liabilities.

6.78 The amounts required to be disclosed by the Draft Standard (sub-paragraph 137(d) and paragraph 138) combine the income effects of (a) changes in the credit risk of an enterprise's financial liabilities with (b) changes in market credit risk spreads. Some believe that the disclosure should be in respect of (a) alone because it is only these effects that are relevant to users (see paragraphs 4.50-4.62). However, the JWG believes that the determination of (a) alone would be unduly burdensome and open to additional measurement variability. It believes that the amounts to be disclosed by the Draft Standard, along with the required supporting qualitative information (paragraphs 141-142), provides sufficient basic information.

Net Gain or Loss Resulting from Changes in Interest Rates

6.79 The Draft Standard (sub-paragraph 137(e)) would require disclosure of a gain or loss that will largely reflect the effect of changes in market interest rates (that is, the net gain or loss arising from changes in basic interest rates and from changes in the credit risk premiums of financial assets). This gain or loss includes the total income effect of derivative financial instruments with underlying variables that are based on interest rates or credit risk. This amount will therefore include a (usually small) interest revenue or expense element because, as explained in paragraphs 6.51-6.54, the JWG does not believe it practicable at this time to require interest to be determined on derivative financial instruments.

6.80 The Draft Standard (paragraphs 143-144) would require only disclosure of narrative information identifying the significant factors that contributed to this net gain or loss. The JWG believes that it would be desirable for there to be separate disclosure of the income effect of changes in credit quality and basic interest rates. However, it believes that these amounts should not be required at this time because it is concerned that there are unresolved questions relating to their cost-effective calculation. It believes that the usefulness and practicality of extending the disclosures provided for in the Draft Standard may be best addressed after a period of experience with these disclosures.

Net Gain or Loss on Impaired Loans

6.81 Some advocate requiring more detailed information about gains and losses on impaired loans. This might include the nature and amount of impairment losses and, separately, reversal of losses, recognised in the reporting period, for each significant class of financial assets. The JWG believes that such additional disclosures may provide useful information, but they are not essential to a basic understanding of an enterprise's income results in most situations. There may be merit in developing requirements for enterprises with extensive lending activities to provide additional information.

Foreign Currency Denominated Financial Instruments

6.82 The only income disclosure required in respect of foreign currency-denominated financial instruments is the net gain or loss on those instruments due to changes in exchange rates in the reporting period (with separate disclosure of any amount presented outside the income statement) (see paragraph 148). Some believe that there should also be disclosure of the income effects of foreign currency-denominated financial instruments on the amounts reported for interest revenue and expense, gains and losses on interest-bearing financial instruments, and gains and losses on other financial instruments. They point out that the disclosure of the net gain or loss on foreign currency-denominated financial instruments resulting from changes in exchange rates has limited information value in itself, because this amount is likely to have a high degree of interdependency with these other income statement effects. For example, an enterprise may achieve a higher interest return on a foreign currency-denominated bond investment than could be achieved on a domestic bond of equivalent risk, but incur a significant exchange loss on that bond. The JWG agrees that this additional information would be useful. However, it concluded that it would be difficult and costly for enterprises to calculate and provide it, and that disclosure of information about foreign currency risk positions (required by paragraph 171 of the Draft Standard) would provide improved bases for assessing these risks and their income implications. It believes that the possibility of expanding required disclosures of the income effects of foreign currency denominated financial instruments may warrant consideration in future based on experience with the required disclosures and inputs from financial statement users.

6.83 Moreover, a fully informative basis for analysis would require that the net gain or loss due to changes in exchange rates be presented for each currency in which the enterprise has significant transactions or exposure. For similar reasons to those noted above, the JWG concluded that this extent of detail should not be required, but that it is sufficient to require only the net gain or loss in a period for all currencies taken together, along with some information about the primary currencies involved.

6.84 Some have advocated determining interest revenue and expense of foreign currency-denominated interest-bearing instruments on the basis of the market rates of interest in the reporting currency jurisdiction, on the grounds that forward exchange contract prices imply the expectation that any interest differential between the reporting currency and the foreign currency will be offset by an exchange gain or loss. In other words, a foreign currency exchange gain or loss is expected if it is implicit in the forward exchange rate at the beginning of a reporting period, since the forward rate reflects the current spot rate adjusted for the difference between interest rates in the domestic and foreign jurisdictions. The argument is that it follows from this that an expected gain or loss implicit in the forward rate should be treated as an adjustment of the interest return on an interest-bearing instrument denominated in a foreign currency. The JWG believes that the fuller presentation is to reflect fair value interest return on the basis of the prevailing rates of interest in the foreign jurisdiction, and disclose the foreign currency gain or loss.

Statement of Cash Flows

6.85 The JWG concluded that no changes are necessary to existing standards for the presentation of the statement of cash flows to accommodate a fair value model for financial instruments.

6.86 The JWG notes, however, that some have raised questions with respect to the appropriate allocation of cash receipts and payments on interest-bearing financial instruments between principal and interest for the purposes of distinguishing cash flows from operating, investing and financing activities in the statement of cash flows. Standards in most jurisdictions provide no guidance on making this allocation. The JWG believes that any guidance to be provided on this matter should give consideration to the context of the fair value representation of interest and principal. It further suggests that consideration be given to revising standards for the presentation of the statement of cash flows to require that the full amount of such receipts and payments be presented as investing or financing activities as appropriate, with no allocation of an interest portion to operating activities. However, the JWG recognises that such a change would require consideration of principles for the presentation of cash flows that are beyond those necessary to accommodate the implementation of the Draft Standard on accounting for financial instruments.

7. Hedges

Introduction

7.1 An enterprise may use financial instruments in managing existing or anticipated future risks. Enterprises have commonly employed various forms of hedge accounting, that is accounting that alters the normal recognition, measurement or income statement presentation of designated hedging instruments or hedged items so that gains and losses on the hedging instruments are recognised in the income statement in the same period(s) as the hedged items enter into the determination of income. The Draft Standard does not permit special accounting for financial instruments that are hedging instruments or hedged items.

7.2 The preclusion of hedge accounting for financial instruments follows from two fundamental principles of the Draft Standard (a) the measurement of financial instruments at fair value, and (b) the recognition of resulting gains and losses in the income statement in the reporting period(s) in which they arise. The JWG has given extensive consideration to whether any exceptions to these principles may be justified on conceptual or practical grounds, so as to provide for some form of hedge accounting for certain hedging relationships involving financial instruments. Its conclusion, that no exceptions should be made, is explained in the following paragraphs.

The Demand for Hedge Accounting

7.3 Hedge accounting practices have developed to address two types of situations.

(a) Where accounting inconsistencies exist, so that existing risk exposures in respect of like assets and liabilities are not recognised and measured on the same basis—with the consequence that counterbalancing gains and losses on the hedging instrument and on the hedged item are recognised in the income statement in different periods. The objective of hedge accounting is to correct this inconsistent income reporting.

(b) Where an enterprise acquires a financial instrument with the purpose of hedging the variability of future cash flows that are expected to arise in a future transaction. In these situations hedge accounting involves deferring gains and losses on the hedging instrument to be treated as credits or charges to income in the future period(s) in which the hedged transaction is recognised in the income statement.

Hedge Accounting to Correct Accounting Inconsistencies

7.4 Accounting inconsistencies are of two types. *Recognition inconsistencies* arise when some assets and liabilities that are subject to financial risks are recognised in the balance sheet while others are not. *Measurement inconsistencies* arise when assets and liabilities that are subject to financial risks are measured on different bases. In both cases gains and losses on counterbalancing risk positions are recognised in the income statement in different accounting periods. For example, an enterprise may enter into a fixed-to-floating interest rate swap to manage the interest rate exposure of its fixed coupon debt. If the swap is accounted for on a fair value basis and the debt on an amortised cost basis, an accounting inconsistency arises, because changes in market rates of interest would give rise to gains or losses on the swap that would be recognised immediately in the income statement, while there would be no recognition of the reciprocal losses or gains on the debt.

Implications of fair value model

7.5 Accounting for all financial assets and financial liabilities at fair value, with changes in fair value recognised immediately in the income statement, eliminates three major sources of demand for hedge accounting to correct for accounting inconsistencies.

(a) There is no need for hedge accounting where an existing financial instrument is used to manage risks arising from other financial instruments. In the example in the preceding paragraph, there is no need for "fair value" hedge accounting for the debt that is hedged by the fixed-to-floating swap,[38] because both the hedge and the hedged item are accounted for at fair value with counterbalancing gains and losses recognised immediately in the income statement.

(b) There is no need or justification for hedge accounting for gains and losses on hedges of anticipated future transactions to acquire assets or issue liabilities that will be measured on a fair value basis.

> Example: On December 1, 2000, Company X anticipates that it will issue debt of 1,000,000 on March 31, 2001. Suppose it enters into a forward contract on December 1, 2000 to sell a bond for 1,000,000 on March 31, 2001, with the objective of hedging the risk that interest rates will rise prior to issuing the debt. Suppose that interest rates do rise and that the forward contract has an asset fair value of 15,000 on December 31. The resulting gain of 15,000 could not qualify for hedge accounting.[39] The gain cannot be deferred to adjust the initial value of the debt on its issuance because the debt will be marked to fair value. There is no future income-earning event to which the gain can be allocated. (It could only be spread over the life of the debt, as an adjustment to interest, if the debt were to be accounted for on a cost basis.) The real effect of this "hedge" is that Company X is subject to the fair value risk of interest rate changes from the moment it enters into the forward contract. It is, therefore, appropriate that gains and losses on the forward contract be recognised in the income statement when they occur.

[38] IAS 39 provides for "fair value" hedge accounting in situations such as that of this example because the standard requires non-hedged debt to be carried at amortised cost and swaps to be measured at fair value.

[39] See, for example, IAS 39 which permits hedge accounting only if certain conditions are met, including that the forecasted future transaction "must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss" (sub-paragraph 142 (c)).

(c) There is no need or justification for hedge accounting for "cash flow" hedges of existing financial assets and liabilities under a fair value measurement model—because the deferral of the gains and losses on the hedging instrument to be recognised in the income statement as the future hedged cash flows are recognised in the income statement would effectively result in restating the income statement to a cost basis.

> Example: Accounting standards in some jurisdictions have allowed enterprises to apply hedge accounting in respect of cash flow risk related to existing floating rate interest-bearing financial assets and liabilities.[40] To illustrate, an enterprise with a floating rate interest-bearing financial asset may acquire a receive-fixed, pay-variable swap to "fix" the interest receipts and thus eliminate the exposure to risk of changes in cash flows due to changes in the market rate of interest. [It is to be noted that in so doing the enterprise creates a fair value risk—because the fair value of the swap will change with changes in interest rates.] The swap may be considered to be analogous to a hedge of future transactions (the future "transactions" being the stream of variable future interest receipts on the asset). Under "cash flow hedge accounting", gains and losses on the swap are presented initially outside the income statement and are transferred to the income statement in future periods to achieve the effect of adjusting the variable interest revenues of the asset to fixed rate revenues—i.e. to adjust reported interest revenue in the income statement to the equivalent of historical cost basis accounting for a "fixed rate" loan. The effect of the swap is to convert a floating rate asset into a net fixed rate asset position. Since fixed rate assets are to be measured at their fair value under the Draft Standard, a gain or loss resulting from a change in the fair value of the swap is properly recognised immediately in the income statement so as to reflect the income statement effects of changes in interest rates on the fair value of the net fixed rate asset position.

Hedges of non-financial assets, liabilities or commitments

7.6 Hedge accounting also is used to address perceived accounting inconsistencies that arise when financial instruments accounted for at fair value are used as hedges of non-financial assets, liabilities or commitments that are not recognised and measured at fair value. In a number of jurisdictions "fair value hedge accounting" is required or permitted where financial instruments are designated as hedges of such non-financial items, provided that certain qualifying conditions are met. This special accounting involves adjusting the carrying amounts of these non-financial items so that they reflect the fair value of the risks that are the subject of the designated hedges. The JWG concludes that this type of special accounting is outside the scope of this Draft Standard because it involves modifying the

[40] For example, IAS 39 provides for "cash flow hedge accounting" in such situations. See IAS 39 sub-paragraph 137(b) and paragraph 158.

accounting only for the non-financial items. Accounting for the financial instruments is unaffected.

7.7 Some believe, however, that "fair value hedge accounting" using financial instruments should be considered to be within the scope of the Draft Standard, and should not be permitted by it. They argue that "fair value hedge accounting" results in selectively recognising and measuring non-financial items as though they were financial instruments with respect to the risks that are designated as being hedged by financial instruments. This, they claim, is inconsistent with the conclusion that non-financial items are outside the scope of the Draft Standard. Further, this special accounting has the unsatisfactory result, in their view, of piecemeal revision of the cost-realisation basis of accounting for non-financial items based on fair value accounting for financial instruments. In their view, a designated financial instrument in this case should be considered to be managing the variability of expected future cash flows of the anticipated future transaction that is expected to arise when the designated non-financial item is realised—that is, it should be treated as the equivalent of a hedge of an anticipated future transaction. The JWG rejects this view for the reason noted above, that the special accounting results only in modifying the accounting for the designated non-financial item and is therefore not within the scope of this Draft Standard.

7.8 The JWG considered whether there are situations in which non-financial items should be recognised and measured as if they were financial instruments. It concluded that certain types of contracts to buy or sell non-financial items are so similar in substance to financial instruments that they should be included in the scope of the Draft Standard (see paragraph 2). In addition, the JWG concluded that consideration of changes to presently accepted accounting for other non-financial items is beyond the scope of this Draft Standard, because the issues are significantly different from those applicable to financial instruments.

Hedges that do not involve financial instruments

7.9 The Draft Standard does not affect the accounting for hedging relationships that involve both a hedging instrument and a hedged item that are not financial instruments and are not otherwise included in the scope of the Draft Standard.

Hedges of Anticipated Future Transactions

7.10 An important aspect of many enterprises' risk management activities relates to the variability of expected cash flows related to anticipated future transactions. Enterprises commonly use financial instruments to offset that variability. Hedge accounting has generally been permitted for such activities if certain qualifying conditions are met. Gains and losses due to changes in fair value of the financial instrument used as the hedging instrument may be deferred by reporting them as assets and liabilities. Alternatively, changes in the expected cash flows from the future transactions are reported in earnings when an event occurs that causes the expectations to change. Those supporting this hedge accounting may argue that it is appropriate because the gains or losses on the designated financial instruments can be expected to be offset by counter balancing changes in the value of the anticipated future transactions. They also argue that it reflects management's intentions in using financial instruments to mitigate anticipated future risks.

7.11 The JWG concluded that special accounting for hedges of anticipated future transactions should not be permitted because it would be inconsistent with accepted concepts and principles of financial accounting for the following reasons.

(a) A change in the fair value of a financial instrument is an event that should be recognised in the income statement in the period in which the change occurs. Those gains and losses should not be deferred because a gain is not a liability and a loss is not an asset. Gains and losses on existing financial instruments cannot meet the accepted definitions of "liabilities" and "assets" in accounting conceptual frameworks. Specifically, gains do not represent probable future sacrifices and losses do not represent probable future benefits.

(b) An expected change in the value of a future transaction cannot qualify for recognition as an existing asset or liability. The argument made for treating gains as if they were liabilities and losses as if they were assets is based on anticipating offsetting effects on the values of future transactions. In other words, to be treated as a liability, it must be anticipated that an existing gain on a hedging instrument will be "paid" by incurring an offsetting loss on a future transaction. But, an enterprise has no basis for anticipating and recognising any obligation for an expected loss on a future transaction. This is because another necessary condition of "assets" and "liabilities" is that they represent existing rights and obligations arising from past events. Changes in the value of anticipated future transactions do not meet this condition for recognition as existing assets or liabilities.

(c) Adjusting the recorded amount of a transaction by the amount of a gain or loss on a hedging instrument results in not recording the transaction at the fair value of the consideration given or received. To defer a gain or loss on a hedging instrument to "basis adjust" the amount actually paid for the hedged asset, or received for assuming the hedged liability, has the effect of measuring that asset or liability as if it had been acquired or issued when the hedging instrument was acquired, rather than when the hedged transaction actually took place.

(d) Management intention is not sufficient to create a right or obligation. An enterprise may take on a financial instrument price risk position now in anticipation of taking an offsetting position in a future transaction. However, an intention to carry out a future transaction is not sufficient to fix a price or create an obligation to carry out a transaction and recognise the expected value changes as current income statement effects.

7.12 Nevertheless, despite these arguments, many believe strongly that some form of hedge accounting is appropriate in respect of hedges of future transactions meeting certain qualifying conditions. Advocates of hedge accounting have raised a number of arguments that need to be carefully addressed against the concepts and principles set out above. These are set out in paragraphs 7.13-7.15, below.

7.13 Some believe that the deferral of a loss on a hedging instrument in anticipation of a future transaction is no different than incurring costs (such as costs of plans to construct an asset, or prepaid transportation costs) which are capitalised as assets. The JWG believes that there is a major distinction between costs and losses. Costs incurred in anticipation of acquiring a future asset are recognised as an asset if they give the enterprise some useful right, for example, a useable plan, or a transportation right that has value. A loss, on the other hand, provides an enterprise with no rights to anything and thus has no value.

7.14 Some are of the view that an investment in a derivative to hedge a future transaction risk is analogous to a prepaid insurance contract, which is recognised and measured as an asset on the balance sheet. Again the JWG believes a clear distinction may be made. An insurance policy is a financial instrument, and its fair value is dependent upon the probability that an insured event of loss to the insured party will occur and the amount that would be payable if it does.[41] In contrast, the fair value of the derivative financial instrument is not contingent on any future event of loss to the holder of the derivative, but is valued on the basis of the price of the variable that is the subject of the derivative.

7.15 Some believe that hedge accounting should be permitted for gains and losses arising on financial instruments designated as hedges of the exchange risk in commitments to acquire non-financial assets for fixed amounts of foreign currency. An enterprise may, for example,

[41] Insurance contracts are excluded from the scope of the Draft Standard, pending further study, as explained in paragraphs 2.23-2.30.

acquire a forward exchange contract with the intention of locking in the local currency amount to be paid for the non-financial asset under such a commitment. The problem is that the commitment is normally accounted for as a non-financial contract with no recognition of an existing foreign exchange risk. It has been argued that in this case hedge accounting should be followed for the gains and losses arising on the forward exchange contract so as to reflect properly the effects of this hedge in the reporting period.

(a) The first question to be asked in relation to this belief is whether the accounting for the commitment is incorrect, that is, whether accounting standards should require that it be recognised as a foreign currency risk exposure to be translated at current exchange rates. If it were to be so treated, there would be no hedge accounting issue. The forward exchange contract and the foreign currency commitment would be accounted for on the same fair value basis in respect of the currency exchange risk, with counter balancing gains and losses recognised immediately in the income statement. The JWG gave extensive consideration to this possibility. It concluded that a commitment to acquire a non-financial item at a fixed price in a foreign currency is a non-financial contract. Further, it concluded that it would not be appropriate to extend the scope of the Draft Standard to treat such a commitment as if it were, or as if it contained, a foreign currency denominated financial instrument (see discussion of this issue in paragraphs 2.58-2.62).

(b) The JWG does not believe that there should be any special accounting for the financial instrument that is designated as a hedge of the exchange risk in this non-financial commitment. This hedging arrangement consists of two separate contracts linked by management's intention:

  (i) a firm commitment to acquire a non-financial asset from one party for a fixed amount of foreign currency at a specified future date; and

  (ii) a forward currency exchange contract with another party.

  The enterprise intends contract (ii) to fix the price of contract (i). However, they are separate contracts with separate parties. Contract (ii) is not part of contract (i), and the enterprise's intention to link the two contracts is not sufficient justification for treating contract (ii) as if it were part of contract (i). However, as explained in paragraph 7.6, the JWG considers possible special "fair value hedge accounting" for the effects of changes in the exchange rate on accounting for the non-financial commitment to be outside the scope of this Draft Standard.

Practical considerations

7.16 Some are of the view that hedge accounting for hedges of anticipated future transactions is justified by its practical benefits in enabling financial statements to portray management's intentions, and that these benefits outweigh the above conceptual problems. The JWG does not accept this view, but believes that these conceptual problems are the source of serious practical problems that stand in the way of reliably implementing any hedge accounting basis. The JWG's most serious practical concerns are summarised below.

(a) Management's identification of a hedge depends on its hedging strategy, and enterprises have different and often conflicting views of future risks. They may manage these risks in directly opposite ways—so that it can be impossible to distinguish speculation or "position taking" from risk reducing hedging strategies. What is viewed to be risk taking by one enterprise may be viewed by another as hedging. To illustrate, one enterprise may wish to hedge the risk that the price to buy a particular commodity in a future period will increase, and it may enter into a forward contract to "fix" that future price in respect of an anticipated future purchase or sale. Another enterprise may have an unrecognised firm commitment to acquire that commodity at a fixed price, and be concerned that it will lose if the price declines. It may then wish to enter into a forward contract to undo that fixed price risk. Thus two enterprises may wish to apply hedge accounting to achieve opposite results.

(b) The number of future risky transactions that could be anticipated by an enterprise may be very large. There may be almost unlimited combinations of streams of future transaction cash flows that will expose the enterprise to various future price risks. A particular existing financial instrument may be capable of being related in many different ways to a wide variety of expected future transactions. For example, debt denominated in a foreign currency may be considered to have an offsetting hedging relationship with a variety of possible configurations of anticipated future foreign currency revenues or other foreign currency cash flow streams.

(c) Management may choose to designate a particular hedge for special hedge accounting, or may elect not to present and disclose it as a hedge.

(d) It is very difficult to define in a clear and operational way what constitutes an effective hedge. For example, many contend that for a hedge to be effective (that is, for it to mitigate a future price risk), the future risk must not be expected to already be reduced by some other existing or likely future offsetting risk exposure. This assessment of net risk exposure would be made on a total enterprise basis. However, standard setters have concluded that it is not practicable to make a total enterprise risk assessment a qualifying condition, because it can not be objectively assessed given the range and complexity of possible future transactions affecting possible future risk exposures.

Income–adjusted approaches to hedge accounting for anticipated transactions

7.17 Recognising the indefensibility of deferring gains and losses on the balance sheet, accounting standards setters have looked for ways to accommodate demands for hedge accounting for future transactions by presenting gains and losses on hedging instruments outside the income statement. Various approaches have been considered. IAS 39 and FASB Statement 133 require that gains and losses on designated hedges of future transactions be initially classified in a special category of equity (IAS 39) and in "other comprehensive income" (FASB Statement 133). These gains and losses are then transferred to the income statement in the future period or periods in which the hedged items are recognised in the income statement. The objective of these standards has been to try to meet the demands for hedge accounting adjusted income statement results, while providing sufficient information to enable users to evaluate management's hedge accounting strategies and their effects, without compromising the balance sheet. Supporters of these standards argue that presentation of gains and losses on qualifying hedges of future transactions outside the income statement enables financial statement users to distinguish the results of these activities. Such reporting could be made fully transparent with disclosure of the objectives of the hedges, the amounts of gains and losses presented outside the income statement, and the effects of subsequent transfers to the income statement.

7.18 These approaches are open to concerns that they result in conceptually unsound representations of income. It is difficult to explain why accounting that is unacceptable for balance sheet purposes can be acceptable for income statement presentation, because the same conceptual and practical problems with hedge accounting outlined in earlier paragraphs also apply to income statement presentation. The JWG is concerned that deferring gains and losses on hedging instruments from recognition in the income statement complicates and confuses the fair value measure of income, because it mixes some anticipated gains and losses on expected future risk exposures with income resulting from actual financial instrument positions in the reporting period. Furthermore, any form of hedge accounting requires complex rules, which, for the reasons set out in paragraph 7.11, must be arbitrary to a significant degree to be operational. The JWG believes that the goals of understandability and transparency can be best accomplished by presenting relevant information about these hedging arrangements in notes to the financial statements without complicating income statement presentation.

7.19 Some contend that precluding hedge accounting income statement adjustments could undermine an enterprise's efforts to use financial instruments to mitigate risks expected to arise in future transactions, by presenting income statement results that are inconsistent with management's intentions and expectations. The JWG does not agree with this contention. It believes that the measurement of financial instruments at fair value, and the recognition of gains and losses in the income statement in the periods they arise, best represents what has actually happened, and does not misrepresent or detract from the economic purpose of these hedging activities. A financial instrument may be considered to serve its purpose as a hedge of a risk that is expected to arise as a result of a future transaction, if it helps to stabilise the value of the enterprise with respect to that risk in that transaction.

7.20 To illustrate, suppose that an enterprise anticipates selling 1,000 units of a commodity in one month's time. Assume that it is concerned that the price of the commodity may decrease between now and then and so acquires an option to sell 1,000 units of the commodity at the current price of 10 per unit for settlement net in cash at any time in the next month. Suppose that the price decreases to 9 per unit one week later. In this example the combined value of the option and the amount of the expected future revenues can be expected to be 10,000 whether or not there is a decline in the price of the commodity. Thus the acquisition of the option enables a stabilisation of the expected future value to the enterprise with respect to the effect of that price risk on that anticipated sale. This is demonstrated when the commodity price changed, because it resulted in a gain on the option of 1,000 and expectations that future revenues will decline by a commensurate amount. This expected stabilisation effect depends on management not changing its intention and on the expected sale taking place. Thus, it cannot be known whether the expected stabilisation effect is actually achieved until the future events take place, and it is not appropriate to recognise the anticipated effects of these future events until they take place. The enterprise's intention to continue to hold the option and its expectations for the future sale do not in any way affect the actual balance sheet and income statement results at the end of that week. What is known is that the option had a fair value of 1,000 and the enterprise experienced a 1,000 increase in the fair value of that financial instrument during that period.

Foreign Currency Hedges of the Net Investment in a Foreign Entity

7.21 Exchange differences arising on the translation of net investments in foreign entities from functional currencies to the reporting currency are required to be presented outside the income statement by most standards of accounting for foreign operations. It has been common for enterprises to designate financial instruments denominated in the foreign currency of a foreign entity as hedges of the "translation risk" on these net investments. Accounting standards and practice have sanctioned or required that gains and losses on these designated financial instruments also be presented outside the income statement.[42]

7.22 The Draft Standard makes no exception for gains and losses on these financial instruments; they are to be recognised in the income statement in the period in which they arise. The JWG believes that their presentation outside the income statement is not justified by the designation of the financial instruments as hedges in this case any more than in other hedging situations.

[42] See, for example, paragraph 19 of IAS 21, The Effects of Changes in Foreign Exchange Rates.

8. Disclosure

Objectives of the Disclosure Requirements

8.1 One of the JWG's fundamental principles underlying the Draft Standard is that financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies (see paragraphs 1.31-1.37).

8.2 A number of accounting standards and certain securities regulations presently require reasonably extensive narrative and numerical disclosures about financial instruments and certain financial risks. On the one hand, the Draft Standard brings forward those disclosures from existing standards that the JWG believes continue to be relevant to financial statements prepared on the basis of the Draft Standard recognition and fair value measurement principles.[43] A number of the disclosure requirements of existing standards are no longer necessary because they were instituted to help compensate for shortcomings in recognition and measurement practices. In particular, supplementary disclosures of the fair value of recognised and non-recognised financial instruments, of situations where carrying values exceed fair values of financial assets, of unrealised gains and losses presented outside the income statement on "held-for-sale" financial instruments, and descriptions of non-recognised financial instruments, are no longer necessary. In addition, it is expected that disclosure of accounting policies would be simplified, because they will not need to explain complex, mixed measurement accounting.

8.3 On the other hand, the Draft Standard puts in place some extensions to existing disclosure requirements to provide more comprehensive information about financial risks. The adoption of a consistent fair value measurement basis for financial instruments provides a foundation for disclosing additional information about the effects of financial risks and changes in market risk conditions.

8.4 The JWG believes that the Draft Standard's disclosure requirements should be evaluated as a package. They are intended to provide an integrated set of disclosures that complement and reinforce each other. The disclosures of the financial risks that are significant to an enterprise, and of the role of financial instruments in changing the risks the enterprise faces in its activities, and the disclosures of the enterprise's financial risk management objectives and policies, all provide context to enhance a user's ability to evaluate disclosures about the financial instruments held, financial risk positions, and income statement results.

[43] The disclosures in this Draft Standard would replace, for example, those presently contained in IAS 32, Financial Instruments: Disclosure and Presentation.

Significant Financial Risks

8.5 The JWG believes that a description of the financial risks that were significant to an enterprise during the reporting period provides a fundamental underpinning for an understanding of an enterprise's use of financial instruments. From information about the significant financial risks faced by an enterprise financial statement users can understand the significance of the enterprise's financial risk management objectives and polices and can assess whether the enterprise has generated returns that are acceptable for the level of risk.

8.6 Many existing accounting standards already call for general disclosure of financial risks.[44] However, most of these disclosures do not require a comprehensive description of an enterprise's significant financial risks. Furthermore, existing accounting standards do not define what is meant by "financial risk".

8.7 An enterprise's activities could be subject to many different risks that may be managed by financial instruments. For example, revenues from sales denominated in foreign currency would be affected by changes in foreign exchange rates and the value of commodity inventories might be affected by changes in commodity prices. However, this Draft Standard is concerned with accounting for financial instruments. Therefore, financial risk disclosure in accordance with this Draft Standard is required only to the extent that a financial instrument is subject to the risk or the enterprise manages the risk by using a financial instrument. Other risks related to non-financial items are not addressed.

8.8 Many believe that it is not sufficient to provide information about financial risks only. They advocate that to understand fully the risks that affect an enterprise, information is also needed about non-financial risks—particularly since, in many businesses, these risks are more significant than the financial risks. The JWG agrees that information about non-financial risks is important. However, it believes that it is beyond the scope of this Draft Standard to require disclosures about non-financial risks. However, the Draft Standard does require that sufficient information be provided about an enterprise's primary activities to provide context for evaluating financial risks and an enterprise's financial risk management objectives and policies.

Financial Risk Management Objectives and Policies

8.9 Disclosure of an enterprise's objectives and policies for using financial instruments to manage each of the significant financial risks that affect its activities provides a benchmark against which to assess performance during, and the position at the end of, the reporting period. The disclosures help users of financial statements to evaluate the implications of an enterprise's risk management objectives and policies for future expectations about financial

[44] See, for example, IAS 32, Financial Instruments: Disclosure and Presentation.

risk and return. They also enable users to assess the enterprise's effectiveness during the reporting period in using financial instruments to achieve a return that is commensurate with the risk taken.

8.10 Some existing accounting standards already require a description of financial risk management objectives and policies.[45] The JWG proposes a more comprehensive disclosure of objectives and policies in respect of existing risk positions as well as those relating to the use of financial instruments in managing risks associated with transactions expected to occur in future reporting periods. This includes placing this description within the context of the primary business and financial activities that give rise to these risks.

8.11 Significant changes in an enterprise's financial risk management objectives and policies could have major implications for a user's evaluation of future risk and return expectations. Therefore, it is important for financial statement users to know whether significant changes in risk management objectives and policies have been made during the reporting period or have been decided upon for future reporting periods. Paragraph 162 of the Draft Standard would require disclosure of such changes.[46]

8.12 The Draft Standard and Application Supplement do not provide extensive guidance about the precise nature and detail of the disclosures to be provided about financial risk management objectives and policies. The JWG believes that each enterprise will need to evaluate this for themselves, in relation to the extent and significance of its financial risks and its use of financial instruments. The JWG believes that these disclosures can be provided at a sufficiently general level to avoid concerns about releasing proprietary information about an enterprise's risk management strategies, while at the same time providing useful information to financial statement users. The JWG does not believe that the required disclosures should be overly onerous to prepare and present because they are based on an enterprise's established objectives and policies and, in many cases, are already required by existing standards. It is expected that experience with these disclosures over time will provide the basis for subsequent evaluation of their effectiveness and possibly enable future improvements in the standards and supporting material.

Terms and Conditions of Financial Instruments

8.13 The JWG believes that information about the terms and conditions of financial instruments is important for an understanding of an enterprise's financial risk position and objectives and policies for managing that position. The contractual terms and conditions of a financial

[45] For example, paragraph 43A of IAS 32, Financial Instruments: Disclosure and Presentation, was added in 1998 to require disclosure of financial risk management objectives and policies, including the enterprise's policy for hedging each major type of forecasted transaction for which hedge accounting is used.

[46] Decisions to change significantly risk management objectives or policies made in the period after the reporting date would be disclosed in accordance with standards for post-balance sheet events. See, for example, IAS 10, Events After the Balance Sheet Date.

instrument are an important factor affecting the amount, timing and certainty of future cash flows. Some believe that much of the information that is provided in accordance with this kind of disclosure requirement has little information value. However, requirements are presently in place in many jurisdictions to provide such information.[47] The JWG does not have evidence to support abandoning these disclosures and does not believe that they become any less relevant as a result of adoption of the recognition and measurement principles in the Draft Standard.

8.14 One aspect of existing disclosures that is no longer necessary is the requirement to separate such descriptions between those relating to recognised and those relating to unrecognised financial instruments. All such instruments would be recognised in accordance with this Draft Standard. Disclosure about the currency in which receipts or payments are required is also unnecessary since, when currency risk is significant, this information would be provided in accordance with the disclosures about currency risk (see paragraph 171(a)).

8.15 Some advocate that information about notional principal amounts of derivative instruments is unnecessary. They claim that, when all financial instruments are recognised and measured at fair value, such a disclosure conveys little useful information and could, therefore, be deleted from existing disclosures. They also claim that, since many derivative financial instruments can be cancelled by issuing offsetting instruments, the reported nominal amount actually increases while exposures are reduced. Supporters of this disclosure believe that it provides information about the volume of activity in financial instruments, as well as a useful benchmark against which to assess the potential significance of changes in risk conditions for changes in the fair value of derivative instruments. The JWG does not believe that the information is less relevant because of adoption of the Draft Standard. The Draft Standard, therefore, continues to require this disclosure.

8.16 One additional disclosure proposed by the JWG is to require information about any features of a financial instrument that significantly concentrate or leverage risk. This is a disclosure that has been called for by securities regulators. Not only is risk concentration or leverage prevalent in certain derivative instruments, but securitisation and similar transactions often leave the transferor with a residual interest that, while being small in fair value terms, bears most of the potential for gains and losses on the transferred assets. Disclosure of the relative riskiness of such interests is needed for users of the financial statements to understand the nature of the transactions entered into and of the assets and liabilities held.

8.17 The JWG also proposes that information about restrictions on an enterprise's ability to dispose of or use financial assets as a result of requirements outside the financial

[47] See, for example, paragraphs 47-51 of IAS 32, Financial Instruments: Disclosure and Presentation.

instrument contract is important. Such information provides users with information about the extent to which the enterprise's use of the instruments is limited.

Financial Risk Position at the Reporting Date

8.18 The objective of disclosures about an enterprise's financial risk position is to provide qualitative and quantitative information to assist financial statement users in assessing the extent of the significant financial risks that affect an enterprise at the reporting date.

Basic Interest Rate Risk

8.19 The proposed disclosure for basic interest rate risk presents information about fair values in a similar manner to that presently required in some accounting standards[48] for historical cost-based amounts. The proposed disclosure complements information that is to be provided about interest on a fair value basis, in accordance with the income statement presentation requirements of the Draft Standard.

8.20 The interest rate re-pricing information provides users of financial statements with information about the extent of the enterprise's exposure to future changes in interest rates. Those financial assets and financial liabilities that have interest rates fixed for longer periods of time are likely to be subject to more variability in their fair values as a result of future changes in interest rates.

8.21 In order to provide a complete picture of the enterprise's interest rate risk positions it is important that this disclosure includes derivative financial instruments that are subject to basic interest rate risk. Therefore, even though such instruments are excluded from the requirement to calculate fair value based interest revenue and expense on practicality grounds (see paragraphs 6.51-6.54), they are required to be included in this disclosure.

Currency Risk

8.22 Very little disclosure is typically required about currency risk by existing accounting standards. However, many financial instruments are subject to currency risk and it is not possible to fully understand other risk disclosures—particularly those relating to interest rate risk—without some information about related currency risks. Accordingly, the JWG would require that, when currency risk is significant, an enterprise should provide additional analysis of its interest rate risk exposures by principal currency. In order to keep this disclosure at a reasonable level for enterprises that undertake transactions in multiple currencies, the Draft Standard allows this additional analysis to be restricted to the main currencies in which the enterprise does business.

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[48] See, for example, paragraph 56 of IAS 32, Financial Instruments: Disclosure and Presentation.

8.23 In accordance with most foreign currency accounting standards,[49] gains and losses arising on translating financial assets and financial liabilities from the functional currency of certain foreign operations into the reporting currency of the reporting enterprises are presented outside the income statement. Accordingly, the analysis of fair value by the main currencies of denomination, required by sub-paragraph 171(a), separately identifies financial assets and financial liabilities of foreign entities, so that a financial statement user can understand the extent to which changes in currency positions are likely to result in income statement effects or equity effects.

8.24 The Application Supplement suggests that it could be useful to supplement information about interest rate and currency risk with an analysis of the fair value of financial assets and financial liabilities according to the time periods in which cash flows are contracted to occur, in order to portray any significant timing mis-matches in net cash flows. While often useful, the JWG was not convinced that the benefits of providing this information would exceed the costs in all cases.

Credit Risk

8.25 Disclosures about credit risk have, to date, tended to focus both on maximum credit risk exposure and significant concentrations of credit risk.[50] However, since the maximum credit risk exposure is, to a considerable extent, captured by the fair value of financial instruments reported on the balance sheet, the JWG has refocused the credit risk disclosures on those instances where the fair value differs from the maximum exposure and on significant concentrations of credit risk and arrangements entered into to manage those risks.

8.26 Users of financial statements have indicated that they need to understand the maximum credit exposure in the event that other parties fail to perform their obligations—including failing to deliver collateral. Accordingly, the JWG believes that disclosure of the maximum credit risk exposure arising as a result of financial guarantees written or of failure to recover the value of collateral held in the event that other parties fail to perform their obligations, is necessary for all such financial instruments, and separately for significant concentrations.

8.27 The JWG considered whether the fair value of financial instruments should also be disclosed by category of credit quality. However, it believes that it would be difficult to require such information in a consistent manner without specifying the credit rating categories that should be used (which is not required for measurement purposes—see paragraph 4.39). The JWG believes that, without further development of a consistent basis

[49] See, for example, IAS 21, The Effects of Changes in Foreign Exchange Rates.
[50] See, for example, paragraph 66 of IAS 32, Financial Instruments: Disclosure and Presentation.

for disclosure, the benefits of such information would not outweigh the costs of preparation.

Other Significant Financial Risks

8.28 Rather than specify detailed disclosures for each additional type of significant financial risk, which would go beyond that required by any existing accounting standards, the Draft Standard would require a general disclosure of quantitative information about the extent to which an enterprise is affected by other significant financial risks at the reporting date. Depending on the significance of the risk, the Application Supplement provides some examples of the manner in which such disclosures might be provided. However, other significant financial risks could take many different forms and the best manner in which to disclose such information has not been the subject of sufficient accounting study or experience to prescribe specific requirements. Best practices for such disclosures are likely to evolve with experimentation and the JWG does not believe that it should specify precise disclosures for such risks at this time, although it encourages further work to develop these disclosures in the future.

Financial Risk Position at the Reporting Date Compared with that During the Reporting Period

8.29 With the ready availability of financial instruments in today's markets, the financial risk profile of an enterprise can change significantly over a short period of time. Users of financial statements need information about the risk profile during the reporting period, from which the enterprise has generated returns. The Draft Standard would meet that need by requiring information to help them understand whether the risk profile at the reporting date is representative of that throughout the reporting period. The JWG considered requiring disclosure of maximum, minimum and average positions during the reporting period, as is encouraged or required by some existing accounting standards.[51] However, information of that kind is currently captured by only a few enterprises. For many other enterprises, significant time and costs might be needed to calculate and maintain the information. Furthermore, average values can vary considerably depending upon the intervals used for calculation of averages. As the interval becomes narrower the average becomes more precise, but the cost of calculation also increases. The JWG, therefore, decided to propose a more general requirement for information about the amount by which risk positions during the reporting period vary from the position at the end of the reporting period, while noting that such information might be provided by disclosing highest and lowest, or average, positions.

[51] See, for example, sub-paragraph 94(c) of IAS 32, Financial Instruments: Disclosure and Presentation.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

8.30 Financial statement users widely believe that, in order to fully understand financial risk exposures, it is not only necessary to report the fair value of financial instruments, but it is also essential to provide information about the extent to which fair value could change as a result of changes in the underlying risk conditions.

8.31 A number of methods of providing such information are used presently, including sensitivity analysis and value-at-risk—particularly in the financial services industry. However, these measures are subject to a number of drawbacks. For example, sensitivity analysis shows the effect only of the enterprise's chosen changes in market prices, focuses only on a single risk and takes no account of the likelihood of a particular change occurring. Similarly, value-at-risk methodologies are continuing to evolve and are criticised by some because the calculation is complex and different results can be obtained depending on the assumptions used. While many enterprises are interested in value-at-risk as a way of monitoring and managing risk, there is presently little consensus on a single methodology for performing the calculations. Finally, some believe that while value-at-risk is a good way of measuring the market risk of instruments that are held for trading, it is less appropriate for an enterprise's other financial instruments.

8.32 Some believe that it could be useful to require enterprises to make disclosures about the potential effects of changes in risk conditions on financial position, in spite of the lack of standardised models or assumptions. They believe that inter-period comparability of such disclosures, consistently applied within an enterprise, has information value even if comparability between enterprises is not possible. However, others note that as techniques develop enterprises would probably enhance them considerably, impairing even inter-period comparability.

8.33 The JWG concurs that such information is important. However, most commentators would agree that existing methods have shortcomings. In addition, techniques in this area are continuing to evolve and the JWG believes that it is still too early in the development of risk management technologies to attempt to specify a single disclosure approach or to require standardised models or assumptions. To do so might inhibit the development and implementation of superior methodologies. For these reasons disclosure of sensitivity to changes in market risk is encouraged, rather than required.

8.34 The JWG considered requiring enterprises that already use such risk measures to disclose information about the measures that they use. However, the JWG was concerned that such an approach might be seen to penalise those that are at the leading edge of such developments and might inhibit others from experimenting in this regard.

8.35 The JWG also considered whether an enterprise that changes the methodology, parameters or assumptions used in calculating a disclosed risk measure should restate the risk measure for the comparative prior period. The JWG concluded that such disclosure would be unduly onerous—particularly since the JWG is seeking to encourage voluntary reporting of risk measures.

Financial Instruments Used to Manage Risks Associated with Transactions Expected to Occur in Future Reporting Periods

8.36 The JWG believes that many enterprises that have established objectives and policies for using financial instruments to manage risks associated with transactions expected to occur in future reporting periods will wish to disclose information about the effects of those policies on the enterprise's financial position and performance. Some believe that, in order to provide adequate information for financial statement users to understand the effects of such objectives and polices, an enterprise should be required to provide certain information about the financial instruments and future transactions to which that policy applies whenever it has such a policy. However, others believe that it is inconsistent to require disclosure of information about financial instruments that are used to manage future risks when the Draft Standard prohibits hedge accounting for the financial instruments involved in such a relationship.

8.37 The JWG believes that when an enterprise chooses to separately identify the amounts of gains and losses in the reporting period on financial instruments identified as entered into to manage risks associated with transactions expected to occur in future reporting periods, users need sufficient additional information to understand the context of those gains and losses. The JWG, therefore, would require certain disclosures in such circumstances.

8.38 In developing these disclosures, the JWG has attempted to balance the need for a reasonable level of accountability with the desire to keep disclosure requirements as straightforward as possible. The JWG believes that the basic information that would be required by paragraph 181 should not be onerous for an enterprise. An enterprise should be expected to have this information available for internal management purposes because it simply reflects the implementation of management's policy for using financial instruments to manage future risks. The JWG also believes that the disclosures are sufficiently general to minimise any concern that they could result in releasing commercially sensitive information.

8.39 The JWG also considered whether the Draft Standard should contain provisions to help ensure that such disclosures are provided in a consistent manner from period to period. It considered whether, if an enterprise makes such disclosures, it should be required to provide information about all similar risk management relationships and continue to provide that information unless the enterprise changes its financial risk management objectives and policies, in which case such a change in policy would be disclosed in accordance with paragraph 162. However, the JWG concluded that this would be too onerous and that it is sufficient to require disclosure only until the future transactions related to the identified hedging instrument occur or are no longer anticipated to occur.

8.40 Some believe that an enterprise should be required to provide certain minimum information about financial instruments used to manage risks associated with future transactions whenever it has a disclosed risk management objective and policy related to such risk management. They disagree that such a disclosure requirement would be inconsistent with the prohibition of hedge accounting for financial instruments. They believe that these are two distinctly different matters. Hedge accounting for financial instruments is precluded for the reasons set out in section 7 of this Basis for Conclusions. However, this does not mean that the use of financial instruments to help manage future risks is not a justifiable activity or that users do not need information about these activities. They believe that users should be provided with complete and consistent information about all of an enterprise's uses of financial instruments to manage risks associated with future transactions, so that they can fully understand its disclosed policies and the effect that they have had on its financial position and performance. Further, those who favour this broader disclosure requirement are concerned that an approach based on whether an enterprise elects to disclose gains and losses on certain financial instruments that were intended to manage risks associated with future transactions could be applied in an incomplete and inconsistent manner from period to period.

8.41 The JWG considered whether to require an enterprise to disclose information about whether financial instruments identified in prior periods as being used to hedge risks associated with future transactions were effective in managing future risk positions. However, the JWG was not convinced that the benefits of such disclosure would always outweigh the costs of preparation.

8.42 The JWG does not believe that there is any need to prescribe rules for when a financial instrument may be considered by the enterprise to manage future risks, or for what may constitute an effective risk management strategy. Rather, it believes that the disclosures required when an enterprise separately identifies gains and losses provide information to help users to make these evaluations for themselves. In addition, since there is no hedge accounting for financial instruments, the effects of these risk management practices do not affect financial instrument balance sheet positions or reported financial performance results.

8.43 The JWG believes that enterprises should assess, depending on their individual circumstances, the significance to users of making additional disclosures. The JWG believes that, in some cases, additional information could be useful, but it is not convinced that the benefits from additional disclosure would, in all cases, justify the preparation costs. Accordingly, paragraph 182 of the Draft Standard only encourages such additional disclosures.

Accounting Policies

8.44 The Draft Standard does not explicitly address disclosure of accounting policies. These would be disclosed in accordance with other accounting standards.[52] The disclosure of accounting policies would be expected to be less complex than the disclosures necessary in accordance with existing accounting standards. This is because the proposed recognition and measurement principles would result in more uniform and consistent accounting than current practices involving a mix of methods. The policy disclosures based on existing mixed measurement accounting standards would be replaced by policies that focus on the methods used to determine fair value.

Methods Used to Estimate Fair Value

8.45 Policies and assumptions used in estimating the fair value of financial assets and financial liabilities are critical to the balance sheet measurement and resulting gains and losses under the Draft Standard. The proposed disclosures focus on the methodology for estimating fair values in order to give users of financial statements an indication as to which measurements are based on the usually more reliable measures of fair value (observable market exit prices) and which are based on valuation techniques.

8.46 When valuation techniques are used, fair values would often be sensitive to key assumptions. In some instances, a choice might exist between equally valid assumptions to determine the fair value of a particular instrument. In such circumstances, the JWG believes that users need to understand which assumption has been chosen and what the effect would have been if an alternative assumption had been adopted. It believes that the importance of this information outweighs any concern that such information is not presently required in most accounting standards for other financial statement items that might be subject to similar measurement uncertainties.

8.47 In order to aid financial statement users' understanding of the effects of changes in an enterprise's own credit risk on the fair value of its own financial liabilities the Draft Standard would require disclosure of the events that the enterprise has taken into account.

8.48 Paragraph 102 of the Draft Standard precludes an enterprise from adjusting observable market exit prices for the potential effect of selling a different quantity of the financial instrument from that for which a market exit price is observable. The primary reason for this preclusion is that market information necessary to estimate any adjustment is not likely to be available (see paragraphs 4.34 and 4.35). The JWG believes that, in such circumstances, the fact that a large block of financial assets might not be capable of immediate realisation at its recorded fair value should be disclosed. This disclosure allows users of financial information to understand the fact that there could be some variability in

[52] See, for example, IAS 1, Presentation of Financial Statements.

the measurement amount from that recorded, even though the precise amount of the variability cannot be quantified with sufficient reliability for accounting measurement.

8.49 If an enterprise determines that it is not practicable to make a reliable fair value estimate of an investment in a private equity instrument, paragraph 122 of the Draft Standard permits those financial assets to continue to be carried at their previous carrying amounts. The JWG believes that in such circumstances, financial statement users need to know that the measurement basis for such financial assets differs from that for other financial instruments. If a reliable measurement subsequently becomes available, or the financial asset is sold, disclosure would be required of the adjustment to the carrying amount of the instrument to put it back on a comparable basis with other financial instruments, since that adjustment would occur entirely in the period of sale or re-measurement, rather than in the period(s) in which economic events affected the fair value of the financial asset.

8.50 The JWG concluded that some of the existing disclosures for such items, like information about the reasons why fair value could not be determined, and the principal characteristics of the instrument pertinent to its fair value, provide little information of relevance to enable users to estimate future cash flows. It, therefore, decided not to require such disclosures.

Derecognition Disclosures

Sale and Repurchase Transactions and Stock Lending Transactions

8.51 A transferor might transfer a financial asset to a transferee that has the practical ability (which can be exercised unilaterally and without attaching additional restrictive components) to further transfer the entire asset to a third party. However, the transferor might simultaneously enter into an agreement with the transferee that ensures that the transferor is both entitled and obligated to receive the transferred asset back, in exchange for a sum that reflects the original transfer price plus what amounts to interest on the cash paid at that time by the transferee. (Many sale and repurchase transactions and stock (or securities) lending transactions meet this description.) The "repurchase agreement" means that, although the transferor will derecognise the asset in accordance with the Draft Standard, it will continue to have much the same exposure to the asset as it did prior to the transfer. In such circumstances, the JWG believes that, to help users understand the nature of the transaction and the relationships between the assets involved, it is useful to provide information about the assets recognised and derecognised as a result of the transaction.

Retained Interests in Transferred Assets

8.52 The unbundling and rebundling of contractual rights and contractual obligations arising from financial instruments that now takes place means that users cannot make traditional assumptions about the amount and type of risk inherent in certain balance sheet items. For example, in some securitisations the originator may derecognise a portfolio of receivables and recognise instead a residual interest that has a greater risk of variability in value than the portfolio of receivables. To help users understand the amount and type of risk inherent in such items separately from the enterprise's overall financial risk profile, the Draft Standard would require disclosures about such assets and the risks underlying them.

Location of Disclosures

8.53 The JWG considered whether some of the disclosures might be provided in management discussion and analysis or similar documents that accompany the financial statements, rather than in the notes to the financial statements. The JWG believes that each of the proposed disclosures is necessary for full and fair presentation, as opposed to being supplemental. Furthermore, not all enterprises are required to provide additional management discussion and analysis. Therefore, if the Draft Standard allowed such disclosures to be provided outside the financial statements valuable information could be omitted from many financial reports. Accordingly, the JWG believes that all of the proposed disclosures should be provided within the financial statements.

Historical-cost-based Disclosures

8.54 The JWG considered whether certain disclosures of a historical cost nature should be required in order to provide users with familiar information—perhaps for a transitional period. The JWG concluded that some information of this nature would be determinable from disclosures of terms and conditions of financial instruments and that to require additional information that is not consistent with the recognition, fair value measurement and presentation model imposes an unnecessary burden on preparers of financial statements. Any enterprise that wishes to provide such additional information is, of course, not precluded from doing so.

8.55 Some enterprises might wish to separately disclose realised and unrealised gains and losses, particularly when they have some significance for purposes such as determining distributable income or taxable income. However, since such information is not relevant to the fair value measurement model on which this Draft Standard is based, the JWG does not believe that such disclosures should be required of all enterprises—rather that they should be optional.

Specific Industry Disclosures

8.56 The JWG believes that the disclosures in this Draft Standard are appropriate for all enterprises. It has not considered whether additional disclosures might be useful in certain industries to explain the specific nature of that industry's use of financial instruments. Some standard setters have additional disclosure requirements for certain industries.[53]

[53] For example, additional requirements for disclosures of financial instruments are contained in IAS 30, Disclosures in the Financial Statements of Banks and Other Financial Institutions.

9. Effective Date and Transition

Effective Date

9.1 The choice of an effective date will involve consideration of the current need for improved recognition and measurement standards and the extent of preparation necessary for enterprises to be in a position to adopt the standard. The JWG believes that enterprises may need up to two years from the date of issuance of a standard to make the necessary changes to their accounting and reporting systems and to identify any implementation problems in sufficient time to ensure that they can be satisfactorily addressed and resolved. The JWG believes that a delay of more than about two years would be undesirable, given the need for comprehensive recognition and measurement standards on financial instruments.

9.2 The Joint Working Group believes that early adoption should be encouraged. This would enable those that wish to apply the standard to do so, and also provide an opportunity for those that do not choose early adoption to learn from the experiences of those that do. Since the requirements of the Draft Standard are, in many cases, interdependent, the JWG does not believe that an enterprise should be permitted to adopt parts of the Draft Standard at differing times. However, for those parts of the Draft Standard that are not interdependent, the JWG believes that enterprises should be permitted to adopt these parts early, as long as they do not contravene accounting standards existing at the date of adoption. For example, many of the disclosure requirements are in accordance with existing accounting standards and might be adopted early.

9.3 Further, the Joint Working Group believes that the standard should be adopted only at the beginning of a financial year. To adopt the standard at a date within a financial year would result in inconsistent principles being applied within one fiscal period.

9.4 Some do not believe that the need for new accounting standards for financial instruments is as urgent for smaller or non-public enterprises as it is for public enterprises. They recommend that, as a minimum, implementation by smaller or non-public enterprises should be deferred to enable a period for education and an opportunity to benefit from the experience of more sophisticated public enterprises. The JWG believes that about two years is sufficient time for all enterprises to implement the Draft Standard and does not believe that the need for a standard based on this Draft Standard is any less urgent for these enterprises than it is for the biggest, most sophisticated enterprises. The JWG, therefore, believes that differential implementation dates are unnecessary. The JWG also notes that, if differential implementation dates were to be adopted, then a definition of what constitutes smaller or non-public enterprises would be necessary. It believes that this is an issue best left for individual jurisdictions to consider (see also paragraphs 2.10 to 2.12).

Supplemental Financial Statements

9.5 The JWG considered whether to require preparation of comprehensive, supplemental, fair value financial statements for a period—say, a year or two—in parallel with financial statements prepared in accordance with existing practices. Under such an approach, the supplemental financial statements would replace the existing financial statements after the transitional period. The advantages of such an approach include:

(a) a period of time to gather information and resolve issues;

(b) opportunities for further evaluation and field tests, with the subsequent ability to improve the Draft Standard and supporting material in light of this experience;

(c) time for preparers and users to become familiar with the information provided; and

(d) when the time comes to replace the primary financial statements prepared in accordance with existing practices, comparative information will be available.

9.6 On the other hand, such an approach has a number of disadvantages, including:

(a) the need to maintain existing standards and practices;

(b) the cost of preparing two sets of financial statements; and

(c) potential confusion as to which are the "real" numbers.

9.7 The JWG has not attempted to reach a conclusion as to whether supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices. However, the JWG believes that it is important, whether supplemental or primary financial statements are prepared, that they are complete and rigorously apply the requirements of the Draft Standard.

Transition

Transition—Overall Approach

9.8 The JWG has provided general standards only for the most common situations that will arise on transition, since existing accounting standards and statutory requirements for recognition and measurement of financial instruments vary considerably by jurisdiction. As a result, individual jurisdictions may have to develop more specific principles to deal with transition in the context of their particular situations.

9.9 The Joint Working Group believes that standard setting bodies should implement the Draft Standard comprehensively rather than in a piecemeal manner. A major benefit of the Draft Standard is that it reflects a consistent set of requirements, based on a coherent framework. This benefit would be eroded by piecemeal implementation resulting in an inconsistent mix of recognition and measurement requirements. The experience of leading standard setters in developing piecemeal approaches also indicates that they result in significantly greater complexity and costs for both preparers and users.

9.10 If a jurisdiction were to decide that it wished to adopt only parts of the Draft Standard, then additional considerations would have to be taken into account by that jurisdiction. These would include defining the parts that should be implemented and considering the need for additional requirements to address the consequences of omitting any parts of the Draft Standard.

Transition—Valuation Adjustments

9.11 When the Draft Standard is first applied many financial instruments will be measured at fair value for the first time. A one-time adjustment will be necessary to restate the value of these financial instruments. The JWG believes that the simplest and clearest presentation of gains and losses arising from that adjustment is to adjust the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied.

9.12 Enterprises that already record certain items at fair value may need to change their accounting policies to reflect the fair value measurement principles required by the Draft Standard. The JWG believes that such changes in the measurement of fair value arising from implementation of this Draft Standard are little different from the adjustments that would arise on measuring items, previously carried at cost, at fair value for the first time in accordance with this Draft Standard. Therefore, for purposes of implementing this Draft Standard all such transitional valuation adjustments are treated as an adjustment to the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied.

Transition—Unwinding Existing Hedge Accounting

9.13 Existing hedge accounting practices generally involve one of four approaches:

(a) deferral of gains and losses on hedging instruments on the balance sheet;

(b) deferral of gains and losses on hedging instruments in equity or in a performance statement separate from the income statement;

(c) deferral of gains and losses on hedging instruments as basis adjustments of the hedged item; or

(d) deferral of gains and losses by maintaining the hedging instrument at cost.

Implementation of this Draft Standard would no longer permit any approach that modifies the accounting for financial instruments.

9.14 Three possible approaches might be considered to unwinding such accounting.

(a) Accept prior accounting for all previous transactions and apply the new standard only to transactions occurring after the effective date. This would require no opening adjustments to reverse deferred gains and losses on hedging instruments.

(b) Adjust opening retained earnings for any gains and losses not recognised in the income statement under previous accounting. This would require identification of those gains and losses that relate to hedges that have not unwound at the beginning of the period in which the Draft Standard is adopted.

(c) Adopt an approach somewhere between (a) and (b), above.

9.15 The JWG does not believe that the approach described in paragraph 9.14(a) is appropriate. This is primarily because it would involve retaining the effects of past hedge accounting practices for what could be a prolonged period, in parallel with the accounting in accordance with the Draft Standard, thus detracting from comparability and understandability of the financial statements. On the other hand, the JWG believes that adjusting the carrying amount of hedged items to eliminate the deferred gains and losses referred to in paragraph 9.13(c) would often be burdensome. It is also possible that records would not have been maintained to separately track the amounts that would need to be adjusted. The JWG, therefore, proposes to require adjustments to opening retained earnings for any gains and losses of the types referred to in paragraphs 9.13(a), 9.13(b) and 9.13(d). Gains and losses of the type referred to in paragraph 9.13(c) would not be adjusted. Although this approach retains some balance sheet items carried at amounts inconsistent with those that would be required under this Draft Standard, the JWG believes that this approach represents a practical compromise, the effects of which will become insignificant over time.

Transition—Gains and Losses Previously Recorded Directly in Equity

9.16 In addition to gains and losses from hedge accounting, certain gains and losses on financial instruments from periods prior to adoption of a new standard might have been presented directly in equity or in a performance statement separate from the income statement—for example those arising on “available-for-sale” assets under IAS 39. The JWG believes that these gains and losses should be transferred as an adjustment to the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied. This is the simplest and clearest approach, and also avoids future adjustments to the income statement for the effects of past accounting.

Transition—Derecognition

9.17 Ideally, assets and liabilities that would not be derecognised under the Draft Standard should be reinstated on adoption of the Draft Standard. However, the JWG believes that it is likely to be unduly onerous to expect enterprises to change the accounting for derecognition transactions that occurred prior to the effective date of the Draft Standard. Accordingly, if a transaction undertaken prior to the beginning of the financial year in which the Draft Standard is initially applied resulted in derecognition of transferred assets, the JWG believes that the accounting for that transaction should not be changed to conform to the requirements of the Draft Standard. However, the JWG believes that any financial instruments resulting from the previous accounting for derecognition transactions should be identified and recognised and measured at their fair value on initial adoption of this Draft Standard, either separately or as part of a financial asset or financial liability incorporating other rights or obligations.

9.18 To enable users to understand what might be "missing" from the financial statements, the Draft Standard would require a general description of the financial assets or financial liabilities that have been derecognised that would not have been derecognised under the Draft Standard. The JWG considered also requiring disclosure of the unrecognised fair value at the end of each reporting period, but concluded that in many cases it would be unduly onerous to determine this amount for assets and liabilities that had been transferred.

Transition—Hybrid contracts

9.19 An enterprise might have to separate the financial and non-financial sets of rights and obligations in a hybrid contract on application of the Draft Standard that had not been previously separated. Two possible methods might be considered for doing that:

(a) determine values based on the fair values of the rights and obligations at the date of initial application of the Draft Standard; or

(b) determine values based on the fair values of the rights and obligations at the date of initial acquisition or issuance of the hybrid contract.

9.20 The first alternative is clearly the simplest. It might not always produce perfect results (since the non-financial sets of rights and obligations might be allocated a value different from that which they would have been allocated at the date the hybrid contract was acquired or issued). However, for practical purposes, the Joint Working Group proposes that this is the alternative that should be adopted.

Transition—Restatement of Prior Period Financial Statements

9.21 The JWG proposes that prior period financial statements should not be restated on initial adoption of the proposals in a standard. To restate prior period financial statements to unwind the effects of basis adjustments to hedged items not measured at fair value and prior derecognition transactions often would be unduly onerous, and in many cases would be impractical. To only partially restate prior period financial statements would be to provide comparative information that is neither on the basis of accounting in this Draft Standard, nor that used previously.

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APPENDIX A

Dissenting Views

A.1 Members of two delegations of the JWG dissent to the document as a whole. However, both of those delegations support publication of the document. They believe that the document represents an important contribution to the debate on a comprehensive standard on accounting for financial instruments, and that it provides a basis for further discussions with constituents. Furthermore, they believe that the comment process is important to promoting a better understanding of the issues and constituent views.

Dissenting Views of the French Delegation

A.2 The members of the French delegation dissent because they believe fair value is not relevant for measuring all business activities and transactions. While accepting the objectives and terms of reference of the JWG, the dissenting delegation concluded, based on the work of the JWG, that fair value is not relevant for certain business transactions and activities that are not managed or subject to performance measurement based on fair values. This specifically applies to financial instruments in the banking book of banks, including demand deposits and other financial instruments used in asset and liability management (ALM). [This issue is analysed in paragraphs 1.6-1.13 of the Basis for Conclusions, especially 1.10-1.11.] The issues related to the application of fair value principles to the business activities of banks are discussed in the Joint Working Group of Banking Association's paper of October 1999 (referred to in paragraph 2.3 of the Basis for Conclusions).

A.3 Other circumstances, business activities, or transactions for which the delegation believes fair value is not relevant include those in the following paragraphs (the sequence of individual points follows the structure of the Draft Standard and does not represent a sequence by priority).

Certain Financial Instruments for which there are No Liquid Markets

A.4 Based on research carried out by the JWG, the delegation believes the lack of reliability of fair value measurement and valuation techniques for financial instruments for which there are no observable market prices, and for certain quoted financial instruments traded on illiquid markets, is such that it compromises the accuracy, reliability and comparability between enterprises and the consistency between periods for the same enterprise. This outweighs any benefit that might be derived from a fair value basis of accounting for these instruments. Comparability is a very important qualitative characteristic of financial statements and, based on the JWG research and on past experience, it is the delegation's view that the guidelines provided cannot be sufficient to overcome this issue and achieve comparable results. [Considerations relating to reliability generally are discussed in paragraphs 1.14-1.21 of the Basis for Conclusions. See also discussions in the Draft Standard, Application Supplement and Basis for Conclusions about the use of market prices for similar instruments and the use of valuation techniques in circumstances where quoted market prices may be infrequently available or not determined by normal market interactions.]

Debt Financing Non-financial Assets Carried at Cost

A.5 The delegation believes such debt should not be measured on a fair value basis with the change in fair value recognised in the income statement as this is inconsistent with the measurement and accounting for the non-financial assets, which continue to be on a cost-based accounting basis. The same comments as those on mis-matches in respect of hedging of future transactions (see paragraph A.9 below) apply to this situation. [This issue is analysed in paragraphs 4.49 and 6.15-6.16 of the Basis for Conclusions.]

Application of the Fair Value Model to Own Credit Risk in respect of an Enterprise's Financial Liabilities

A.6 The delegation points out that effects of changes in own credit risk of the reporting enterprise reflect changes in its internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. Therefore, they see a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's financial liabilities, while not reporting potential offsetting changes in unrecognised goodwill. Furthermore, taking into account an enterprise's own credit risk, which reflects the possibility of an insolvency, might contradict the general presumption that the enterprise will continue as a going concern. [This issue is analysed in paragraphs 4.56-4.58 of the Basis for Conclusions.]

Fair Value Interest

A.7 The delegation believes that fair value interest does not provide useful or relevant information to users or for management purposes, as fair value interest has no relationship with contractual cash flows. The delegation believes that interest on interest-bearing financial instruments measured at fair value should continue to be determined on the historical cost "effective interest" basis. They point out that this basis is familiar to users and that this method has important information value because it reflects the contracted interest rate inherent in an interest-bearing financial instrument. They do not see a convincing demonstration of the practicability of calculating fair value interest nor of the feasibility of reconciling fair value interest with historical cost-based interest or cash flows. Further, they do not believe that fair value interest has a better predictive value compared to historical cost-based interest. [This issue is analysed in paragraphs 6.58-6.76 of the Basis for Conclusions.]

Hedging of Future Transactions

A.8 An important aspect of many enterprises' risk management activities relates to the variability of expected cash flows related to anticipated future transactions. Enterprises commonly use financial instruments to offset that variability. It is the delegation's view that not deferring gains and losses due to changes in fair value of the financial instrument used as the hedging instrument, or not using an alternative method of accounting that reflects management's intentions in using financial instruments to mitigate anticipated future risks, results in an inconsistency in reporting the effects of changes in the fair value of the hedging instrument and the counter balancing changes in the value of the anticipated future transaction. The delegation recognises the practical problems in implementing such hedge accounting, but believes that its benefits, in portraying management's decisions and in allowing a proper matching of gains and losses, outweigh the practical problems and the mis-match that will result from the JWG proposal. [This issue is analysed in paragraphs 7.10-7.20 of the Basis for Conclusions.]

A.9 Also, the JWG concluded that a commitment to acquire a non-financial item at a fixed price in a foreign currency is a non-financial contract. Further, it concluded that it would not be appropriate to extend the scope of the Draft Standard to treat such a commitment as if it were, or as if it contained, a foreign currency denominated financial instrument. Although the delegation recognises that the objective of the JWG was not primarily directed to non-financial items, the mis-match problem should have been addressed and resolved by the JWG. [This issue is analysed in paragraphs 2.58-2.62 and 7.15 of the Basis for Conclusions.] In this context, the delegation refers to the fact that the JWG has accepted a similar exception from the basic requirements of the Draft Standard in that the effects of foreign currency translation do not have to be reflected in the income statement as long as the standards for foreign currency translation have not been revised. They believe that, without a resolution of this mis-match problem financial accounting will be even further removed from reflecting the economics of sound risk management.

Concluding Comment

A.10 It is the member's belief that implementation of a full fair value model which does not recognise specific business activities or transactions where a fair value basis of accounting is not relevant may have broad macro economic and financial stability implications on certain markets, which are not understood.

Dissenting Views of the German Delegation

A.11 The members of the German delegation support the basic premise that fair value measurement of financial instruments has major conceptual advantages since it provides to the users of financial statements a more faithful representation of the amounts, timing and probabilities of future cash flows. However, in the view of the members of that delegation, this Draft Standard does not meet the objective set for the JWG, which was to make operational the fair value framework outlined in the March 1997 IASC Discussion Paper, Accounting for Financial Assets and Financial Liabilities. Some significant implementation questions are not addressed in sufficient detail in the Draft Standard, and it leaves too many questions to be resolved by individual financial statement issuers and their auditors. Also, in their view some major conceptual issues have not been properly analysed by the JWG. The German delegation believes that before the requirements in the Draft Standard could be implemented on a reasonable and consistent basis, those conceptual issues must be reconsidered and additional guidance on implementation issues must be provided.

A.12 The major specific reasons for the German delegation's dissent from the Draft Standard are outlined in the following paragraphs (the sequence of individual points follows the structure of the Draft Standard and does not represent a sequence by priority).

Scope

A.13 The delegation emphasises—according to the JWG's definition of financial instruments—the need for a strict distinction between financial instruments and non-financial assets and liabilities. The distinctive feature of financial instruments is that they are not exposed to operational risks of the reporting enterprise. Accordingly it is their belief that paragraphs 2, 3, 5 and 76 of the Draft Standard inappropriately extend its scope to servicing assets and liabilities and to non-financial portions of certain contracts, which the JWG acknowledges are not financial instruments according to its own definition. [These issues are analysed in paragraphs 2.16-2.19 and 2.37-2.52 of the Basis for Conclusions.]

Derecognition

A.14 Paragraphs 64-65 provide that, in certain situations, a transferor of financial assets with an obligation to repay consideration received at the time of the transfer must recognise as a liability the maximum amount that might have to be repaid. The transferor also continues to recognise a corresponding portion of the assets that were transferred. In the view of the dissenting delegation this represents an exception to the components approach that the JWG has adopted for derecognition of financial instruments, solely to maintain the presentation of secured borrowings. This presentation and accounting respectively ignores the contractual agreements and results in the situation that the respective derivative financial instruments (for example, repayment options) are not recognised even though they clearly represent financial assets or liabilities. The JWG's justifications for this exception, in paragraphs 3.38-3.71 and 3.93-3.102, are not seen as compelling by the dissenting delegation, who feel that the Basis for Conclusions presents many good arguments in favour of the components approach.

A.15 Furthermore, in their view, the non-recognition of financial assets and financial liabilities in the case of specific sub-participations and similar transactions is not compatible with the general offsetting rules (see, for example, paragraph 33 of IAS 32). [This issue is analysed in paragraphs 3.36 and 3.37 of the Basis for Conclusions.]

Fair value measurement

A.16 The delegation advocates that, in all cases where bid and asked prices exist, fair value should principally be determined by using mid-point prices, since, in their view, they reflect the assessments of all market participants and not only the assessments of one side of the market (i.e., of those who sell for the purpose of measuring financial assets or of those who settle for the purpose of measuring financial liabilities). Furthermore, the application of mid-point prices would be more consistent with the decision of the JWG that transaction costs should not be included in the fair value measurement. [This issue is analysed in paragraph 4.17 of the Basis for Conclusions.]

Measurement of financial liabilities—Own credit risk

A.17 The delegation points out that effects of changes in own credit risk of the reporting enterprise reflect changes in its internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. Therefore, they see a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's financial liabilities, while not reporting potential offsetting changes in unrecognised goodwill. Furthermore, taking into account an enterprise's own credit risk, which reflects the possibility of an insolvency, might contradict the general presumption that the enterprise will continue as a going concern. [These issues are analysed in paragraphs 4.56-4.58 of the Basis for Conclusions.]

Reliability and feasibility of fair value measurement—Implementation Guidance

A.18 It is the delegation's view that it is the mandate and objective of the JWG to operationalise the full fair value model on the basis of the framework outlined in the March 1997 Discussion Paper. This includes the provision of appropriate and useful valuation guidance. In their view the Application Supplement includes only a very general description of how the fair values of non-traded financial instruments should be determined. Not only with regard to the practicability of fair value measurement, but also with regard to the comparability of financial statements, they doubt whether reporting enterprises should be able to choose between different types of valuation techniques and to determine without detailed guidance the appropriate inputs to the applied valuation models. They point out that comparability is a very important qualitative characteristic of financial statements and that, based on past experience, it would be doubtful whether the setting of general principles only is sufficient to achieve comparable results. [This issue is analysed in paragraphs 1.38-1.40 and throughout Section 4 of the Basis for Conclusions.]

Income presentation and cash flow statement

A.19 The delegation does not see a convincing demonstration of the practicability of calculating fair value interest. Further, they are not convinced that fair value interest has a better predictive value compared to historical cost-based interest. In their view, the results of the proposed field testing, as well as further discussions with users of financial statements, would be necessary to clarify the practicability as well as the relevance of this approach. [This issue is analysed in paragraphs 6.58-6.77 of the Basis for Conclusions.]

A.20 Further, the Draft Standard does not specify how payments on interest-bearing financial instruments should be presented in the statement of cash flows. The dissenting delegation believes that the Draft Standard should have addressed whether the payments should be divided between interest and principal and, if so, whether, for purposes of cash flow presentation, interest should be based on fair value, historical cost, or contractual payments. They point out that this lack of guidance is likely to result in inconsistent application by financial statement issuers. [This issue is analysed in paragraphs 6.85 and 6.86 of the Basis for Conclusions.]

"Mis-match problems" between financial instruments and other balance sheet items or transactions

A.21 Despite the basic differences between financial instruments and non-financial assets and liabilities, there are close relationships between the two. The delegation is of the opinion that in certain situations, those relationships might justify exceptions to the basic requirement that all changes in fair values of financial statements should be recognised immediately in income in order to avoid recognising in different periods gains and losses on closely related items. Some major examples are debt financing non-financial assets and hedges of non-financial assets/liabilities or firm commitments.

A.22 Taking into account its restricted objective to develop a comprehensive accounting standard for financial instruments, the JWG has concluded that the individual standard setters should consider whether it would be necessary to resolve mis-match problems by modifications of the accounting standards for non-financial assets and liabilities. However, the delegation believes that, although it is recognised that the objective of the JWG was not primarily directed to non-financial items, the apparent mis-match problems should have been addressed and resolved by the JWG. In this context the delegation notes that the JWG has accepted a similar exception from the basic requirements of the Draft Standard in that the effects of foreign currency translation do not have to be reflected in the income statement as long as the standards for foreign currency translation have not been revised.

A.23 They believe that, without a resolution of the mis-match problem, financial accounting will be even further removed from reflecting the economics of sound risk management. [This issue is analysed in paragraphs 4.49, 6.15 and 6.16 and Section 7 of the Basis for Conclusions.]

APPENDIX B

Consequential Amendments

B.1 This appendix identifies the main areas where amendments would be necessary to existing accounting standards as a result of adopting the JWG Draft Standard. Specific amendments will differ by jurisdiction. The objective of this appendix is to highlight only the general nature of the main amendments that are likely to affect most jurisdictions.

Presentation of Financial Statements

B.2 The proposals in the Draft Standard for balance sheet and income statement presentation would necessitate consequential changes to existing requirements for presentation of items on the face of the financial statements.[54]

Leases

B.3 Lease accounting standards for finance leases typically require historical cost accounting for the lease receivable by the lessor and lease payable by the lessee. Under this accounting, lease income and lease payments are required to be apportioned between principal and interest, with the finance charge allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance for each period.[55] The Draft Standard would require that finance lease receivables and payables be accounted for in the same way as other financial instruments (see paragraphs 211-213). Accordingly, amendments to lease accounting standards would be necessary to implement this.

Revenue

B.4 Existing requirements for revenue recognition from financial instruments, particularly those related to recognition of interest income and expense,[56] would require amendment to be consistent with the income statement presentation requirements of the Draft Standard.

Foreign Currency Translation

B.5 In most jurisdictions, existing accounting for foreign currency translation requires that monetary items be translated at each reporting date to reflect the exchange rate in effect at that date, as applied to the foreign currency market price.[57] However, international practice is not consistent with respect to the treatment of forward exchange contracts. Conforming

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[54] See, for example, IAS 1, Presentation of Financial Statements.
[55] See, for example, paragraphs 17 and 30 of IAS 17, Leases.
[56] See, for example, IAS 18, Revenue.
[57] See, for example, IAS 21, The Effects of Changes in Foreign Exchange Rates.

amendments to accounting standards for foreign currency translation would, therefore, be necessary.

B.6 In addition, the JWG proposes no exception for income statement recognition of gains and losses arising on financial instruments designated as hedging translation risks on net investments in foreign entities (see Basis for Conclusions, paragraphs 7.21-7.22). This would necessitate change to those foreign currency translation standards that permit such special accounting.

Business Combinations, Accounting for Investments in Associates and Financial Reporting of Interests in Joint Ventures

B.7 Standards for business combinations and equity accounting[58] would require amendment to address the determination of the amount to be used for the equity shares acquired in a step-acquisition. This Draft Standard does not cover subsidiaries and equity accounted investees, but in step acquisitions, the Draft Standard will normally require that investments are accounted for at fair value before significant influence, control, or joint control is obtained.

Borrowing Costs

B.8 Existing standards that permit, or require, borrowing costs to be capitalised[59] would require reconsideration to take into account the consequences of presenting interest income and expense on a fair value basis.

Financial Instruments: Disclosure and Presentation

B.9 The JWG has not comprehensively reconsidered existing standards for an issuer's classification of financial instruments between liabilities and equity, including the classification of compound instruments by the issuer, or for when a financial asset and a financial liability may be offset[60]. Accordingly, the JWG has not considered whether changes might be necessary to existing presentation standards[61] to be consistent with the Draft Standard.

B.10 The JWG believes that the scope and definitions in the Draft Standard should replace those in existing standards that address presentation and recognition and measurement of

[58] See, for example, IAS 22, Business Combinations, IAS 28, Accounting for Investments in Associates, and IAS 31, Financial Reporting of Interests in Joint Ventures.

[59] See, for example, IAS 23, Borrowing Costs.

[60] However, paragraph 3.37 of this Basis for Conclusions does note that implementation of the JWG's proposals for arrangements to pass cash flows through one enterprise to another would enable the three party offset provisions to be deleted from paragraph 36 of IAS 32 and put in what some would consider to be a more appropriate recognition and derecognition context.

[61] See, for example, IAS 32, Financial Instruments: Disclosure and Presentation.

financial instruments. Changes to the definition of a financial instrument would also necessitate some changes to other existing standards that use different definitions.

B.11 The JWG expects that the comprehensive disclosure requirements in this Draft Standard would replace existing disclosure requirements.

Financial Instruments: Recognition and Measurement

B.12 This Draft Standard is intended to comprehensively address recognition, derecognition and measurement of financial instruments. Accordingly, other standards addressing these subjects,[62] including those relating to measurement of specific financial instruments, such as impaired loans or investments, would be withdrawn or significantly amended.

[62] See, for example, IAS 39, Financial Instruments: Recognition and Measurement.

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APPENDIX C

Glossary of Terms

This appendix contains definitions of terms or phrases as used in this Draft Standard.

Adequate compensation ***is the amount of benefits of servicing that the market believes would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.***

Basic (or "risk-free") interest ***is the amount of interest that compensates the lender for the time value of money.***

Basic (or "risk free") interest rate risk ***is the risk of changes in the fair value or cash flows of an asset or liability due to changes in the basic interest rate.***

Benefits of servicing ***are revenues from contractually specified servicing fees, late charges and other ancillary sources, including any float, that the servicer is entitled to receive only if it performs the servicing of the financial assets.***

Cash ***comprises cash on hand and demand deposits.***

Cash equivalents ***are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.***

A clean-up call option is a call option (or similar right) held by a servicer of transferred components, or its affiliate, to purchase the remaining transferred components if the amount of those remaining components falls to a level at which the cost of servicing them becomes burdensome in relation to the benefits of servicing. The servicer of transferred components or its affiliate may be the transferor.

The components of a financial instrument are the contractual rights to future economic benefits and the contractual obligations to transfer economic benefits that make up the financial instrument.

A conditional financial instrument is a financial instrument that requires delivery of another financial instrument or exchange of financial instruments only if specified future events occur.

Contractually specified servicing fees ***are all amounts that, according to the contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to exercise their actual or potential authority under the contract to have the financial assets serviced by another servicer.***

Credit risk ***is the risk that one party will fail to discharge its contractual obligation and thereby cause another party to incur a loss.***

Credit risk premium ***is the premium over the basic interest rate that the market requires to cover (a) the effects of expected defaults due to the failure of the borrowing party to discharge its contractual obligation and (b) compensation for assuming the risk of default. The credit risk premium includes any interest rate spread over the basic interest rate for risks relating to industry or geographic sectors.***

Currency risk ***is the risk of changes in the value of an asset or liability due to changes in exchange rates.***

Current market expectations rate of interest ***is the current per period rate of interest reflected in current interest forward rates implicit in observable market interest yield curves.***

Current yield to maturity ***is the average per period rate of interest that equates the fixed or determinable cash flows of an interest-bearing financial asset or liability with its fair value.***

Derecognition ***of an asset or liability or component thereof is ceasing to recognise that asset, liability or component on an enterprise's balance sheet.***

An equity instrument is a financial instrument that represents a residual interest in the assets of an enterprise after deducting all its liabilities.

Fair value ***is an estimate of the price an enterprise would have received if it had sold an asset or paid if it had been relieved of a liability on the measurement date in an arm's-length exchange motivated by normal business considerations.***

A financial asset is a financial instrument that is an asset.

A financial guarantee is a contract that requires payments to be made to a creditor if a debtor fails to make payment when due.

A financial instrument is one of the following:

(a) ***cash;***

(b) ***an equity instrument;***

(c) ***a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to receive that financial instrument in exchange for no consideration other than release from the obligation; or***

(d) ***a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party.***

A <u>financial liability</u> is a financial instrument that is a liability.

A <u>financial risk</u> of an enterprise is any risk to which a financial instrument held or issued by that enterprise is subject.

<u>Float</u> is the amount of funds available to an enterprise between the time that money is received and the time that the enterprise is required to make payment using those funds.

<u>Foreign currency—</u>according to the context a currency may be foreign with respect to either:

(a) ***the functional currency of a foreign entity; or***

(b) ***the reporting currency of the reporting enterprise.***

A <u>foreign currency denominated financial instrument</u> is one for which the settlement amount at any given time is determined in terms of a foreign currency.

A <u>foreign entity</u> is an operation (for example, a subsidiary, division, branch, joint venture, etc.) whose financial statements (a) are prepared in a currency other than the reporting currency of the reporting enterprise and (b) are consolidated with or accounted for under the equity method in the financial statements of the reporting enterprise.

The <u>functional currency</u> of an entity is the currency of the primary economic environment in which the entity operates. Normally, that is the currency of the environment in which that entity primarily generates and expends cash. A reporting enterprise may have multiple functional currencies, one of which is normally the same as the reporting currency.

A <u>hybrid contract</u> is a contract that has one or more sets of rights and obligations that, if they were separated from the contract would be accounted for as financial instruments that fall within the scope of this Draft Standard, and one or more sets of rights and obligations that do not fall within the scope of this Draft Standard.

An <u>impaired loan asset</u> is a loan asset whose credit quality has deteriorated to the extent that it is more likely than not that the lender will fail to receive the full amounts owing on or before the scheduled payment dates in accordance with the terms of the loan contract.

An <u>insurance contract</u> is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest

rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).

<u>Interest-bearing financial assets (liabilities)</u> comprise all financial instruments except cash on hand, equity instruments, and forward contracts (including swaps), options and similar derivative financial instruments.

<u>Interest revenue (expense)</u> is the return to the lender (cost to the borrower) for the temporary use of money. Within the context of measuring financial instruments at fair value, it is the market return (cost) on the fair value of an enterprise's interest-bearing financial assets (liabilities) for a reporting period. It includes (a) basic interest; (b) credit risk premium; (c) liquidity risk premium; and (d) any premium to the lender for bearing risks of adverse variability of expected cash flows apart from credit risk and liquidity risk.

<u>Liquidity risk</u> is the risk that a loss may be incurred because a position cannot be eliminated quickly.

A <u>loan asset</u> is a contractual right, that is not traded on an exchange or in dealer markets, to receive cash or other financial instruments of fixed or determinable amounts and timing in exchange for no consideration other than releasing the borrowing party from its obligations to the enterprise.

The <u>reporting currency</u> is the currency in which the reporting enterprise presents its financial statements.

The <u>reporting enterprise</u> is the enterprise whose financial statements are addressed in this Draft Standard.

A <u>servicing asset</u> results from a contract to service financial assets if the benefits of servicing are more than adequate compensation.

A <u>servicing liability</u> results from a contract to service financial assets if the benefits of servicing are less than adequate compensation.

A <u>transfer</u> occurs when one party passes to another party or parties the whole, or some component, of one or more of its assets.

APPENDIX D

Members of the Financial Instruments Joint Working Group of standard setters

Name	**Position**	**Country/Organisation**
Alex Milburn (Chair)	Former Board Member, International Accounting Standards Committee	IASC
Wayne Lonergan	Former Board Member, Australian Accounting Standards Board	Australia
Patricia Stebbens	Senior Project Director—Accounting, Australian Accounting Standards Board	Australia
Tricia O'Malley	Chair, Accounting Standards Board, Canadian Institute of Chartered Accountants	Canada
Ian Hague	Principal, Accounting Standards, Canadian Institute of Chartered Accountants	Canada
Gerard Gil	Representative of the Conseil National de la Comptabilité (French Accounting Standards Committee)	France
Etienne Boris	Representative of the Conseil National de la Comptabilité (French Accounting Standards Committee)	France
Jochen Pape	Representative of the Institut der Wirtschaftsprüfer & Board Member, International Accounting Standards Committee	Germany
Günther Gebhardt	Chair, Financial Instruments Task Force, German Accounting Standards Committee	Germany
Norbert Breker	Project Manager, Institut der Wirtschaftsprüfer	Germany
Shigeo Ogi	Japanese Institute of Certified Public Accountants	Japan
Tatsumi Yamada	Member, Business Accounting Deliberation Council, Japanese Institute of Certified Public Accountants & Board Member, International Accounting Standards Committee	Japan

Appendix D – JWG Members

Mike Bradbury	Board Member, New Zealand Financial Reporting Standards Board	New Zealand
Craig Heppleston	Representative of the New Zealand Financial Reporting Standards Board	New Zealand
Erik Mamelund	Board Member, Norwegian Accounting Standards Board & Board Member, International Accounting Standards Committee	Nordic Federation
Allan Cook	Technical Director, U.K. Accounting Standards Board	United Kingdom
Paul Ebling	Project Director, U.K. Accounting Standards Board	United Kingdom
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The JWG also recognises the significant time and effort contributed to this project by the following individuals.
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