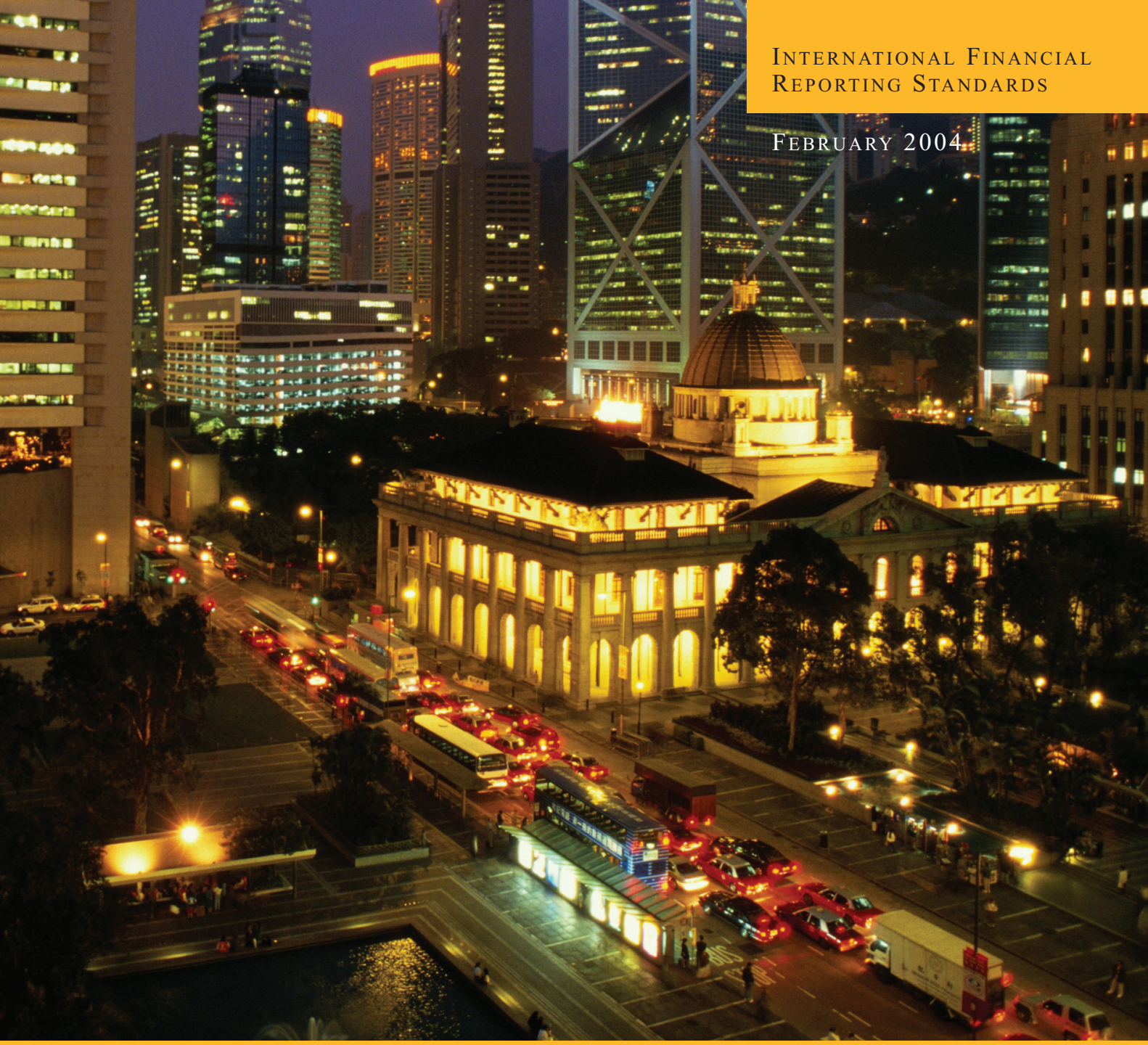

INTERNATIONAL FINANCIAL REPORTING STANDARDS

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ERNST & YOUNG

Quality In Everything We Do

IAS 32 and IAS 39 revised: An overview

Contents

Introduction

The International Accounting Standards Board ("IASB") published on 17 December 2003, in electronic form, the revised IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. They replace the Standards currently being applied by entities already reporting under International Financial Reporting Standards ("IFRS"). Also, they will be the versions of the Standards that will apply to those entities applying IFRS for the first time in 2005.

However, the revised IAS 39 does not yet cover the treatment of fair value hedges of portfolios of assets and liabilities. The proposals for this were set out in an exposure draft ("ED") in August, which we summarised and commented on in our Financial Instruments developments newsletter in September (a copy of the September newsletter can be forwarded on request). It is expected that this component of the Standard will be issued by the end of the first quarter of 2004. In addition, IAS 39 will also be further amended by proposals set out in a number of other EDs on other topics, as described in more detail, below.

The effective date for the changes in the two Standards is for financial years beginning on or after 1 January 2005, although earlier adoption is permitted (as long as both new Standards are adopted in full). See also the section on first time adoption, below. One of the main concessions is that firms applying IFRS for the first time in 2005 do not need to restate their comparative numbers for 2004 to comply with IAS 32 or IAS 39.

However, firms will need to consider their positions carefully before availing themselves of this concession. This is because the financial markets may well demand that companies publishing IFRS financial statements for the first time in 2005 should produce at least one year of fully comparable financial information. This means that many firms may still wish to set their date of transition to IAS 32 and IAS 39 as 1 January 2004.

The standards still need to be endorsed by the European Commission before they will be mandatory for European listed companies. This endorsement process will not commence until the treatment of fair value hedges of portfolios of assets and liabilities has been finalised. There is a possibility that the standards may not be endorsed in time for 2005 adoption because challenges raised during the endorsement process can not be addressed in the time available. This would have serious implications for the transition to IFRS in Europe.

The purpose of this document is to summarise the two Standards (excluding the disclosure requirements of IAS 32) and the main changes to the current versions of IAS 32 and 39. It is designed to be relatively brief and a fuller analysis will be published by Ernst & Young in due course. As a result, this document should not be relied upon to set out all the changes in IAS 32 and IAS 39, and readers should refer to the new Standards or consult with their usual Ernst & Young contact before concluding on the accounting treatment of specific transactions.

Definitions

The five key definitions are:

A **financial instrument** is widely defined, as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

A **financial asset** is defined as:

- cash;
- an equity instrument of another entity;
- a contractual right to receive cash or another financial asset from another entity (including trade receivables, although the application of IAS 39 will normally be immaterial, unless payment is deferred); or
- a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable (such as a swap with a positive fair value).

A **financial liability** is defined as any contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial instruments with another entity under conditions that are potentially unfavourable (eg a swap with a negative fair value).

The new Standards have added further detail to these definitions, to help distinguish financial assets and liabilities from an entity's own equity instruments (see Debt v Equity).

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Finally, a **derivative** is a financial instrument with the following three characteristics:

- its value changes in response to a change in price of, or index on, a specified underlying financial or non-financial item or other variable;
- it requires no, or comparatively little, initial investment; and
- it is to be settled at a future date.

The definition of a derivative has been clarified. Importantly, a contract will meet the definition of a derivative regardless of whether it is settled net or gross. This differs from US GAAP which excludes contracts that are settled gross.

Scope

IAS 32 and 39 are very wide in scope and cover all financial instruments except where specifically addressed by another standard, such as:

- interests in subsidiaries, associates and joint ventures (see IAS 27, IAS 28 and IAS 31) unless, according to those standards, they should be accounted for under IAS 39;
- interests in leases (IAS 17) except for any embedded derivatives and the derecognition and impairment provisions of IAS 39 relating to receivables and payables;
- assets and liabilities under employee benefit plans (IAS 19);
- the subsequent measurement of financial guarantees that provide for specified payment to be made to reimburse specified debtor defaults (IAS 37); and
- contracts for contingent consideration in a business combination (IAS 22).

The main changes in scope since the existing Standards are:

- Loan commitments are excluded (see IAS 37) unless: they can be settled net in cash or another financial instrument, are designated as trading, or the entity has a past practice of selling the resulting loans shortly after origination.
- Insurance contracts are excluded where they provide for reimbursement of an incurred loss specific to the insured party. However, such contracts are included where a financial risk is insured, eg a change in an interest rate, security price, commodity price, FX rate, index of prices or rates, a credit rating or a credit index.
- A contract for the purchase or sale of a non-financial asset is treated as a financial instrument if:

  a) it gives either party the right to settle in cash or another financial instrument, or is readily convertible to cash, unless the contract is "normal", ie it is expected to result in receipt or delivery of the non-financial item for the entity's expected purchase, sale or usage requirements; or

  b) the contact does not provide for net cash settlement, but:

  – the entity has a past practice of selling or closing out the contract and settling the gain or loss (by reference to market prices) net in cash with the counterparty or entering into offsetting contracts; or

  – the entity has a past practice of taking delivery of the underlying commodity and selling it shortly thereafter, to generate a profit from short-term fluctuations in price or a dealer's margin.

  The IASB added the term 'readily convertible to cash' in a), above, only in November. By this we understand the Board to mean any asset that is marketable, which will cover many commodities but will exclude manufactured goods.

  Again in November, the IASB decided to add the clarification that a written option on a non-financial item is never "normal", since the writer of the option cannot ensure receipt or delivery. As a result, any written option on a non-financial item that can be settled net in cash or another financial instrument, or is readily convertible into cash, is included within the scope of IAS 32 and IAS 39.

  The changes in b), above, mean that the activities of most commodity traders are now covered by the Standards.

  IAS 2 *Inventories* has been revised to be consistent with this change. The measurement rules of IAS 2 no longer apply to those inventories of commodities held by commodity broker – traders who measure their inventory at fair value less costs to sell. Gains and losses in such cases must be recognised in profit or loss.

- ED 5 (Insurance Contracts) proposes an amendment to bring within the scope of IAS 39 derivatives based on climatic, geological or other variables.

Classification and measurement of financial instruments

IAS 39 requires that assets and liabilities are all classified into one of five categories, which dictate the accounting treatment, as shown in Insert A.

Items are measured either at fair value, or at amortised cost so as to record a constant effective yield. Both of these approaches are explained in more detail, below. It should be noted that:

- As in the original IAS 39, the held to maturity (HTM) category is limited in its application since, if the entity sells or reclassifies more than an immaterial part of the portfolio, (apart from in a few exceptional, limited, circumstances) it is banned from using the category for at least a two year period. Also, it is not possible to apply hedge accounting to a hedge of the interest rate risk of an HTM asset.

Insert A: Classification and measurement

Category	Description	Measured at fair value	Measured at amortised cost
Loans and receivables	Unquoted loan assets, whether originated or acquired, where there is no intent to sell the asset in the short term	×	✓
Held to maturity ("HTM")	Debt assets acquired by the entity, to be held to maturity	×	✓
Held "at fair value through profit and loss" ("FVP")	All derivatives (except for those eligible for hedge accounting) Other items intended to be actively traded Any item designated as such at origination, including liabilities	✓ To p&l	Record at cost if fair value cannot be reliably measured (very limited – use only for unquoted equity instruments and derivatives thereon)
Available for sale ("AFS")	All assets not in the above categories	To equity – unless impaired– but interest is recorded in p&l based on the asset's effective yield	Record at cost if fair value cannot be reliably measured (very limited – use only for unquoted equity instruments and derivatives thereon)
Non-trading liabilities	Other liabilities	×	✓

- The circumstances in which held at "fair value through the profit and loss" (FVP) or available for sale (AFS) items should be held at cost, because the fair value cannot be reliably measured, is very limited. It is reserved for unquoted equity instruments and derivatives thereon, only where a valuation methodology cannot be applied as the range of fair value estimates is significant or the probabilities of the various estimates within the range cannot be reasonably assessed. Modelling techniques that are well established, such as those used by private equity houses, would normally be considered as providing a reliable estimate of fair value. It should also be noted that certain private equity investments can only escape being accounted for as associates, in accordance with IAS 28, where they are treated as FVP under IAS 39, and so will not be eligible for this exclusion.
- The Standard prohibits designating financial instruments as "FVP" if fair value cannot be reliably measured.
- As interest arising on an AFS asset must be recorded at the effective yield (including amortisation of any premium or discount and transaction costs), the gain or loss taken to equity for an AFS debt instrument will only be the extent to which the fair value is greater or less than the asset's amortised cost.
- For monetary AFS assets, such as bonds, any foreign currency gain or loss resulting from translation of the amortised cost is recognised in profit or loss. As equity instruments are not monetary assets, where they are treated as AFS any foreign currency translation gain or loss will be recorded in equity, unless the foreign currency risk is hedged (see below).

The main changes since the previous text of IAS 39 are:

- The category of loans and receivables that may be accounted for at amortised cost has now been extended to include loans acquired by the enterprise as well as those originated by it. On the other hand, loans quoted in an active market cannot be included in this caption and must be treated as FVP, HTM or AFS.
- The 'FVP' classification in the original standard has been replaced by the broader category 'financial assets or liabilities at fair value through the profit or loss' (FVP). In addition to items that are classified as actually held as part of a trading portfolio, the category is now available for any asset or liability as long as it is designated as such at initial recognition. This designation is irreversible; an entity may not reclassify an instrument into or out of the FVP category while it is held. This amendment has been controversial as it requires an entity to consider its own credit spread when determining the fair value of its own debt. Yet it may make it easier for entities to achieve the same results as hedge accounting, by fair valuing both the hedged item and the

hedging instrument, without the need to meet all of the hedge accounting criteria. However, unlike hedge accounting, if the hedge is removed, the asset or liability being hedged must continue to be fair valued. In addition, the impact on the profit and loss account may be more volatile since the credit component of the asset or liability must also be considered in the fair value calculation. This is unlike hedge accounting where the entity can designate only the risk free rate as the risk being hedged and exclude credit spreads when determining the fair value of the hedged asset or liability. However, whilst the revised standard permits all liabilities to be classified as FVP, European law currently only allows liabilities to be so treated if the are held as part of a trading portfolio. This issue would need to be remedied before European entities can make full use of the new provision.

- Changes in fair value of an AFS asset must be recorded in equity, until it is impaired or derecognised, at which time the cumulative gain or loss is transferred to profit or loss. The previous option, to record the gains and losses directly in profit or loss, has been removed as it is no longer necessary, since any asset or liability can be treated as FVP.
- Except where a financial asset or liability is classified as FVP, the amount initially recognised should include incremental costs (and fees) that are "directly attributable" to its acquisition or issue. This means that for items recorded at amortised cost, such expenses will be reflected in the effective yield.

Fair value

Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. "It is not the amount that an entity would receive or pay in a forced transaction or distressed sale".

As in the original IAS 39, a distinction is made between instruments quoted on "active markets" and those where there is "no active market". These terms are now more specifically defined and more detailed guidance is given.

Active markets

These are defined as markets where quoted prices are readily available and representative of the prices of actual and regularly occurring transactions.

In an active market the new IAS 39 states that the best evidence of fair value is the published price quotation. It deletes the word "normally" which was included in the equivalent requirement of the original standard.

There may be more than one quoted market price for an instrument, eg in the wholesale and the retail markets. The valid price to use is the one quoted in the most advantageous market to which the entity has immediate access. Consequently not all entities will use the same price as the fair value.

The Standard requires the use of bid prices for long positions and ask price for short positions. Since it defines the difference between bid or ask and mid as representing only transaction costs, adjustments may be required for OTC derivative transactions to reflect differences in counterparty credit risk between the instrument quoted in the market and the one being valued so that the fair value of the specific transaction is achieved.

Where an entity has a portfolio of offsetting transactions, the bid or ask price may be applied to the net open position rather than transaction by transaction. This is important for dealers who run portfolios of transactions and manage their exposure on a net basis and is consistent with generally accepted market practice.

The new version of IAS 39 acknowledges that there may be circumstances when current prices are unavailable and the most recent traded price may be stale, for example if market conditions have changed or the price represented a forced sale transaction. In such circumstances the price should be adjusted. However, it is important to note that no adjustment is allowed simply because an entity has such a large holding of a particular instrument that the market price would almost certainly change if the position was sold (typically referred to as "block discounts"). Therefore, some liquidity adjustments currently applied in practice may no longer be permitted.

Where prices are not available for an instrument in its entirety but only for its component parts, the fair value should be determined based on these components. This is consistent with market practice and increases the range of instruments that will fall into the active market category.

If the convention in the market for a particular instrument is to quote rates, which are model inputs rather than prices, this is the approach that should be followed to determine fair value. This means that many of the more liquid OTC derivative markets, such as the interest rate swap market, probably need to be considered as active markets, even though valuation

models need to be used and adjustments will need to be made for credit or other costs to determine fair value.

Where there is no active market

For instruments which fall into this category, fair value has to be established using a valuation technique, such as recent transactions, the current fair value of similar instruments, discounted cash flow analysis and option pricing models. Wherever there is a technique commonly used in the market, which has been demonstrated to provide reliable price estimates, that approach should be followed.

IAS 39 states that at initial recognition the best evidence of fair value is the transaction price. An alternative valuation is only permitted (and hence a "day one" profit or loss recognised) if it is based on the prices of other observable market transactions or from a valuation technique where all model inputs are verifiable to market quotations. This development is consistent with US GAAP EITF 02-03 and means that a profit or loss can only be recognised on day one if the value can be determined based entirely on observable data. However, one difference, compared to US GAAP, is that IAS 39 applies to all financial instruments, where as EITF 02-03 only applies to derivatives.

The language surrounding subsequent valuations is less clear than for initial recognition. The Standard requires that the valuation technique must make the maximum use of market inputs and rely "as little as possible on entity specific inputs". This appears to allow the valuation to be driven by a model even if not all inputs are observable. However, it also requires that the valuation is consistent with how prices are determined in the market and the model must be "calibrated" against observable market prices.

These requirements probably mean that any deferred day one profit or loss cannot simply be recognised on day two, but may be recognised over the life of the transaction in a systematic manner, rather than having to be deferred until all inputs become observable. This area will require careful consideration.

The Standard sets out some of the inputs required in valuation techniques. It is noteworthy that within this list are two particular factors, volatility and prepayment risk, for which the Standard allows historical analysis as an "observable" source. However, markets do not usually price based on historical analysis of volatility. As a result, use of historical analysis to determine inputs would probably not meet the requirement that valuation must be consistent with how prices are determined in the market.

Nevertheless, the inability to recognise day one profits will reduce the recorded profitability of some trading operations in the short term and create challenges as to how they should be measured for management reporting and bonus purposes. In the longer term this will help reduce volatility of earnings and may lead to trader bonuses that are more closely linked to realisation of profits on complex trades, rather than day one estimates.

Amortised cost

Amortised cost means recording the asset or liability so that the recorded income or expense (including amortisation of any discount or premium, or directly attributable acquisition or issue expenses, or fees received at inception) is equal to the effective interest rate or yield. The effective interest rate is defined as "the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, where appropriate, a shorter period to the net carrying amount of the financial asset or financial liability". For instance, if a 5 year bond is purchased on 1 January 2004 at a price of 92 (ie at an 8% discount) and pays a 5% coupon, the effective yield is 6.9484324% and the amortised cost at the end of each year can be calculated as shown in Insert B.

Insert B: Illustration of amortised cost

Date	Brought forward amortised cost	Payment	Interest at 6.9484324%	Carried forward amortised cost
01/01/04	92,000,000	(5,000,000)	6,392,558	93,392,558
01/01/05	93,392,558	(5,000,000)	6,489,319	94,881,877
01/01/06	94,881,877	(5,000,000)	6,592,803	96,474,680
01/01/07	96,474,680	(5,000,000)	6,703,478	98,178,158
01/01/08	98,178,158	(105,000,000)	6,821,843	0

Generally any costs, premium or discount will need to be amortised over an instrument's life. However, if they relate to a variable rate instrument which reprices to market, they would normally be amortised over the period to the next interest repricing date.

While the calculation of effective yield is comparatively easy for each asset or liability, to make this calculation for the thousands of assets held by a bank will require a systems-based solution. However, for any items acquired at par and paying a constant fixed rate of interest, the effective yield will often be the same as the contractual rate.

For a bank or other financial institution, important rules on the definition of the effective yield are contained in IAS 18 *Income Recognition.* This requires that the effective yield on a loan includes commitment fees (less any related, direct costs) and syndication fees where the syndicator retains a portion of the loan package at an effective yield which is lower than that earned by other participants who are exposed to comparable risks.

The requirements are unchanged from the current version of IAS 39 but the new Standard provides clarification in a number of areas:

- Expected, but not yet incurred, credit losses should not be included in the effective interest rate calculation. However, if an entity purchases a financial asset at a discount, because of previously incurred credit losses, these should be included in the estimated cash flows.
- For assets held at amortised cost, which are subject to call, prepayment, or extension options, entities should calculate the effective interest rate using estimated, rather than contractual, future cash flows. Although there is a presumption that future cash flows can be estimated reliably, contractual cash flows should be used where reliable estimation is not possible.
- Where there is a subsequent change in estimates of the cash flows used in calculating the effective interest rate, as may occur (for instance) where an asset has an uncertain expected maturity due to the issuer having a prepayment option, the entity should adjust the amortised cost of the instrument to reflect actual and revised estimated cash flows. This means that there will be a catch up adjustment to the reported interest whenever there is a change in assumptions, which will be reported as an income or expense. The entity should recalculate the amortised cost by discounting the amount received or paid in the current period, and the remaining estimated cash flows, using the original effective interest rate. (An example is given in Appendix A).

Impairment

The main rule is stated more clearly in the new IAS 39, that impairment losses should be recognised when, and only when, there is objective evidence that an impairment has occurred.

Objective evidence of impairment of an asset will include indicators of financial difficulty or delinquency on the part of the debtor, any concessions made by the lender, a high probability of bankruptcy or financial reorganisation of the debtor, or disappearance of an active market in the investment arising from a financial problem.

The new Standard gives, as further impairment indicators for equity instruments, significant, adverse changes in the technological, market, economic or legal environment in which the issuer operates, or a "significant or prolonged" decline in fair value. The latter phrase is not defined.

The new Standard also requires a loss to be recorded where there are observable data indicating a "measurable decrease" in the estimated future cash flows from a group of financial assets, even if the decrease cannot yet be identified for individual assets in the group. Indicators of this include:

- adverse changes in the payment status of borrowers (eg delays in payment, full utilisation of limits etc); and
- national or local economic conditions that correlate with defaults on assets in the group.

Examples of the latter given in the Standard are an increase in the unemployment rate, a decrease in property prices, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions.

Impairment of assets recorded at amortised cost

Where there is objective evidence of impairment, the carrying amount of an asset should be reduced to the present value of expected future cash flows, discounted at the instrument's original effective interest rate. Where the interest rate is variable, the discount rate would be the current effective interest rate determined under the contract.

The determination of whether an asset is impaired should be carried out separately for each individually significant asset but

may be made collectively for groups of similar assets that are not individually significant. However, if assets are individually significant and have been tested and no impairment is indicated, they are required by the new Standard to be included in a further, collective assessment.

General provisions?

The new requirement to subject individually assessed assets to a second, collective assessment, is designed to allow recognition of losses believed to exist in the portfolio but not yet evident (sometimes referred to as 'latent losses'). This has been the stated purpose of most banks' general provisions in the past. The key difference is that this loan allowance can only be made under IAS 39 to the extent that there are adverse changes in the payment status of borrowers, or economic conditions that can be shown to correlate with defaults on the assets. While the approach is, in theory, feasible for retail loan portfolios in some countries, finding the data and establishing the correlations will prove a considerable challenge in many cases. These new rules will be difficult to apply to wholesale loans due to the paucity of data and the novelty of the required process. If banks do not have the data to make a provision this may mean that some provisions will need to be released upon first time adoption of IFRS. It should, however, be noted that the Standard does allow the use of peer group experience where entities have no, or limited, entity-specific loss experience.

Taking a very simple example (ignoring the time value of money), if a bank grants €100m of 10 year loans and expects to lose €9m in loan losses, it might charge 1% a year above the risk-free interest rate. After the first year has passed (assuming none of the loans have defaulted), as the bank has received the first year's 1% spread the future cash flows will have declined by this amount. It may be appropriate to record an impairment allowance of €1m.

Future cash flows in a collective assessment are to be estimated based on historical loss experience. For instance, credit card companies frequently classify their loans by the number of months they are overdue and track the proportion that progress from one category to the next and end up as losses. An impairment provision can then be calculated using this data for each category, including those loans that are not yet overdue. For this still to be possible it will be necessary to demonstrate that there has been a measurable decrease in the expected cash flows on those loans not yet overdue since they were first advanced. This may be difficult to achieve until after the first payment date has passed and interest becomes payable on the balance.

Impairment of available for sale assets

As in the existing IAS 39, once there is objective evidence that an AFS asset is impaired, any losses recorded in equity must be transferred to profit or loss.

The main changes are:

- if the AFS asset is an equity instrument, an impairment loss cannot be reversed through profit or loss as long as the asset continues to be recognised. Hence any increase in fair value after an impairment has been recorded can only be recognised in equity. However, impairment provisions on debt instruments can be reversed through profit and loss account if the increase can be "objectively related to an event occurring after the impairment loss was recognised"; and
- for equity investments, a significant *or* prolonged decline in fair value below its cost now represents objective evidence of impairment. This means that a "significant" equity price fall would automatically result in impairment, even if only temporary. Given that impairment provisions cannot be reversed through profit and loss this could have serious implications.

Embedded derivatives

An embedded derivative is a component of a hybrid instrument that includes both a derivative and a host contract – with the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. Examples would include financial instruments with call or put options, or with equity conversion features, or where interest payments are linked to equity or commodity prices.

The rules for embedded derivatives in the new IAS 39 have been updated for inclusion of the guidance contained in the IGC Q&As.

The embedded derivative is required to be separated and recorded at fair value, with gains and losses taken to profit or loss, if:

i) the hybrid instrument is not already recorded at fair value with gains and losses taken to profit or loss;

ii) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

iii) the economic characteristics and risks of the embedded derivative are not "closely related" to those of the host instrument.

Examples of where the characteristics and risks of the embedded derivative are not regarded as closely related, and so the derivative needs to be separated and recorded at fair value, include:

- terms in a debt or insurance contract whereby interest or principal payments are, or can be, based upon a commodity or equity price;
- an equity conversion feature embedded in a debt instrument held as an asset;
- a call, put or prepayment option embedded in a debt instrument, unless the option's exercise price is approximately equal to the debt instrument's amortised cost on each exercise date;
- an option or other provision to extend the term of a debt instrument, unless there is a concurrent adjustment of the interest rate to reflect market prices; and
- credit derivatives embedded in debt instruments.

Examples of where the characteristics and risks of embedded derivatives are regarded as closely related and therefore the derivatives are not required to be separated and recorded at fair value include:

- embedded derivatives based on interest rates or an interest rate index that can change the amount of interest that is paid on an interest-bearing debt instrument, unless the investor will potentially not recover substantially all of its recorded investment or could at least double the initial rate of return compared to the market return on a similar debt instrument without the embedded derivative;
- a floor or cap on a debt instrument as long as it is out of the money; and
- an embedded foreign currency derivative in a non-financial instrument such as a contract for the purchase or sale of a non-financial item or an operating lease, provided that it is not leveraged and contains no option features and requires payments denominated in:
  - the functional currency of one of the "substantial" parties to the contract, or
  - the currency in which the price of the good or service is routinely denominated around the world (such as $US for crude oil transactions), or
  - a currency that is commonly used in economic environments where the local currency is unstable or illiquid.

The revised IAS 39 makes it clear that the embedded derivative is to be measured at inception at fair value and the residual value is assigned to the host, so as to create no gain or loss at inception. (As a result, the treatment of a convertible bond will be different from the perspective of the holder and the issuer, since IAS 32 requires the issuer's liability on the bond to be initially recorded at fair value and the residual value is assigned to the equity component).

In those rare circumstances when the fair value of the derivative cannot be determined, it should be computed as the fair value of the hybrid contract less the fair value of the host contract. If this is also impossible to calculate then the combined instrument must be treated as a financial instrument FVP.

The embedded derivatives requirements of IAS 39 will cause problems for many entities engaged in non-financial services activities who are adopting IFRS for the first time. They will need to examine very carefully all of their contracts to ensure that there are no embedded derivatives that need to be accounted for in this manner, in particular, embedded foreign currency and commodity derivatives.

Hedge accounting

As already stated, all derivatives must normally be recognised at fair value on the balance sheet, with all changes in fair value normally recorded in current year profit or loss. However, this may not be symmetrical with the

Insert C: Key steps to achieving a qualifying hedge

1. Identify the type of hedge – fair value, cash flow, or net investment
2. Identify the hedged item(s) or transaction
3. Identify the nature of the risk being hedged and the period being hedged
4. Identify the hedging instrument
5. Demonstrate that the hedge will be highly effective
6. Document all the above from the start of the hedge relationship
7. Monitor effectiveness

recognition of gains and losses on a hedged item, if it is not an asset or liability that is held at fair value with gains or losses taken to profit or loss. Hedge accounting tries to match the timing of profit or loss recognition on the derivative with that of the item being hedged, but it can only be applied when the derivative meets specific criteria. The key criteria that must be met are summarised in Insert C.

There are three types of hedge:

a) Fair value

A fair value hedge is defined as the hedge of the exposure to changes in the fair value of:

- a recognised asset or liability; or
- a previously unrecognised firm commitment to buy or sell an asset at a fixed price; or
- an identified portion of such an asset or liability, or firm commitment;

that is attributable to a particular risk and could affect reported profit or loss.

In each case, you wish to protect yourself from changes in the fair value of the asset or liability arising from market price movements because its price or cash flows are fixed.

The main difference from the original IAS 39 is the inclusion of hedges of committed purchases or sales of assets as fair value hedges rather than cash flow hedges, but entities are given an option to treat hedges of the foreign currency exposure of a firm commitment as either a fair value or a cash flow hedge.

Examples include:

- a receive fixed, pay floating, interest rate swap used to hedge a fixed rate liability;
- a purchased put option used to hedge an AFS equity instrument;
- a forward foreign exchange contract used to hedge the foreign currency exposure on an AFS equity instrument; and
- an oil forward contract used to hedge oil inventory.

b) Cash flow

A cash flow hedge is defined as a hedge of the exposure to variability in cash flows attributable to a particular risk associated with a recognised asset or liability, or a highly probable forecast transaction, which could affect profit or loss.

This is used where, for instance, the cash flows on an asset or liability are not fixed (eg a floating rate bond), so that you are at risk not to changes in fair value but to changes in cash flows.

Examples include:

- a pay fixed, receive floating, interest rate swap used to lock in the cost of a floating rate liability;
- a foreign exchange forward contract used to hedge the currency exposure of an operating lease denominated in another currency;
- a forward foreign exchange contract entered into to hedge a highly probable forecast transaction; and
- a pay fixed, receive floating, interest rate swap used to lock in the cost of a future, highly probable, borrowing.

c) Hedge of a net investment

In addition to the two main types of hedge already described, IAS 39 adds the traditional process of matching foreign currency gains or losses on a derivative or liability against the revaluation of a foreign operation. The gain or loss on the hedging instrument is recorded in equity to offset the gains and losses on the net investment, to the extent that the hedge is highly effective.

While this does not change the treatment contained in many local GAAPs, IAS 39 requires the normal hedge classification and effectiveness testing to be applied (see below). Note that this type of hedge accounting is not available for the stand alone accounts of the parent company if overseas subsidiaries and associates are not equity accounted, where the hedge will be a fair value hedge of the investment. The accounting treatment is the same as applied to cash flow hedges.

Depending upon whether the hedge is a fair value or cash flow hedge, the accounting treatment is very different:

Accounting treatment of qualifying hedges

Insert D summarises the key accounting treatment for hedges.

Gains and losses on fair value hedges are offset (to the extent the hedge is effective) by changes in value of the hedged item due to the hedged risk. However, even if fully effective, the best that can be achieved with a cash flow hedge is that the gain or loss on the derivative instrument is recorded in equity. It is

Insert D: Accounting treatment for qualifying hedges

	Fair value hedges	Cash flow hedges
1. Gain or loss on hedging instrument	Recognised immediately in p&l	To the extent the hedge is effective, in equity
2. Adjustment to hedged item.	Change in fair value due to the hedged risk recognised immediately in p&l	N/A
3. Hedged ineffectiveness is recorded in p&l	By default	Calculated
4. Gain or loss in equity is transferred to p&l	N/A	At the same time as the change in the hedged cash flows or related non-financial asset or liability is recognised in p&l

then transferred to profit or loss so as to offset the impact on profit or loss of the change in value of the hedged item. Therefore, while the income statement is protected by cash flow hedging, the entity will still record significant increases or decreases in its net assets in the short term, with an impact on gearing ratios and Return on Equity calculations, etc.

One elective exception is available where a forecast transaction results in a firm commitment to buy or sell a non-financial asset or liability. The amount deferred in equity can be transferred to the recognised value of the asset or liability. Although different from US GAAP, this will be a relief to manufacturing concerns who use cash flow hedges to lock in cost of raw material or other inventory items.

Constraints on hedge accounting

There are significant constraints on applying hedge accounting.

a) Hedged items

The hedged item can be a recognised asset or liability, an unrecognised firm commitment, an uncommitted but highly probable forecast transaction, or a net investment in a foreign operation. It can be a single asset, liability, commitment or transaction, or a group of such items as long as they have similar risk characteristics. The definition of "similar risks characteristics" is very restrictive: "the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items".

A portfolio of assets and liabilities is not permitted to be a hedged item. As a result, a hedge of a net position has to be treated as a hedge of specific assets or liabilities within the overall portfolio. In addition, this would preclude the use of a purchased put option or an index future to protect the fair value of a portfolio of FTSE 100 AFS securities. Even though the instruments give a perfect economic hedge of the portfolio, because the fair value of the individual securities in the portfolio do not move in an approximately proportional manner to the fair value of the portfolio as a whole, the portfolio cannot be designated as a hedged item!

The treatment of fair value portfolio hedges is the subject of the ED issued in August. We will not know the final resolution of the issues debated within the ED until Q1 2004. However, to date it has been clear that the IASB intends to maintain the principle of not allowing net positions to be designated as the hedged item for the purposes of hedge accounting. Furthermore, paragraph 49 of the revised Standard specifically states that the value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This means that demand deposits are not subject to changes in fair value and are not therefore eligible to be hedged for changes in fair value. This presents a challenge for banks who treat such items as though they do change in value for interest rate movements and build such expectations into their hedging strategy.

A firm commitment to acquire a business in a business combination cannot be a hedged item, except for hedges of FX risk. Meanwhile, an equity method investment cannot be the hedged item in a fair value hedge, as the equity investor does not recognise changes in fair value in earnings, but accounts for its share of the investee's profit or loss.

If the hedged item is a financial asset or financial liability, it may be treated as a hedged item with respect to the risks associated with only a portion of its cash flows or fair value. For instance, it is possible to hedge only part of the life of an asset, or only the risk-free interest rate on a loan by a bank to a customer or a bond.

In contrast, a non-financial asset or liability can only be designated as a hedged item in its entirety, or for a hedge of foreign currency risk. This significantly reduces the likelihood of achieving an effective hedge for non-financial items such as purchase or sales of commodities (see Hedge effectiveness, below).

b) Hedging instruments

All derivatives can be treated as hedging instruments, except for written options (unless they are designated as an offset to purchased options), including any that are embedded in another financial instrument. A non-derivative financial asset or liability can only be designated as a hedge of foreign currency risk.

A key requirement is that all hedging derivatives must involve a third party. Intra-group transactions are not eligible for hedge accounting treatment in a set of consolidated accounts, causing significant difficulties where a group operates through a separate treasury function. In these circumstances it is usually necessary to identify, on a case-by-case basis, external derivative trades that may be designated as hedges of assets, liabilities, commitments or forecast transactions.

It is possible to designate only a portion of a hedging instrument, such as 50% of its notional amount as the hedge. However, it is not possible to designate a hedging instrument only for a portion of its life.

Two or more derivatives, or proportions thereof, may be viewed in combination and jointly designated as a hedging instrument. However, if the combination involves a written option component and a purchased option component it will not qualify as a hedging instrument if it is, in effect, a net written option, so that a net premium is received. In addition, a single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and the different risk positions.

c) Hedge effectiveness

There are two tests of hedge effectiveness:

- prospectively, at inception and throughout its life, each hedge must be highly effective, defined as where changes in the fair value or cash flows of the hedged item "almost fully offset" changes in the fair value or cash flows of the hedging instrument; and
- retrospectively, measured each period, the hedge is highly effective, so that actual results are within a range of 80-125%.

The rule for prospective effectiveness has been debated on several occasions by the IASB in the last 12 months but the Board decided in October to maintain a stricter requirement than the 80-125% rule used for the retrospective test, that expected changes in fair value or cash flows must almost fully offset. This is considerably more stringent than the practice applied in the US.

There are two areas which represent particular challenges in practice:

- **Hedges of non-financial items** – It is only possible to hedge non-financial items in their entirety, and not a component, yet the hedging instrument available may only be one of the drivers of change in value of the hedged item. For example, a purchase of jet fuel may be hedged using a crude oil futures contract. Is it possible to achieve hedge accounting if the prospective test requires that changes in fair value or cash flows must 'almost fully offset'?

  We understand that the 'almost fully offset' test is designed to require that entities aim to apply the most appropriate hedge ratio, rather than cause difficulties where there is basis risk. The application guidance for the revised standard (AG 100) specifically sets out an example of hedging Brazilian coffee using a forward contract on Colombian coffee. In this example a regression analysis is performed and, assuming that there is a high correlation between the two prices, the slope of the regression line is used to establish the hedge ratio. Even though the basis risk will lead to hedge ineffectiveness, which will need to be within the 80 – 125% range, at the outset the results are deemed to "almost fully offset" if there is high enough correlation and this hedge ratio is used.

- **Group with a central treasury function –** As internal trades are not eligible for hedge accounting, it is necessary

for the group to identify external derivatives that match assets or liabilities and designate these as hedges. In this process it is often not possible to find external trades that exactly match the assets or liabilities in terms of amounts, tenure, interest rates etc. The use of an 80%-125% range made such an exercise feasible. Going forward, without this degree of flexibility, it may be much more difficult to allocate external derivatives against individual assets or liabilities.

The retrospective test must be carried out at least every reporting period. In practice, the more frequently the calculation is done the quicker any ineffectiveness can be noted and the hedge adjusted, so minimising the ineffectiveness recorded in profit or loss.

Entities are permitted to test effectiveness retrospectively on either a period-by-period basis or cumulatively. Hedges are normally more likely to fall within the 80-125% limits if the test is applied cumulatively.

In measuring effectiveness the Standard allows segregating the time value from the intrinsic value of an option (or the interest element and spot price of a forward contract) and designating only the latter as part of the hedge relationship. The effect will be to account for the time value as an ineffective portion of the hedge and record the change in fair value in profit or loss.

Ineffectiveness for cash flow hedges (for instance due to overhedging) is always recorded in profit or loss.

The method of testing effectiveness is not dictated by the Standard but it needs to be selected at the outset and applied consistently.

d) Documentation

All hedges must be designated, tested for effectiveness and documented at inception. Documentation must include the hedged item, the hedging instrument, the nature of the risk being hedged, the risk management objectives and hedge strategy, plus the method to be used for testing effectiveness.

Hedges cannot be designated or documented retrospectively.

Discontinuation of hedge accounting

Entities have to discontinue, prospectively, hedge accounting where:

- the hedging instrument expires, is sold or terminated or exercised (excluding situations where a hedge is replaced or rolled over into another hedging instrument and this is part of the entity's documented hedging strategy); or
- the hedge no longer meets the effectiveness criteria; or
- the forecast transaction that is a subject to a cash flow hedge is no longer highly probable; or
- the entity revokes the designation.

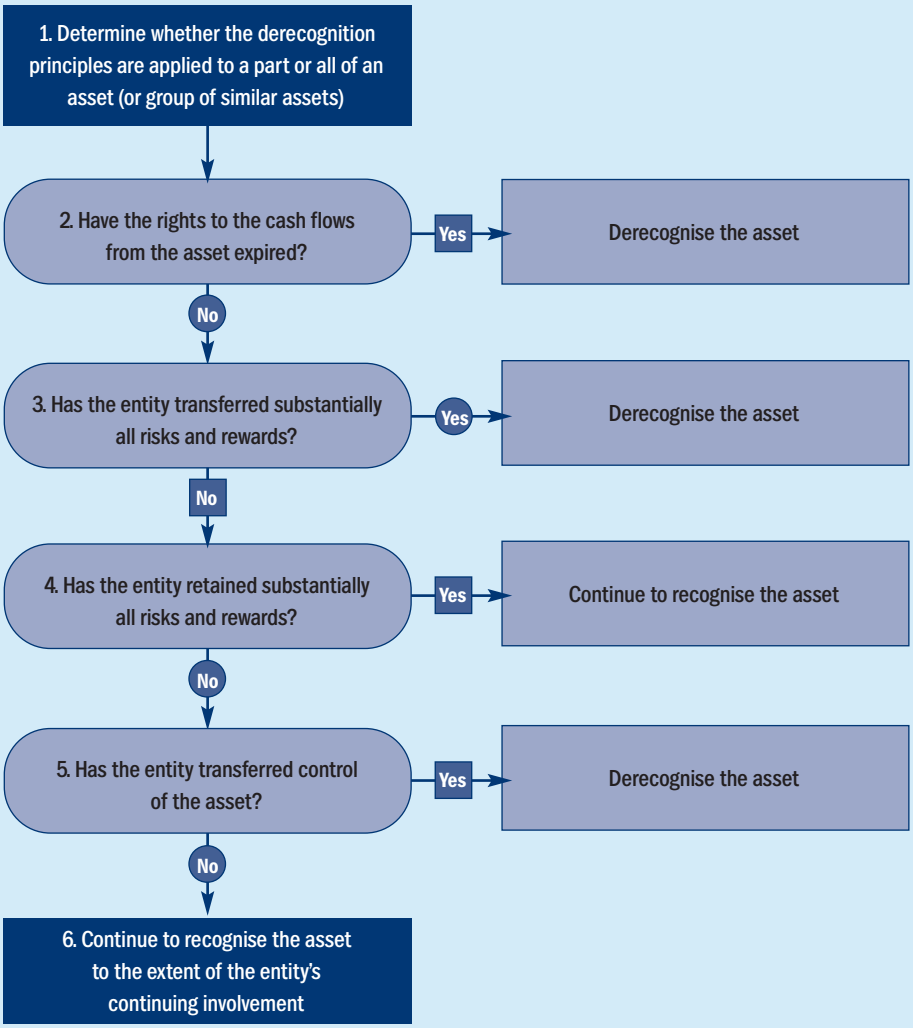
Insert E sets out the accounting treatment.

Hedge accounting for a forecast transaction is only possible as long as the transaction is highly probable. If the transaction ceases to be highly probable and is only probable, then any further gains or losses on the derivative instrument are recognised in the profit and loss account but the amount so far recorded in equity is permitted to remain there until the forecast item occurs. If (and only if) a forecast item is no longer expected to occur, any amounts previously recorded in equity in respect of the hedge must immediately be reclassified to profit or loss.

Insert E: Treatment when hedge accounting is discontinued

Treatment of:	Fair value hedges	Cash flow hedges
1. Future changes in fair value of hedging instrument	Continue to be taken to p&l	Recognised immediately in p&l
2. Changes in fair value of hedged item	Treat as if not hedged For hedges of interest-bearing assets, adjustment to date is amortised to p&l over the period to maturity	N/A
3. Amounts recorded to date in equity: a) hedged item still exists or still expected to occur	N/A	Transferred to p&l at the same time as the change in the hedged cash flows is recognised in p&l
b) hedged item or transaction sold or no longer expected to occur	N/A	Transferred to p&l immediately

Insert F: Simplified flowchart for derecognition



Business consequences

Many entities will find that the IAS 39 hedge accounting rules are considerably more restrictive than those that they have previously applied, with the result that they will report much more volatile earnings and net assets. This will require careful communication to analysts and other stakeholders while, in many cases, debt covenants will need to be renegotiated to reflect these changes.

Derecognition of financial instruments

The IASB has abandoned the derecognition rules that were published in the exposure draft in 2002 and has reverted to the concepts contained in the original IAS 39. Nevertheless, this is the area where the rules have probably changed the most since the original Standard. In this document we first set out the general rules, then the specific application to securitisations.

General rules – sales with "strings attached"

Where an asset is sold, but the sale agreement contains clauses whereby the transferor does not transfer all the risks and rewards, a number of questions need to be asked. These are shown in Insert F, which is a simplified version of the one contained in the Standard to highlight the general rules.

1. Should the derecognition principles be applied to part or all of an asset?

The Standard allows you to consider components of an asset where the cash flows from the asset can be specifically identified, such as where a bond is separated into its principal and interest only strips and one of the strips is sold.

Also, it is possible to derecognise a portion of an asset where any continuing participation by the transferor is strictly proportional to the total cash flows received on the asset. For example, in a debt sub-participation, if the counterparty obtains a right to a 90% share of the cash flows from a loan, the following questions would be applied to 90% of the instrument. However, when an entity transfers the rights to the first or last 90% of cash collections from an asset, ie not on a strictly proportional basis, then the derecognition criteria are applied to the asset in its entirety.

2 Have the rights to the cash flows expired?

If there are no longer cash flows accruing to the entity, the asset would have no value and should be derecognised.

3 Has the entity transferred substantially all risks and rewards?

Examples of where an entity has transferred substantially all the risks and rewards include sales where the transferor retains an option to repurchase at fair value, or a sale with a call or put option which is deeply out of the money. In these cases the asset is derecognised. There is some guidance in the Standard that the net present value of future cash flows before and after the transfer should be considered to determine the extent of risks and rewards which have been transferred.

4 Has the entity retained substantially all risks and rewards?

Repos and stock lending are examples of where an entity retains substantially all the risks and rewards, along with sales with an attached deeply in the money call or put option, sales linked to a total return swap, and loans where the transferor guarantees all the risks. The asset continues to be recognised in full.

5 Has the entity retained control of the asset?

Between the two extremes of questions 3 and 4, where the entity has transferred some of the risks and rewards (eg a sale of a loan with a guarantee of just the credit risk, or a sale of asset with an at the money put or call option), the next question is whether it has lost control of the asset.

Control is defined as having been lost where the transferee has the practical ability to sell the asset to a third party, without imposing restrictions on the sale. The critical question is what the transferee is able to do in practice. If a marketable asset is sold subject to a call option, for instance, the transferee is deemed to be able to sell the asset since it would be able to go back into the market to acquire it, should the transferor exercise the call option. On the other hand, where the market in an asset does not exist or is illiquid, the transferee would have to retain it in case the transferor exercises the option. Since, in practice, many assets are semi-marketable, this test will often be difficult to apply.

Where a non-marketable asset is sold with a written put option, the transferee is deemed to be unable to sell the asset without imposing a similar option, if the put option is "sufficiently valuable".

6 Continue to recognise the asset to the extent of the entity's continuing involvement

If the transferor has transferred some of the risks and rewards but retains control, the asset must be recorded "to the extent of the transferor's continuing involvement". The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in its fair value.

Where the continuing involvement is a guarantee, the entity will continue to record the asset as the lower of the amount of the asset and the maximum amount of the consideration received in the transfer that the entity could be required to repay. In this case, a liability is created for the fair value of the guarantee, plus the guaranteed amount. The fair value of the guarantee is reduced over time in accordance with IAS 18 and the carrying value of the asset reduced for any impairment losses.

Take, as another example, an asset recorded at fair value, which continues to be recognised due to, first, a retained call option and, second, a written put option:

i) The asset will continue to be recorded at its fair value, with the associated liability recorded at the option exercise price less the time value of the option if the option is in or at the money, or the fair value of the transferred asset less the time value of the option if the option is out of the money.

ii) The asset is recorded at the lower of the fair value of the transferred asset and the option exercise price. The associated liability is measured at the option exercise price plus the time value of the option.

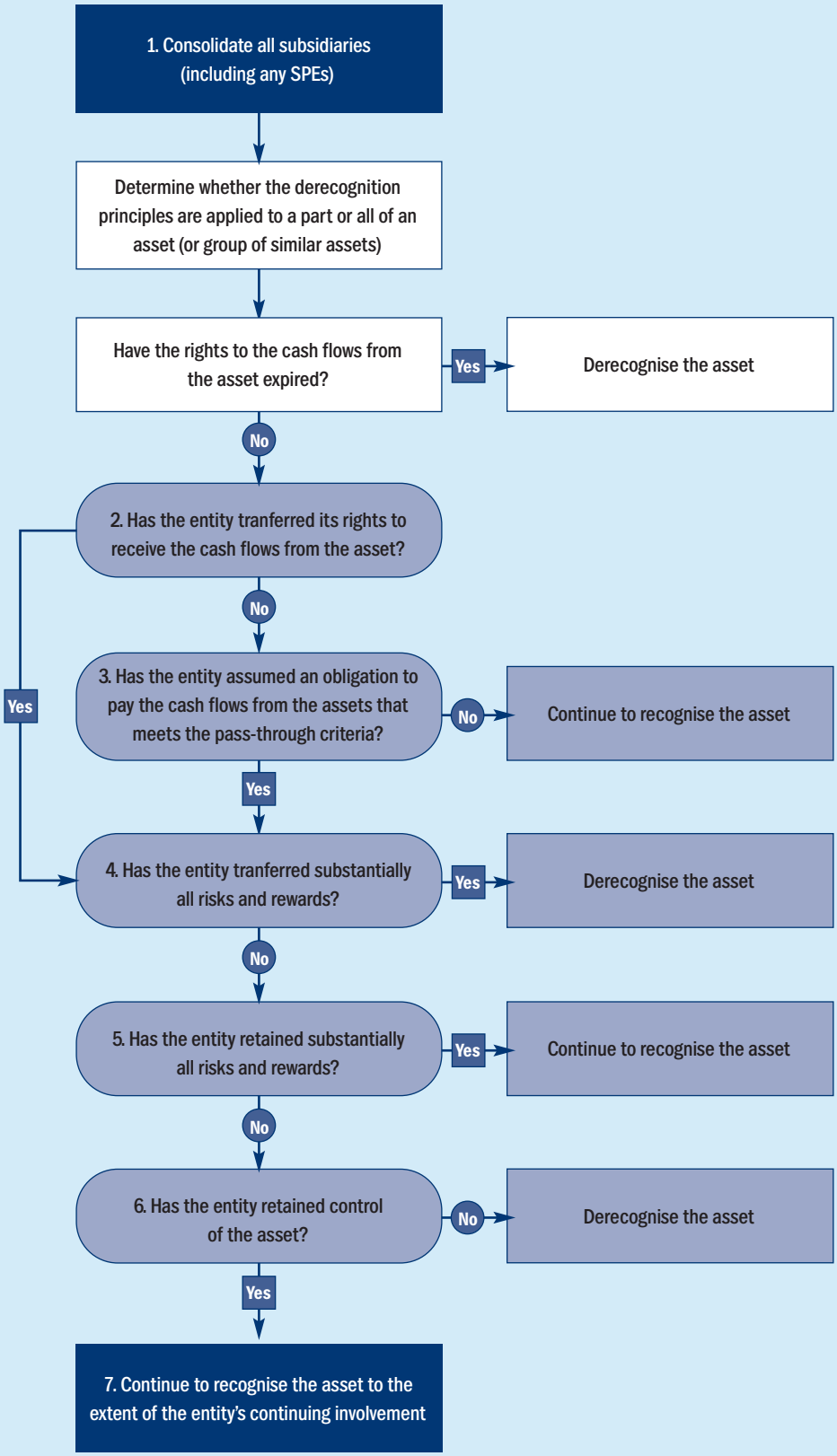
In each case, the liability is recorded so that the net carrying amount of the asset and the liability is equal to the fair value of the rights and obligations retained by the entity.

Similarly, if the transferred asset is recorded at amortised cost, the asset will continue to be recognised, while the liability will be measured so that the net carrying amount of the asset and liability is the amortised cost of the rights and obligations retained.

Recognition of gains and losses on transfer

Where there is only a partial transfer, due to continuing involvement in the asset transferred, the entity is required to allocate the previous carrying amount of the asset between the part it continues to recognise and the part it can derecognise, based on their relative fair values on the date of transfer. The gain or loss to be recorded in profit or loss is the difference between the carrying amount allocated to the part of the asset derecognised and the consideration received (together with any allocated gain or loss previously recorded in equity, if the asset is held as AFS).

Insert G: Flowchart for derecognition of securitisation assets



Derecognition of a financial liability

The rules, as in the original IAS 39, are much more restrictive. A liability can only be derecognised when it is discharged, is cancelled or expires. If the issuer of a debt instrument repurchases it, the instrument is regarded as extinguished, even if the entity is a market maker and intends to resell it in the near term. In addition, an exchange of debt instruments with substantially different terms results in the derecognition of the original debt and recognition of a new one.

Securitisations

In this section the derecognition rules are applied to securitisations and other structures involving special purpose entities ('SPEs'), ie vehicles that may not be legally owned by the entity and are set up to facilitate the issue of debt instruments that transfer some or all the risks and rewards of an asset or group of assets to third parties. The standard includes a flowchart as guidance in this area, this is shown as Insert G.

1 Consolidation of SPEs

The derecognition provisions should be applied to the reporting group, hence an entity must first determine which subsidiaries to consolidate under IAS 27 and SIC 12.

SIC 12 specifically requires that SPEs are consolidated wherever the substance of the relationship indicates that the SPE is controlled by the entity. Indicators of control contained in SIC 12 include where the activities of the SPE are conducted for the specific benefit of the entity, where the entity has the decision-making powers to

obtain the majority of the benefits (even if set up on "auto-pilot") and where, in substance, the entity retains the majority of the SPE's residual ownership risks and/or the majority of the benefits.

Although SIC 12 may in due course be replaced as part of the consolidation project, it will still be in place in 2005. Implicit in SIC 12 is the notion that somebody should consolidate an SPE, since its activities must be conducted on somebody's behalf and so as to meet somebody's business needs! The easiest way to avoid consolidating an SPE is to demonstrate that somebody else has effective control. An exception to this rule, arguably, is where two or more entities can be regarded as having equal effective control, and pool their assets, since there is (as yet) no equivalent of SIC 12 to deal with quasi joint ventures or associates, or any entity where no one person has effective control, such as most mutual funds.

It should be stressed that there is no equivalent in IFRS of a Qualifying SPE as in US GAAP.

2 Has the entity transferred its rights to receive the cash flows from the assets?

The majority of legal sales of assets will involve the transfer of the rights to receive the cash flows. However, in a securitisation there will often be no legal sale of the asset, because either:

i) the rights to the assets are transferred by equitable assignment rather than by a sale; or

ii) because the assets have been sold to an SPE which is required by SIC 12 to be consolidated and so, from the perspective of the group, there has been no sale.

If there has been no transfer of the rights to the cash flows it is necessary to address question 3.

3 Has the entity assumed an obligation to pay the cash flows from the assets that meet the pass-through criteria?

If there has been no transfer of the rights to receive the cash flows, or the SPE needs to be consolidated, the only way of derecognising its assets is if the pass-through test is met. This is where the entity (which will include any consolidated SPE) collects cash flows on the asset and passes them through to another person or persons and fulfils all three of the following requirements:

i) the entity has no obligation to pay amounts to eventual recipients unless it collects equivalent amounts from the original asset;

ii) the entity is prohibited from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows; and

iii) the entity is obliged to remit any cash flows it collects without material delay.

Short term advances by an entity to the transferee, with right of full recourse, do not violate the pass-through criteria. To meet the 'without material delay' clause, the entity is only entitled to reinvest cash collections in cash or cash equivalents, from the collection date to the date of required remittance to the eventual recipients, and interest earned thereon must be passed to the eventual recipients. Where an SPE has to be consolidated, the test will not be met where there are significant timing differences in the maturity of the assets and the maturity of the issued notes. This is because the cash received on maturity of the assets will need to be reinvested for a significant period prior to repayment of the notes. Further, the restriction of reinvestment to cash and cash equivalents means that any structure where there is recycling of monies (ie reinvestment in similar assets, as will happen, for instance, in securitisations involving short term assets) will not qualify.

The impact of this for securitisations involving an SPE is that the assets will need to be recorded on the balance sheet, in full, unless:

i) the SPE is not consolidated; or

ii) the pass-through criteria are satisfied.

Taking SIC 12 and the pass-through test together, a very significant number of securitisation structures will need to be consolidated in full on somebody's balance sheet. While we understand that most banking regulators will, in any event, assess capital requirements based on their own rules rather than on the accounting treatment, this will increase the balance sheet sizes of banking groups but, more importantly, often their customers. This will have a significant effect on gearing ratios.

4 & 5 Risks and rewards

If the pass-through criteria are met by the entity we must then consider whether:

i) it has transferred substantially all of the exposure? If yes, derecognise.

ii) it has retained substantially all of the exposure to the likely variation in cash flows? If yes, continue to recognise the asset entirely.

In securitisation structures it is possible that the entity will have retained substantially all the risks and rewards – eg where the likely losses are not expected to exceed 5% of the assets and the entity retains a junior tranche of the notes and/or equity, which together come to, say, 10% of the notes issued. In this case the entity will need to continue to recognise the asset in its entirety, just as if it had failed the pass-through test. To transfer substantial risks or rewards it will be necessary for the note holders (excluding the entity) to take substantial risk or for another party to do so, such as by providing credit protection, or by taking on significant interest rate risk from the entity.

6 Control

Where the entity has transferred some of the risks and rewards, such as by retaining an equity tranche that does not contain all of the risks and rewards, it has to apply the control question.

As the note holders normally have no power to sell the underlying asset, the transferor will normally be deemed to have retained control.

7 Continuing involvement

As a result, an entity will be required to recognise the asset to the extent of its "continuing involvement", which we assume to mean the value of the equity or any other component retained.

In summary, the group needs to be able to demonstrate:

i) it can satisfy the pass-through test; and

ii) it has not retained substantially all the risks and rewards associated with the asset;

in order to at least achieve partial derecognition.

These requirements are likely to be challenging for many securitisation structures. Examples of the treatment of several finance structures are provided in Appendix B to this publication.

Transition

For those entities already using IFRS there is no requirement to recognise any assets previously derecognised under the old IAS 39 before 1 January 2004, although it can elect to from any date of its choosing provided it has the necessary information.

The rules for first time adoption of IFRS allows "grandfathering" of any derecognition of assets that had been achieved under the previous GAAP before 1 January 2004, but with the very important caveat that all SPEs that require consolidation under SIC 12 shall, in any event, be consolidated

Debt v equity

Because of the definition of a financial liability, an equity instrument can have no contractual obligation either to deliver cash or another financial asset, or to exchange financial instruments with another entity under conditions that are potentially unfavourable. This has particular implications for preference shares and shares in mutual funds and co-operatives.

Preferred shares

The particular rights attached to preferred shares must be assessed carefully in determining whether they should be classified as equity or a liability.

- Redeemable preference shares, where redemption is mandatory or at the holder's option, are treated as liabilities because the issuer has an obligation to the holder – an inability to meet the obligation does not negate it.
- If redemption is at the issuer's option, or the preference shares are non-redeemable, then the rights to distributions are critical. It now seems, from the revised text of IAS 32, that if distribution is in any way at the discretion of the issuer, then the shares will be classified as equity because there is no obligation to pay the distribution. Past history, intent and financial strength are not relevant to the classification. If, for example, there is a requirement for the issuer's board to approve dividends, then an obligation is not established until such approval is given. It appears that the requirement for board approval may be sufficient for such shares to be classified as equity.

As a result we expect that many more preference shares will be treated as equity, than under the original IAS 32.

Mutual funds and co-operatives.

Shares in mutual funds and co-operatives are liabilities, as they

can be redeemed. This is new to the revised IAS 32. The IASB has provided illustrations of how a mutual fund or co-operative should present their accounts. Where there is no equity the balance sheet could look (in summary) as follows:

Non-current assets	X
Current assets	X
Total assets	X
Current liabilities	(X)
Non-current liabilities excluding net assets attributable to unit holders	(X)
Net assets attributable to unit holders	X

The example income statement treats distributions to unit holders as a finance cost and labels the bottom line "change in net assets attributable to unit holders".

The example balance sheet where there is some equity looks (in summary) like this:

Non-current assets	X
Current assets	X
Total assets	X
Current liabilities	(X)
Share capital repayable on demand	(X)
Total assets less current liabilities	X
Non-current liabilities	X
Reserves (eg retained earnings)	X
	X
Memorandum note – Total members' interests	
Share capital repayable on demand	X
Reserves	X
	X

The "dividend" paid on any instrument treated as a liability is recorded as an interest charge rather than as a dividend.

Ownership by an entity of its own shares is never an asset of that entity. As treasury shares, they are deducted from equity, and any gains and losses are taken to equity. This will cause significant problems for market making activities and where an entity's own equity is held as a hedge of a derivative.

Some instruments have both a liability and equity component – eg convertible bonds. In the revised IAS 32 the fair value of the liability at inception (excluding the conversion option) must be classified in the liability section of the balance sheet and the residue of the issue proceeds is recorded in equity.

In the revised Standard the definitions of a financial asset or liability have been extended to include:

i) any non-derivative contract that can be settled by a variable amount of an entity's own equity instruments, so that the value of the shares to be delivered is always equal to a fixed sum (so that the holder has no equity risk); or

ii) a derivative on the entity's own equity that can be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of equity shares.

The accounting treatment depends primarily on the method of settlement, whether gross (ie with the underlying equity being transferred) or net (with settlement of the gain or loss on the transaction in cash or shares), and whether either the issuer or the counterparty has the choice of gross or net settlement.

Contracts involving an entity's own equity

Insert H: Contracts involving an entity's own equity

Derivative contract	Gross physical settlement	Net settlement (net cash or net shares)	Issuer/counter party choice of gross or net settlement
Forward to buy	L	D	L
Forward to sell	E	D	D
Purchased or written call	E	D	D
Purchased put	E	D	D
Written put	L	D	L
Total return swap	–	D	–

Items labelled "D" in Insert H are to be treated as derivatives and held at fair value, with gains or losses taken to profit or loss.

Items labelled "E" are treated as equity. Therefore, for instance, the premium on a written call option requiring gross settlement will be recorded as equity.

For any item with an "L" in the above table, an amount equal to the present value of the amount that could be paid out needs to be reclassified from equity to a liability of the entity, since it will no longer meet the definition of equity.

In practice, firms will need to look very closely at any transactions involving their own equity, to ensure that they do not suffer significant income volatility or equity erosion as a result of these new requirements.

Trade date v settlement date

IAS 39 and 32 require financial instruments to be recorded from their trade date, except for "regular way trades". These are bonds or equities that settle according to the normal rules of an exchange. They may be accounted for either on a trade date basis or a settlement date basis. In the latter case, they still need to be measured for the gain or loss from trade date if measured at fair value, even though they are only recognised in the balance sheet when they settle.

Offset

A financial asset and liability can only be offset when an entity:

- has a legal right of offset (as in a derivative master agreement); and
- intends to settle on a net basis, or to realise the asset and liability simultaneously (eg through the operation of a clearing house).

Since they are not expected to be settled simultaneously, a number of swaps entered into with the same counterparty will normally need to be recorded gross in the balance sheet, with profitable swap as assets and loss-making swap as liabilities. This will cause many firms' balance sheets to be significantly grossed up under IFRS.

Effective date of IAS 32 and 39

The effective date of the Standards will be financial years beginning on or after 1 January 2005, although early adoption is permitted as long as both new Standards are adopted early, in full.

Transition rules and first time adoption

While the Standards must, in general, be applied retrospectively, as already mentioned the new derecognition rules will only apply to assets or liabilities derecognised on or after 1 January 2004. (Although, the new derecognition rules can be applied retrospectively if the entity chooses to do so). However, firms will need to apply SIC 12 and consolidate any SPE they control.

While designation as FVP can normally only be made on initial recognition, entities are able to make this selection, retrospectively, when the new IAS 39 is first applied. In this case, all financial instruments re-designated must be reflected in the comparative financial statements and disclosure of the amounts and original classification given.

The following rules are set out for first time adopters:

- Comparative figures need not be restated for IAS 32 and 39 if 2005 is the first year of adoption. Therefore, for instance, for an entity with a calendar year accounting period, hedges will only need to be designated by 31 December 2004. However, in practice, many firms may see a need to set their date of transition as 1 January 2004 and produce their 2004 comparative numbers in accordance with IAS 32 and 39, either to satisfy market needs by providing comparative information, or as a badge of accounting competence!
- All assets and liabilities should be classified according to the categories of the Standard. All assets and liabilities classified as available for sale or FVP, including all derivatives, must be recorded at their fair value in the balance sheet at the date of transition. All other financial assets and liabilities must be recorded at their amortised cost. The net gain or loss is recorded as an adjustment to retained earnings, except for the extent to which the fair value of an AFS asset differs from its

amortised cost, which is recorded in a separate component of equity.

- Any amounts previously deferred as assets or liabilities in respect of hedges should be reversed against retained earnings.
- Hedge accounting will only be applied to transactions at the date of transition where the hedge is eligible for hedge accounting under IAS 39 and such items were previously designated as such. They do not need to have been documented and tested for effectiveness before transition date.
- After the date of transition, gains and losses on the hedging instrument qualify for hedge accounting treatment only where the hedges fully meet the criteria in IAS 39. Therefore, it will be necessary, in practice, to document and test effectiveness etc, before the date of transition, to ensure that hedge accounting can be fully achieved once the new financial year starts.

There is also a requirement in IFRS 1 to produce three reconciliations on first time adoption, assuming that the entity does not apply IAS 32 and 39 for the 2004 comparative numbers:

i) the closing balance sheet at 31 December 2003 under local GAAP and the opening balance sheet at 1 January 2004 under IFRS excluding IAS 32 and 39;

ii) the closing balance sheet at 31 December 2004 under local GAAP and the opening balance sheet at 1 January 2005 under IFRS; and,

iii) the closing balance sheet at 31 December 2004 under IFRS excluding IAS 32 and 39 and the opening balance sheet at 1 January 2005 under IFRS including IAS 32 and 39.

APPENDIX A – Change in estimation of the expected life of a bond recorded at amortised cost

As an illustrative example of where estimates used to calculate effective yield are adjusted, take a bond with a principal value of 100,000 which pays 5% coupon per year for the first two years and 7% thereafter, but has an option to prepay or extend at the end of year 4. If the holder of the bond originally does not anticipate the cash flows extending beyond year 4, the effective interest rate would be 5.942% and the interest income for each period would be as follows:

	Balance b/f	Expected cash flows	Interest income at effective rate	Balance c/f
Year 1	100,000	5,000	5,942	100,942
Year 2	100,942	5,000	5,999	101,941
Year 3	101,941	7,000	6,057	100,998
Year 4	100,998	107,000	6,002	0

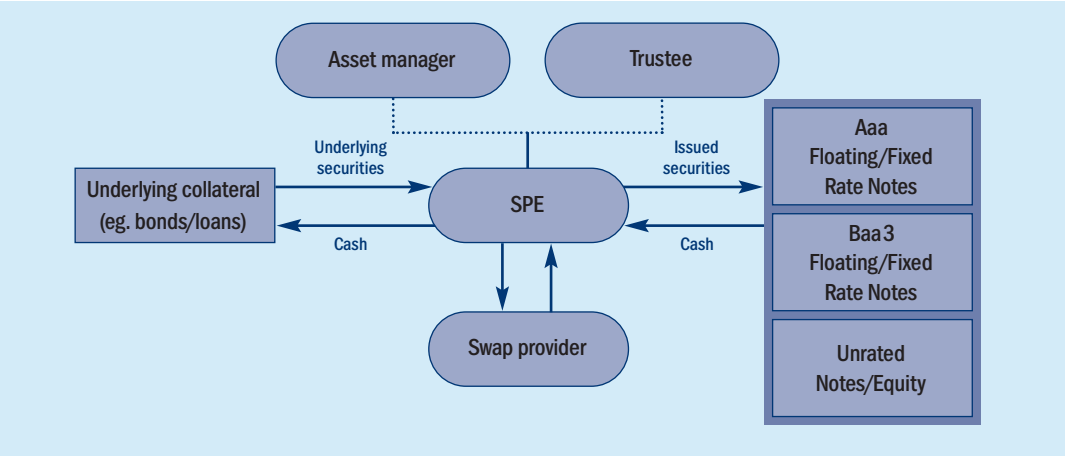
Next, assume that at the end of year 2, the expected cash flows are revised so that the bond life is re-estimated to the end of year 5. The effective interest rate is kept constant at 5.942%, which means that the holder would recognise a catch up credit to income, at the end of year 2, of 889.

	Balance b/f	Expected cash flows	Interest income at effective rate	Catch up	Balance c/f
Year 1	100,000	5,000	5,942		100,942
Year 2	100,942	5,000	5,999	889	102,830
Year 3	102,830	7,000	6,111		101,941
Year 4	101,941	7,000	6,057		100,998
Year 5	100,998	107,000	6,002		0

This method was chosen by the IASB mainly because it is logical and straightforward to apply, while being consistent with the impairment methodology.

APPENDIX B – Accounting analysis of certain financing structures using SPEs

Collateralised Debt Obligations (CDOs)



Overview of structure

Collateralised Debt Obligation (CDO) structures are created for two distinct purposes:

- balance sheet CDOs are initiated by the holders of assets, such as commercial banks, to raise funds or transfer the risk of assets; and
- arbitrage CDOs are initiated to provide equity investors with a leveraged return between the return on assets and financing costs.

A typical structured CDO would include the following features:

- the assets are transferred directly to the SPE by the arranger, or sourced directly from the market;
- these assets are actively managed within predetermined guidelines;
- the SPE will enter into a swap transaction to modify the cash flows;
- the note holders will receive a market interest rate and their note is secured on the underlying portfolio of assets; and
- the structure will include several tranches of debt from the AAA notes to the subordinated debt piece, which, along with the equity will absorb the "first loss" on the underlying assets. Consequently the risks of the different note holders will vary.

Accounting Analysis – applying the flow chart

The accounting analysis requires an assessment of the relative positions of the arranger, the swap provider, the asset manager and the note holders. Generally a number of these roles will be played by a single organisation and the arranger may also be an investor. For different combinations of roles and different priority of payments within a structure the accounting analysis will vary. Therefore, we provide below an indication of the key factors that should be considered in determining who should consolidate the SPE and whether the transferor can derecognise assets transferred to the SPE.

Consolidation of the SPE?

The consolidation issue is the most significant challenge when assessing a CDO structure. Indicators of control over the vehicle must be assessed for each significant party:

- If the party that transferred the assets to the vehicle owns a majority of the equity or purchased subordinated debt it will be hard for the transferor to prove he does not control the vehicle.
- The asset manager has significant discretion, within the operating guidelines of the structure, to buy and sell assets. If there is a significant performance related fee, so that the asset manager is exposed to the variability of earnings, this may suggest he has the majority of risks and benefits of the structure and therefore should consolidate it. He may also be an equity investor.
- In order to demonstrate that the swap provider does not have control the swap must be transacted at the current market rate and the cash payments be sufficiently senior in the cash flow waterfall so the provider is not subject to significant risks and benefits of the vehicle.

Has the entity transferred its rights to receive cash flows from the assets?

The transfer of assets into the SPE may be through a true sale of the underlying instrument or by equitable assignment. Should the transferor consolidate the SPE then even if the transfer is through a true sale, the group will still be entitled to the cash flows from the asset and so would need to satisfy the pass-through criteria. However, if the transferor is not required to consolidate and if the transfer is a true sale, the pass-through criteria do not apply.

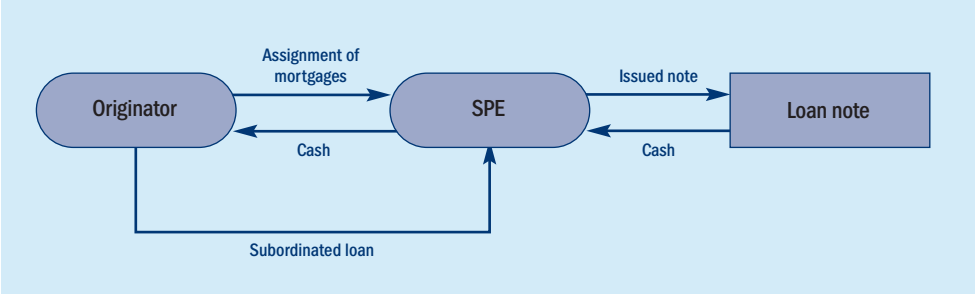
Have the pass-through conditions been met?

For the party who controls the vehicle, the pass-through conditions must be met from the perspective of the reporting group. Therefore, cash received on the underlying assets must be passed on to the note holders without material delay and cannot be reinvested, except in cash and cash equivalents and any interest passed to the eventual recipients. CDOs may fail to meet the pass-through structure as during certain stages of the CDO's life, cash is accumulated and used to pay fees or purchase different assets during the reinvestment period.

Has the entity transferred substantially all the risks and rewards?

To determine whether the transferor has transferred substantially all the risks and rewards of the underlying assets will require a detailed assessment of the position of the transferor of the assets, the swap provider, the asset manager and the note holders, before and after the transfer. The key considerations are outlined above and depending on the circumstance will result in different accounting treatments.

Residential Mortgage-Backed Securitisations



Overview of structure

Residential Mortgage-Backed Securitisations are executed by an originator for funding, capital relief and, in some situations, risk transfer. A typical structure would include the following features:

- the originator transfers the residential mortgages to the SPE by equitable assignment, at an agreed value plus an amount of deferred consideration;
- the deferred consideration enables the excess profit in the SPE to be transferred back to the originator;
- the structure is credit enhanced by a subordinated loan from the originator to the SPE;
- the originator continues to administer the loans under a servicing agreement for an arm's length fee (and from the mortgagee's perspective there is no change in the relationship with the originator); and
- the SPE issues loan notes secured by the mortgages to third parties who receive a market interest rate for their investment.

Accounting analysis – applying the flow chart

The accounting analysis requires an assessment of the relative positions of the originator and purchaser of the notes.

Consolidation of the SPE?

The originator is exposed to the first loss of the SPE through its subordinated loan, while it also receives the excess spread through the deferred consideration. Therefore, the originator has "rights to the majority of the benefits and may be exposed to risks incident to the SPE" and would probably consolidate the vehicle.

Has the entity transferred its rights to receive cash flows from the assets?

No, the originator continues to receive the underlying cash flows on the mortgages.

Have the pass through criteria been met?

As the originator has to consolidate the SPE, the pass-through criteria need to be considered from the perspective of the group.

The cash flows received by the SPE are only paid out to the note holders as they are received. There will be a timing mismatch as collection of cash on the underlying mortgages is determined by the loan agreement with the mortgagees but the coupon on the loans and their principal repayment will be structured for periodic payments. So long as the cash is merely held until the next coupon date this will not be considered a 'material delay'. Any short term reinvestment of this cash must be in cash or cash equivalents and interest earned on the reinvestment passed to the note holders. If such interest is not paid to the note holders, or if there is 'material delay', then the loans will need to be recognised, in full.

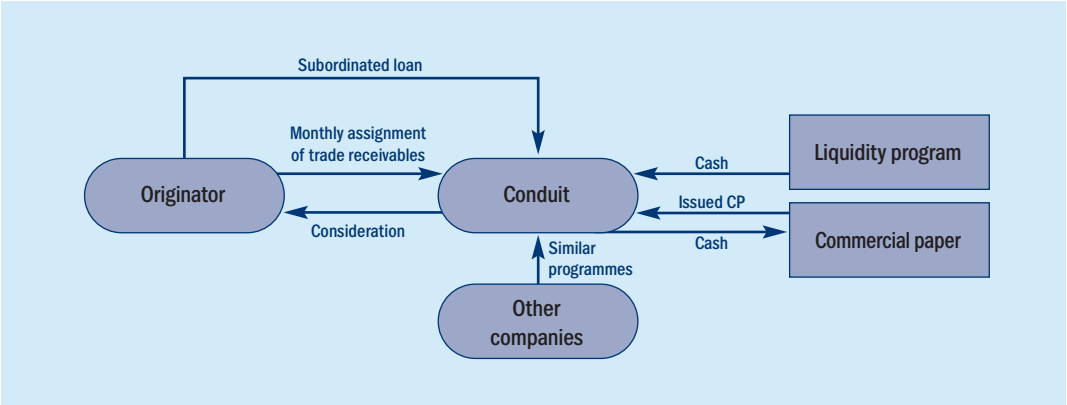
Another area of concern may be the excess spread that forms part of the originator's deferred consideration, in particular if it is collected in the vehicle and repaid at the wind up of the structure. This could be seen as contravening the 'material delay' condition. Careful structuring may be able to avoid this issue.

Has the entity transferred substantially all the risks and rewards?

Given that the originator is exposed to the first loss and receives the excess spread, it is unlikely to be considered to have transferred substantially all the risks and rewards. Take an example, where the subordinated loan is set at 5% of the value of the loan notes. If there is evidence that the risk of loss inherent in the mortgages is considered to be less than 5% then substantially all the risks and rewards will have been retained unless it can be demonstrated that another type of risk, eg interest rate risk, is significant and has been transferred. Otherwise all the loans should continue to be recorded in the balance sheet

The securitisation could be structured differently so that subordinated notes are issued to third parties to transfer risk, rather than a subordinated loan being kept by the originator. Nevertheless, the mechanism for extracting deferred consideration may result in the SPE being consolidated under SIC 12 and as a result the pass-through criteria will probably not be met.

Trade receivables



Overview of Structure

This structure provides the originator with low cost funding as the credit risk of the commercial paper is linked to the quality of the receivables rather than the originator's corporate credit rating. Further, it helps to diversify the funding sources and can limit the originator's exposure to the risk of the assets.

These structures are frequently sponsored by banks who put in place the conduit vehicle and then get paid a market fee for arranging liquidity and other facilities to the vehicle and arranging the programme. A typical structure would include the following features:

- the originator equitably assigns a portfolio of short term trade receivables to the conduit at par, each month. The sale is non-recourse to the originator;
- the originator makes a subordinated loan to the conduit, which has the effect of covering a certain level of losses on the assets;
- collections on the assets are used to purchase new assets from the originator. The originator will continue to service the receivables under a servicing agreement; and
- the conduit issues commercial paper (CP). The CP holders receive a market rate of interest, the paper is secured on the trade receivables portfolio and the CP is repaid out of collections with priority over the subordinated loan.

Two distinct variations of this structure are common:

a) where each CP programme is specifically linked to the trade receivables from an individual transferring company, with no access to risks or benefits of other companies' assets being transferred to the conduit. This is more common for credit card receivables and large company trade receivables; and

b) where the CP programme is linked to all the assets transferred by a number of transferring companies and there is no direct linkage to any specific transferring company's assets. Instead the CP is secured on the total assets.

Accounting Analysis

Consolidation of the SPE?

In variation a) above, the conduit is used by a number of companies but each CP programme is separate, so that CP holders are only exposed to the assets that back their specific programme. Each programme is therefore treated as a separate 'protected cell'. The originator must consider whether it needs to consolidate its individual cell. This is likely since the subordinated loan means that each originator retains significant risks and benefits from the low cost of funding.

In variation b) above, there is no linkage between the CPs and the specific assets of each originator. Each originator does not control the vehicle. More at risk of consolidation could be the sponsoring bank, who must ensure that all the services it provides are strictly at arm's length market rates and do not lead to indicators of control.

Has the entity transferred its rights to the cash flows?

The underlying cash flows on the receivables still flow to the originator.

Have the pass through conditions been met?

a) If the conduit cell needs to be consolidated then this question needs to be answered from the point of view of the originator and the conduit cell. The cash received on receivables are transferred to the vehicle as they arise. It is then used to repay CP or to reinvest in additional receivables. Because the cash received will be used to purchase new assets from the originator, from the perspective of the group, the pass through criteria are unlikely to be met.

b) If the conduit cell does not require consolidation, the pass through test needs only to be satisfied by the originator. It passes all monies it receives to the conduit, without delay, and so probably meets the criteria. However, if collections on the assets are automatically used to purchase new assets from the originator then the criteria of remittance without material delay will probably not be met.

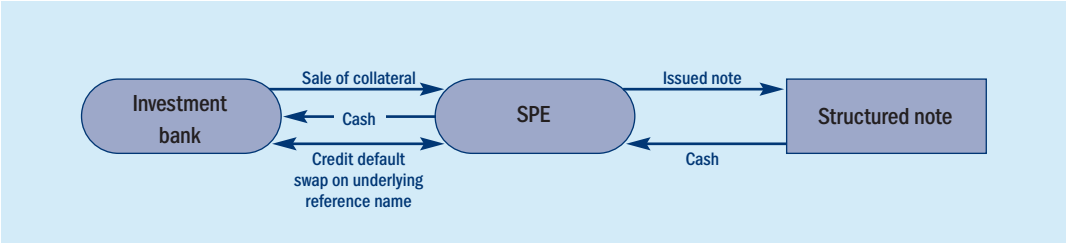
Has the entity transferred substantially all the risks and rewards?

Even if the pass through criteria are met, if substantially all the risks are retained, through the subordinated loan, then no derecognition will be possible. If the subordinated loan is set at a level where some risk is, in practice, transferred to the CP holders (so that the originator does not retain substantially all the risks and rewards), then we must consider who controls the asset.

Has the entity transferred control of the asset?

As the note holders normally have no power to sell the underlying asset, the transferor will normally be deemed to have retained control. As a result, the entity will be required to recognise the asset to the extent of its continuing involvement. In this example this will mean continuing to recognise the asset to the level of the subordinated loan.

Credit Linked Notes



Overview of structure

These structures are usually set up by an investment bank, on behalf of a client who buys the entire note issue. The investor achieves exposure to, and earns returns commensurate with, the underlying credit name in a way that matches the investor's specific requirements, eg in terms of maturity, currency and fixed/floating coupon.

A typical structure would include the following features:

- the SPE issues the note to the investor. The investor receives a return commensurate with the risk of the reference name and is at risk of losing the principal amount if there is a 'credit event' on the underlying reference name;
- the proceeds are used to purchase high quality collateral, for example government bonds; and
- the investment bank enters into a credit default swap with the SPE through which the SPE receives the additional coupon to pay the note holder, in excess of the income on the government bonds. The SPE pays the investment bank nothing unless there is a 'credit event' on the underlying reference name which will normally be based on standard ISDA definitions. If there is a credit event then the nominal value of the note will be paid to the investment bank.

Accounting Analysis

Consolidation of the SPE?

The structure will be set up on 'autopilot' by the investment bank. To prove it does not control the vehicle, the bank would need to demonstrate that the swap was transacted at market rates so that it does not have the "rights to the majority of the benefits ….". The exact circumstances of the transaction will determine whether the SPE is consolidated.

Have the entity transferred its rights to receive cash flows from the asset?

If the investment bank does not control the SPE then it must assess whether the sale of collateral to the SPE was a true sale. This will generally be the case.

Have the pass-through criteria been met?

If the investment bank does control the SPE then the pass-through criteria will need to be considered from the perspective of the group. The cash flows from the SPE will only be paid out to the noteholders as they are received. There will be a timing mismatch between collections on the underlying assets and interest and principle payments on the notes. So long as the cash is only aggregated to the next coupon date and all interest is paid to the noteholders, then this will not be considered a material delay and the pass-through criteria would be met. The credit default swap will probably meet the definition of a derivative and be recorded at fair value.

If you would like to discuss any of these proposals in more detail, please contact your normal Ernst & Young contact or

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