



International Accounting Standards Board®

Press Release

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INTERNATIONAL ACCOUNTING STANDARDS BOARD ISSUES REVISED STANDARDS ON FINANCIAL INSTRUMENTS

The International Accounting Standards Board (IASB) today issued revised versions of its two Standards dealing with financial instruments. IAS 32 deals with the disclosure of financial instruments and their classification as debt or equity. IAS 39 deals with recognition, derecognition, measurement and hedge accounting.

The release of these revised Standards is part of the IASB's initiative to improve fifteen of the Standards that it inherited from its predecessor body (the International Accounting Standards Committee—IASC), in time for them to be used by companies adopting International Accounting Standards for the first time in 2005.

These two accounting standards provide comprehensive guidance on the accounting for financial instruments. The need for such guidance is crucial. Financial instruments are a large part of the assets and liabilities of virtually every company, in particular financial institutions. They also play a central role in the efficient operation of financial markets. As an illustration of the importance of financial instruments, at the end of June 2003, the Bank for International Settlements estimated that the total estimated notional amount of over-the-counter (OTC) derivatives contracts stood at US\$169.7 trillion with a gross market value of \$7.9 trillion.

Financial instruments, including derivatives, can be useful tools for managing risk. But they can also be very risky themselves. In recent years there have been many “disasters” associated with derivatives and other financial instruments, including Barings, (in part) Enron, and others.

The Standards require companies to disclose their exposure to financial instruments and to account for their effects—in most cases as they happen, rather than allowing problems to be hidden away. In particular, IAS 39 requires derivatives to be reported at their ‘fair’ or market value, rather than at cost. This overcomes the problem that the cost of a derivative is often nil

or immaterial and hence if, derivatives are measured at cost, they are often not included in the balance sheet at all and their success (or otherwise) in reducing risk is not visible. In contrast, measuring derivatives at fair value ensures that their leveraged nature and their success (or otherwise) in reducing risk are reported.

The former IASC began work on the original Standards fifteen years ago and issued IAS 32 in 1995 and IAS 39 in 1999. Both Standards were in existence in 2000 when the European Union unanimously agreed to require European listed companies to adopt International Financial Reporting Standards (IFRSs), including International Accounting Standards. The revised Standards improve the previous versions by reducing complexity, clarifying and adding guidance, eliminating internal inconsistencies and incorporating elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance published by the former Implementation Guidance Committee (IGC) set up by IASC. In revising IAS 32 and 39, the IASB did not reconsider the fundamental approaches contained in them. To do so would have resulted in a delay of several years in the production of a new Standard. The requirements in IAS 32 and IAS 39 are very similar to those in equivalent US Standards. The improvements further converge with US GAAP by eliminating ten differences between the two sets of standards.

The IASB has conducted extensive due process in developing the improvements issued today. This includes:

- publishing an Exposure Draft in June 2002 on which the IASB received over 170 comment letters
- conducting nine roundtable discussions in March 2003, in which over a hundred organisations and individuals took part
- discussions with the Standards Advisory Council and the IASB's partner standard-setters
- many meetings with constituents
- discussions about the issues raised on the exposure draft in every Board meeting from March to October 2003. In total, the IASB considered 61 agenda papers about issues raised on the exposure draft, amounting to over 1200 pages.

There was one issue that emerged from the consultation process for which the IASB decided that a further exposure draft was required. The issue was the use of fair value hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as ‘macro hedging’). The IASB published a further exposure draft on this one aspect of IAS 39 in August 2003, with a comment deadline of 14 November. The IASB has received over 120 comment letters and is in the process of finalising its proposals. However, in order to help those companies preparing to adopt the revised IAS 32 and IAS 39 in 2005, the IASB decided not to delay the completion of the rest of the Standards for this one issue to be resolved. Accordingly, the IASB is publishing the revised Standards now, subject to any changes that it might make for macro hedging. Any such amendments to IAS 39 for macro hedging will be issued early next year.

Introducing the Standards, Sir David Tweedie, IASB Chairman, commented,

“With thousands of companies being required to implement international standards it is essential that implementation is made easier. The improvements to the existing IASs 32 and 39 facilitate this for financial instruments and also introduce additional guidance based on extensive discussions with constituents. In a world in which financial instruments are being used ever more extensively, are becoming exceedingly complex and are often a source of confusion for investors, it is essential to have working standards in place, with appropriate guidance.”

The primary means of publishing International Financial Reporting Standards is now by electronic format through the IASB’s subscriber Website. Subscribers are able to access the standards published today through “online services”. Those wishing to subscribe should contact:

IASCF Publications Department, 30 Cannon Street, London EC4M 6XH,
United Kingdom. Tel: +44 (0)20 7332 2730, Fax: +44 (0)20 7332 2749,
email: publications@iasb.org Web: www.iasb.org.

Printed copies of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* (ISBN 1-904230-33-4) will be obtainable, priced together as a set at £20.00 (€32/US\$31) including postage, from IASCF Publications Department when stocks become available in January.

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NOTES TO EDITORS

1. Attached are two notes. Note A describes the background to the standards on financial instruments and the due process that has undertaken in the development of the accounting standards on this subject. Note B is a brief summary of the contents of IAS 32 and IAS 39.

About the IASB

2. The International Accounting Standards Board (IASB), based in London, began operations in 2001. It is funded by contributions from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 Board members (12 of whom are full-time) reside in nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the Board cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.

3. Upon its inception the IASB adopted the body of International Accounting Standards (IASs) issued by its predecessor, the International Accounting Standards Committee.

NOTE A

Accounting for Financial Instruments

Background and Due Process

Accounting for financial instruments is a difficult and controversial subject. The International Accounting Standards Board's predecessor body, the International Accounting Standards Committee (IASC) began its work on the issue some 15 years ago in 1988. During the next eight years it published two exposure drafts, culminating in the issue of IAS 32 on disclosure and presentation in 1995. IASC decided that its initial proposals on recognition and measurement should not be progressed to a standard, in view of

- the critical response they had attracted,
- evolving practices in financial instruments and
- the developing thinking by certain national standard-setters.

In the meantime, IASC concluded that a standard on the recognition and measurement of financial instruments was needed urgently. It noted that whilst financial instruments were widely held and used throughout the world, few countries apart from the United States had any recognition and measurement standards for them. In addition, IASC had agreed with the International Organization of Securities Commissions (IOSCO) that it would develop a set of 'core' International Accounting Standards that could be endorsed by IOSCO for the purposes of cross-border capital raising and listing in all global markets. Those core standards included one on the recognition and measurement of financial instruments.

In March 1997, IASC, jointly with the Canadian Institute of Chartered Accountants, published a comprehensive Discussion Paper, Accounting for Financial Assets and Financial Liabilities, and invited comments on the proposals therein. IASC held a series of special consultative meetings about those proposals with various national and international interest groups and in numerous countries. Those meetings and analysis of comment letters on the Discussion Paper confirmed that the IASC faced controversies and complexities in seeking a way forward. While some acceptance existed of the view put forward in the Discussion Paper—that measurement of all financial assets and liabilities at fair value was necessary to obtain consistency and relevance to users—application of that concept to some industries and to some kinds of financial assets and liabilities continued to present difficulties. Widespread unease was also evident about the prospect of including unrealised gains, particularly on long-term debt, in income as proposed in the Discussion Paper. Furthermore, while several national standard-setters had undertaken projects to develop national standards on various aspects of recognition and measurement of financial instruments, no country had in place or proposed standards that were similar to the proposals in the Discussion Paper.

Completion of a single comprehensive International Accounting Standard on financial instruments based on the Discussion Paper for inclusion, before the end of 1998, in the core standards to be considered by IOSCO was not a realistic possibility. Nonetheless, the ability to use International Accounting Standards for investment and credit decisions and securities offerings and listings was urgent for both investors and business enterprises. Moreover, while financial instruments are widely held and used throughout the world, only a very few countries had any national recognition and measurement standards at all for financial instruments.

Accordingly, in 1997 IASC decided:

- (a) to join with nine national standard-setters to form a Joint Working Group (JWG) to develop the proposals in the 1997 discussion paper. The ultimate aim was an integrated and harmonised standard on financial instruments that would reflect the best research and thinking on the subject worldwide. IASC recognised that this would take several years to develop. The JWG took the first step in the form of a draft standard published in 2000, before the IASB had been constituted.
- (b) at the same time, to develop an International Accounting Standard on the recognition and measurement of financial instruments that would serve until an integrated comprehensive standard was completed. This standard would be based on US GAAP—the only major GAAP with comprehensive requirements for financial instruments. The result was IAS 39, issued in 1999 after a period of exposure and comment.

In August 2001 the International Accounting Standards Board (IASB) announced, as part of its initial agenda, that it would undertake a project to improve IAS 32 and IAS 39 to simplify application and implementation of the Standards.

The Board invited the IAS 39 Implementation Guidance Committee (IGC) to function as an Advisory Committee to the Board in identifying and reviewing issues that should be addressed. The IGC consisted of senior experts in financial instruments with backgrounds as accounting standard-setters, auditors, bankers, and preparers from a range of countries as well as observers from the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the European Commission.

In June 2002 the IASB published an Exposure Draft of proposed improvements to IASs 32 and 39. In response to the Exposure Draft the IASB received over 170 comment letters. In view of this response, the IASB decided to extend the consultation by conducting a series of roundtable discussions.

Roundtables are not a routine part of the IASB's due-process procedures. Rather, the Board decides to hold these public discussions with constituents when it appears that the development of an accounting standard would benefit from a fuller public discussion of the issues involved. The Board decided to use the roundtable format to allow a free and open exchange of views between the Board and respondents and among respondents who may hold differing views. The Board's ultimate goal was to determine whether there are better alternatives to the principles that underlie IASs 32 and 39 or alternative applications of those principles. The roundtable participants included 108 of the over 170 individuals, companies, regulatory bodies, and other organisations that had commented on the Exposure Drafts of proposed amendments to IAS 32 and IAS 39.

Following the roundtable discussions the Board began the process of public discussions by reviewing the roundtable material with its Standards Advisory Council (the Council) and with its partner national standard-setters.

In March 2003 the IASB began its deliberations, in open Board meetings, of the issues raised on the Exposure Draft, keeping in view the insights obtained from the consultation process. It discussed the issues raised by constituents at every meeting between March and October 2003. In total, the Board considered 61 agenda papers dealing with issues raised on the exposure draft, amounting to over 1200 pages.

The Board has agreed many changes to the proposals set out in the Exposure Draft. In particular:

- For IAS 39, the Exposure Draft proposed 15 main changes. The Board confirmed only six of these as proposed, it has added extra guidance or clarified a further six and it has changed three of its proposals (on derecognition, basis adjustment and reversals of impairment on available for sale assets). It has also made a further seven changes in response to comments received.
- For IAS 32, the ED proposed 21 main changes (many on disclosure). The Board has confirmed 17 of these proposals, rejected one (on using past practice to classify certain derivatives on own shares as either equity or liabilities), and added more guidance on three others. It also made six new changes, primarily adding guidance or disclosure requirements.

There was one issue that emerged from the consultation process for which the Board decided a further exposure draft was required. The issue was using fair value hedge accounting for a portfolio hedge of interest rate risk (sometimes referred to as ‘macro hedging’). The Board issued a further exposure draft on this one aspect of IAS 39 in August 2003, with a comment deadline of 14 November. However, in order to help those companies preparing to adopt the revised IAS 32 and IAS 39 in 2005, the Board decided not to delay the finalisation of the rest of the Standards for this one issue. Accordingly, the Board is issuing now the revised Standards, except for any changes that it might make for macro hedging. Any further amendments to IAS 39 for macro hedging will be issued early next year.

NOTE B

Financial Instruments - An introduction to IAS 32 and IAS 39

This brief introduction summarises and comments on the requirements of IAS 32 and IAS 39, and the background to them. It is not intended to be as comprehensive or precise as the standards themselves, and is not a substitute for them.

What are IAS 32 and 39 all about?

IAS 32 deals with the **disclosure** of financial instruments, and with some aspects of their **presentation** in financial statements (ie when instruments are presented as liability or equity and the information to be given in the notes).

IAS 39 deals with the **measurement** of financial instruments and with their **recognition** (ie when they should be included in financial statements and how they should be valued).

Why do we need standards on financial instruments?

Financial instruments are a large part of the assets and liabilities of virtually every company, especially financial institutions. They also play a central role in the efficient operation of financial markets.

Financial instruments, including derivatives, can be useful tools for managing risk, but they can also be very risky themselves. In recent years there have been many “disasters” associated with derivatives and other financial instruments.

The standards require companies to disclose their exposure to financial instruments and to account for their effects – in most cases as they happen, rather than allowing problems to be hidden away.

What companies do the standards apply to?

The standards apply to all companies reporting under international reporting standards (IFRSs).

What financial instruments do the standards apply to?

Broadly, the standards apply to all financial instruments except:

- those covered by another more specific standard – such as interests in subsidiaries, associates and joint ventures, and post-employment benefits (eg pensions);
- insurance contracts, and certain contracts that are similar in nature to insurance contracts; and
- most loan commitments.

The standards also apply to contracts to buy or sell a non-financial item (such as commodity contracts) where these are not for the entity’s own purchase, sale or usage requirements, but for dealing purposes.

What are the main requirements of IAS 32?

Disclosure

IAS 32 requires disclosure of information to increase users' understanding of why financial instruments are used by businesses and the associated risks. This includes information on:

- the risks associated with the entity's financial instruments
- management's policies for controlling those risks
- the accounting policies applied to the instruments
- the nature and extent of an entity's use of financial instruments
- the business purposes they serve

Presentation by the issuer – debt or equity

IAS 32 adopts definitions of liabilities and equity based on the *Framework for the Preparation and Presentation of Financial Statements*, which contains the governing principles that guide the IASB in its work. It is similar to the frameworks used by many national standard-setters.

- A financial instrument is a liability if it is a contractual obligation to deliver cash or other financial assets. The finance cost of liabilities is accounted for as an expense.
- A financial instrument is equity if it evidences a residual interest in the assets of an entity after deducting all of its liabilities. Payments on equity are treated as distributions, not as expenses.
- Convertible debt (that gives the holder a choice of repayment in cash or in shares) is separated into its debt and equity components. More specifically, it is analysed into an issue of ordinary debt at a discount, and a credit to equity for the conversion right.

As well as ordinary debt, liabilities include mandatorily redeemable shares, such as units of a mutual fund and some preferred shares, because they contain an obligation to pay cash. The Board has worked with the mutual fund industry to develop an acceptable presentation for them that highlights the net assets available for unitholders.

Offsetting

A financial asset and a financial liability shall be offset and the net amount reported in the balance sheet when, and only when, an entity both:

- has a current right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Situations that generally do not qualify for offsetting include master netting agreements, where there is no intention to settle net, and so-called "in-substance defeasance" arrangements where assets are set aside to meet a liability but the entity remains primarily liable.

What are the main requirements of IAS 39?

Measurement

IAS 39 divides financial assets and financial liabilities into five classes with three different accounting treatments, as follows:

- Trading assets and liabilities, including all derivatives that are not hedges, are measured at fair value through profit or loss – all gains and losses are recognised in profit or loss as they arise.
- Loans and receivables are ordinarily accounted for at amortised cost, as are most liabilities.
- Held-to-maturity investments are also accounted for at amortised cost.
- All other financial assets are ordinarily classified as available-for-sale and measured at fair value, with all gains and losses taken to equity. On disposal, gains and losses previously taken to equity are recycled to profit or loss.
- There is an option to account for any financial asset or liability at fair value through profit or loss.

There are special rules for hedge accounting, described later.

Another aspect of measurement is **impairment** - ie, when and how losses should be recognised in profit or loss on those assets that are not accounted for at fair value through profit or loss. Whenever there is objective evidence of impairment as a result of a past event, impairment should be recognised. Among other things, the standard clarifies that:

- impairment should take into account only losses that have already been incurred, and not those that might happen in future;
- impairment losses on available-for-sale assets are taken from equity and recognised in profit or loss. For equity investments, objective evidence of impairment may include significant adverse changes in the issuer's market position, or a significant or prolonged decline in the fair value of the investment.

The mixed measurement model used in IAS 39 has been criticised for its complexity, and for the volatility that it can introduce. However, most countries already have a mixed measurement basis – notably for trading assets, which are widely measured at fair value through profit or loss. Thus, IAS 39 has not created a mixed measurement model. It has only refined it.

The alternative would have been to measure all financial assets and liabilities on the same basis – either cost or fair value. Cost was rejected because:

- *Most agree that trading assets and liabilities should be measured at fair value.*
- *Fair value is the only measurement basis that can capture the risky nature of derivatives. This information is essential to communicate to investors the nature of the rights and*

obligations inherent in them. Fair value makes the derivatives visible, so that problems are not hidden away.

Many users support requiring all financial assets and liabilities to be measured at fair value, but this was judged to be too big a change to make at the present time.

To the extent that volatility is due to assets and liabilities being measured on different bases, it can largely be mitigated either by using the option to account for any financial asset or liability at fair value, or by hedge accounting.

Hedge accounting

IAS 39 describes two main kinds of hedging relationship and their accounting treatment:

- A **fair value hedge** – in which the *fair value* of the item being hedged changes as market prices change. Changes in the fair value of both the hedging instrument and the hedged item are reported in profit or loss.
- A **cash flow hedge** – in which the *cash flows* of the item being hedged change as market prices change. Changes in the fair value of the hedging instrument are initially reported in equity and transferred to profit or loss to match the recognition of the offsetting gains and losses on the hedged transaction.

It also specifies that a hedge of a net investment in a foreign operation is accounted for in the same way as a cash flow hedge.

Hedge accounting allows entities to depart selectively from the normal accounting treatment and allows losses to be held back or gains to be accelerated. Therefore the following principles have been adopted in order to provide discipline over the use of hedge accounting, and ensure that entities do not have free choice over when to recognise gains and losses:

- The hedging relationship has to be defined by designation and documentation, reliably measurable, and actually effective.
- To the extent that a hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in profit or loss at the same time.
- All hedge ineffectiveness is recognised immediately in profit or loss.
- Only items that meet the definitions of assets and liabilities are recognised as such in the balance sheet.

Hedge accounting for internal hedges is not permitted, because internal transactions are eliminated on consolidation – the entity is merely dealing with itself. However, internal hedges are often used as a route to the market, via an internal treasury centre. IAS 39 clarifies what needs to be done in order to achieve hedge accounting in this case.

What are the transitional arrangements?

Many entities will be adopting IFRS for the first time in 2005. The most significant transitional arrangements for them are:

- Non-derivative financial assets and financial liabilities that were derecognised prior to 1 January 2004, remain derecognised. This gives a “safe harbour” for securitisation and other transactions that have led to derecognition in the past.
- Comparative information in the first year of adoption need not comply with IAS 32 and 39 but may, in these respects, continue to be prepared in accordance with the entity’s previous GAAP.
- Adjustments are made to the opening balance sheet (including retained earnings) at the date of first compliance, in order to measure all recognised financial assets and financial liabilities in accordance with IAS 39.
- Entities can designate financial instruments as at fair value through profit or loss or available-for-sale on the date they first comply with IAS 32 and 39.
- Existing hedges are eligible for hedge accounting (both for the restated opening balances and subsequently) only if they are properly designated and documented as such no later than the date of first compliance, and otherwise qualify for hedge accounting under IAS 39.

Improvements

IAS 32 and 39 have been revised by the Board as part of its improvements project. The purpose of the review was not to reconsider the fundamental approach to accounting for financial instruments. Rather, the objectives were to reduce complexity by clarifying and adding guidance, eliminate internal inconsistencies, and incorporate into the standards key elements of existing Standing Interpretations Committee (SIC) guidance and IAS 39 implementation guidance. Some of the more significant improvements are:

- There is new guidance on when contracts on an entity’s own equity are liabilities.
- Most loan commitments are now excluded from the scope, and so do not have to be measured at fair value.
- The loans and receivables category is expanded to include purchased loans and receivables (as well as originated ones), recognising that originated and purchased loans are often managed together.
- New guidance is given on the calculation of effective interest rates.
- The derecognition rules have been substantially rewritten to clarify their application.
- Entities have the option to designate at inception any financial instrument as fair value through profit or loss.

This option gives entities the opportunity to simplify the application of IAS 39 in many ways - reducing the need for hedge accounting, eliminating the need to separate embedded derivatives, and eliminating the problems that arise when matched positions of assets and liabilities are not measured consistently.

- There is expanded guidance on the measurement of fair value to facilitate implementation.

- There is clarification that impairment uses an ‘incurred loss’ model rather than an ‘expected loss’ model, and additional guidance on measuring impairment.
- Hedges of firm commitments are now accounted for as fair value hedges, rather than cash flow hedges. This change converges with US GAAP.
- Entities have the option to use the ‘basis adjustment’ method for hedges of forecast transactions that will result in the recognition of a non-financial asset or non-financial liability. Under this method, deferred gains and losses on the hedging instrument are treated as an adjustment to the cost of the acquired asset or liability.
- The Board has worked with the banking industry to develop proposals that would allow fair value hedging for a portfolio hedge of interest rate risk (a macro hedge). These proposals have been published in the exposure draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* and are in the process of being finalised by the Board.