

IASB IAS 32-39 ROUNDTABLE DISCUSSIONS SUMMARY OF SESSIONS ON 10-13 MARCH 2003

A. INTRODUCTION AND OVERVIEW

The notes below represent an observer's notes from the IASB roundtable discussions and do not represent official minutes of the IASB or views of Deloitte Touche Tohmatsu. Therefore, the information contained within should not be relied on.

The purpose of the IASB roundtable discussions is to provide the opportunity for the Board and constituents to meet and discuss issues raised in the comment letters on the IASB's exposure drafts on IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*. Such roundtable discussions are not decision-making meetings of the Board. Rather, they are intended to help increase the Board's understanding of various constituent views and, hopefully, lead to mutually acceptable solutions.

Moreover, by their nature, the roundtables provided an opportunity for the IASB's constituents primarily to air their concerns and disagreements with both the existing IAS 32 and IAS 39 and the amendments to those standards proposed by the Board. Because of the very limited time given to each participant, there was little presentation or discussion on areas of agreement. Therefore, the notes below are biased toward an enumeration of perceived problems without a counter-balance of supportive views.

There were nine sessions of roundtable discussions, each with a different group of constituents. However, all of the discussions covered similar topic areas and the issues raised in each session generally were similar, with the exception of the last two sessions, which were dedicated to discussion of issues related to insurance companies. This memorandum covers the first seven sessions. The last two sessions devoted to insurance issues will follow in a separate memorandum.

Rather than provide a summary of each of the seven discussions separately, this memorandum first lays out the format followed for all discussions and identifies which of the Board members participated at each discussion. The broad industry affiliations of the outside participants also are included. That is followed by a summary by topical area of the key discussion points that occurred during the week. The purpose of the summary is merely to capture the main issues and perspectives to provide a flavor for the discussion, rather than to provide a transcript or to ascribe views to any particular individual.

HIGH-LEVEL OVERVIEW OF ISSUES

In general, the area of greatest concern to those representing retail banks was hedging. In particular they sought the possibility of hedging the net interest rate position of a portfolio of assets and liabilities as a fair value hedge. Investment banks were less concerned about macro-hedging and more concerned about derecognition. Most wanted a risks and rewards approach to derecognition, but when queried by Board members on a simple derecognition example could not agree amongst themselves what the answer would be under the risks and rewards approach. Thus, this suggestion did not provide the Board with a definitive solution.

Insurance companies were concerned about the interaction of the scopes of IAS 39 and the definition of an insurance contract in the first phase of the IASB's insurance project. In addition, they pushed for the Board to relax its provisions with respect to the held-to-maturity classification for insurance companies to permit them to have assets that were funding insurance liabilities to be accounted for as held to maturity, even though an unforeseen event might require them to sell the assets at some point in the future.

A number of constituents raised issues with derecognition, the portfolio approach to impairment, the so-called fair value hierarchy guidance in IAS 39, and the debt-equity classification. The recurring themes were (each is elaborated later in this memorandum):

- The Board should not move to a continuing involvement approach since it introduces a new approach to derecognition that has not been field-tested. Instead, most supported retaining the guidance in IAS 39 as it is along with the IGCs.

- The impairment approach needs to state definitively that it is an incurred-loss model, and the guidance in the draft standard would need to be revised accordingly. In addition the Board should only provide the objective or principle in the standard and leave the methodology for calculating impairment to develop in practice.
- The wording of the fair value hierarchy is too restrictive with respect to the use of valuation models for determination of fair values.
- The debt-equity guidance is inconsistent with the framework. In addition, most who responded to the issue would draw the line differently. Some would not require any obligation settled in shares to be classified as a liability. Others would classify as liabilities only those that included a net share settlement or net cash settlement option.
- Many wanted the Board to expand its guidance on when economic compulsion creates an obligation.

The Board agreed to continue discussions offline with a number of different constituents including the banks and corporate treasuries to better comprehend of technical details of their current hedging risk management systems and controls. Those meetings will take place at future dates.

FORMAT OF THE SESSIONS

Following an introduction and welcome from the Board member designated to chair the session, the format of the discussion generally was for each topic to be introduced by the IASB staff, who provided an overview of the Board's underlying principles in each area (as set forth in the preparatory materials available on the Board's website) and, occasionally, raise one or more questions on which the Board sought advice. Those around the table were then invited to share their perspectives first on the Board's principles and then on specific aspects of the proposals.

With regard to the substance of the discussion, often, constituents expressed the same views already expressed in their comment letters with little elaboration. However, from time to time new ideas circulated around the table. For their part, when Board members disagreed with a view, they generally responded with reasons why they believed a particular view was not consistent with the underlying principles set forth in IAS 32 and IAS 39 or asked constituents to clarify how their view could be implemented in a way that was consistent with the principles. They asked for comments on alternative solutions when those were presented.

Session 1

Board members present: Sir David Tweedie chaired the meeting, and Board members Hans George Bruns, Tom Jones, Jim Leisenring, Tricia O'Malley, and John Smith were seated at the table. Other IASB members observed from the audience.

Participants present: Participants included representatives from industry, retail banking, and investment banking.

Session 2

Board members present: Tom Jones chaired the meeting, and Board members Tony Cope, Bob Garnett, Gilbert Gelard, Jim Leisenring, Tricia O'Malley, and John Smith were seated at the table. Other IASB members observed from the audience.

Participants present: The outside participants consisted primarily of representatives from European banks and European banking oversight organizations.

Session 3

Board members present: Sir David Tweedie chaired Session 3. Board members Mary Barth, Bob Garnett, Gilbert Gelard, Jim Leisenring, and John Smith were seated at the table. Other IASB members observed from the audience.

Participants present: Participants included representatives from industry, banking, and banking and regulatory oversight.

Session 4

Board members present: Sir David Tweedie chaired the meeting, and Board members Bob Garnett, Hans-Georg Bruns, Jim Leisenring, Tricia O'Malley, John Smith, and Geoff Whittington were seated at the table. Other IASB members observed from the audience.

Participants present: The group included mostly preparers from various industry sectors and auditors, with the majority from the UK, and a representative of IOSCO.

Session 5

Board members present: Sir David Tweedie chaired the meeting, and Board members Tony Cope, Jim Leisenring, Warren McGregor, Harry Schmid, and John Smith were seated at the table. Other IASB members observed from the audience.

Participants present: Most participants represented the auditing profession, with a few industry groups also represented.

Session 6

Board members present: Tom Jones chaired the meeting, and Board members Gilbert Gelard, Jim Leisenring, Tricia O'Malley, John Smith, and Tatsumi Yamada were seated at the table. Other IASB members observed from the audience.

Participants present: Participants represented large bank holding companies, investment banks, and banking associations from a number of countries, as well as the European Commission.

Session 7

Board members present: Mary Barth chaired the meeting, and Board members Hans Georg Bruns, Jim Leisenring, Warren McGregor, John Smith, and Geoff Whittington were seated at the table. Other IASB members observed from the audience.

Participants present: Participants included representatives from securitization and derivative dealer groups, plus a number of manufacturing companies.

B. SUMMARY OF ISSUES DISCUSSED

The following sections provide a summary of the key issues discussed in each of the following areas (in order): derecognition and pass-through arrangements; derivatives, hedging, and macro-hedging; provisioning (impairment of financial assets); debt-equity; and option to fair value individual financial instruments.

1. DERECOGNITION AND PASS-THROUGH ARRANGEMENTS

In general, the discussions of derecognition did not evolve beyond what was an appropriate overall approach. Application issues were not addressed in detail. Overall, there were a number who expressed support for the continuing involvement approach proposed in the Exposure Draft. However, more constituents expressed preferences for either a risk-and-rewards or a control-and-components based model instead, with European-based constituents generally preferring a risk-and-rewards model and North American-based constituents generally preferring a control-based model. When asked for preferences between the continuing involvement model and IAS 39 as is (pre-amendment), the majority of participants expressed a preference for IAS 39 as is. A minority indicated that IAS 39 unamended was not operational and therefore suggested the Board adopt an approach similar to U.S. GAAP.

General Derecognition Issues

- By way of introduction, the staff described the principles underlying the continuing involvement model, including an example of how it would apply: If an asset worth 100 is transferred along with a guarantee of 20, the transferor would be considered to have continuing involvement of 20 and therefore a partial sale of 80 and failed sale with respect to the 20.
- A Board member pointed out the difference between various derecognition approaches with the staff example. Suppose the entity transfers asset worth 100 and provides a credit guarantee on 20 percent of the assets but it is known that the "true" credit exposure is 2 percent. Under continuing involvement, 80 would be derecognized and 20 would fail sale accounting. Under the risk and rewards approach, there would be no sale, and under a control-based approach, 98 would be derecognized and 2 would be recognized.
- The Board raised the point that the desires of constituents are inconsistent. On the one hand, there is a desire for sale accounting for securitization transactions. On the other hand there is a desire for accounting as a

secured borrowing for securities lending transaction (so called “repos” or repurchase transactions). The elements of each of those transactions are similar. As a result, it is difficult to determine an approach that would reconcile all views.

- It was noted that current derecognition rules were being abused. For example, entities create structures that qualify for sale accounting during the last month of the fiscal year, only to buy back the transferred assets in the next quarter – effectively removing items from the balance sheet for financial reporting purposes.
- It was noted that the approach to derecognition is important because of the effect on the way the entity is perceived to provide a return on net assets. The Board should consider focusing on developing an approach that provides a fair view of the entity’s position with respect to such returns.
- Some believe that the vast majority of securitizations are not sales (although they might be accounted for as such); however, derecognition guidance is an effort to develop principles to account for the exceptions. The underlying economics of most transactions are best reflected as a secured borrowing, which makes it difficult to develop derecognition rules for the remaining few transactions that should get sale accounting.
- A number of participants expressed concern about too many rules. They encouraged the Board to focus on broad principles without too much detailed implementation guidance.
- A minority expressed a view that a fair value components-based approach would be the ideal long-term approach, however, the Board would not be able to develop and perfect such a model in the short-term.
- Some indicated that a legal isolation criterion is necessary to understand if a true sale existed under any approach. Others stated that a legal isolation criterion would be very difficult to include in an international standard, since the accounting would need to be implemented in a variety of legal environments.
- Some believe the current derecognition provision of IAS 39 (including the IGCs) were not really a problem. Rather the Board should concentrate on revising SIC 12. Under IAS 39 it is possible for an SPE to meet the qualification for treating a transfer as a sale but also to be required to be consolidated under SIC 12.
- A few supported the notion of a “Qualifying SPE” such as is exempt from consolidation under U.S. GAAP. They thought that the QSPE was fairly well defined and a useful notion that might be considered as long as the right limitations are drawn to qualify. Others did not think that exceptions were necessary, particularly under a risk and rewards model. Therefore, they did not support such an exemption.
- Some suggested that the Board develop an approach that focuses on the variability of cash flows in determining whether a substantive risk was transferred.
- Some expressed concern mostly about comparability in the treatment of SPEs among standard setters. What was of greatest importance is that the guidance should be similar across jurisdictions.
- Some who supported keeping IAS 39 as is would like additional guidance on what is meant by “readily obtainable” especially when large block of assets are the subject of the transfer and what is “substantially all” in the case of a total return swap.

Continuing Involvement Approach: Issues Raised by Participants

- The current (unamended) model in IAS 39 is contradictory and, although guidance developed by the Implementation Guidance Committee cleared up some issues, there remain a number of implementation issues. Since there is no consensus that either the risks and rewards or control models should prevail, and the Board would like to develop a more robust model in the longer term (rather than embed either risks and rewards or control-based in the current model), the continuing involvement approach seemed to marry the characteristics of both risks and rewards and control-based models in a way that could be implemented and would resolve problems with IAS 39. For example, the continuing involvement approach resolves issues related to gain on sale accounting related to a control-based model and the need to potentially estimate credit risk under the risks-and-rewards model.
- Some participants who would support the continuing involvement approach expressed a desire that there be a legal isolation criterion as well and enhanced disclosure related to asset transfer transactions.
- Some supported the continuing involvement approach as an interim solution, but stated that a long-term solution is necessary. The Board should field test the approach before requiring it in the final standard. A particular concern by some is that the continuing involvement approach over-relies on contractual terms for the determination of what is sold and what is retained. Some expressed that the amendments to IAS 39 were not supposed to fundamentally change the current standard; however, the continuing involvement approach was a fundamental change.
- Most indicated that they were not convinced that the continuing involvement approach would work. The Board pointed out that the continuing involvement approach was easier to apply and probably more operational in

providing consistent results than either the control-based or the risks and rewards models, however, people did not always agree with how the components of the transaction were measured. In addition, the underlying notion of continuing involvement was implicit or explicit in both of the other prevalent derecognition models.

- It was noted that the continuing involvement approach often provided counterintuitive results. For example, if receivables were transferred with only the credit risk retained, none of the receivables would be derecognized. Logically, the transferor should end up with derecognition except for the fair value of the credit risk retained because that is the value of the continuing involvement. Another example that seems inconsistent to some is different treatments in the case when an entity transfers an asset and retains a call option versus a right of first refusal. One participant noted that the accounting for items under the continuing involvement model contradicted the accounting required for embedded derivatives.
- Many were concerned that the continuing involvement approach introduced a new measurement basis for assets and liabilities that was inconsistent with other aspects of IAS 39. Those measurements were not themselves representative of the value of continuing involvement identified under the approach. In particular, the recognition of an item at something other than its fair value at inception raised the question of whether that item met the definition of an asset or liability in its entirety.

Risk and Rewards Model: Issues Raised by Participants

- Some participants believed that a model based on risks and rewards would better reflect the transferor's position. Most constituents supporting a risk and rewards model would base the measurement of partial sales on the nature of the risks transferred and those retained, as opposed to a components-based approach.
- Some Board members did not believe it would be possible, without extreme effort, for constituents to isolate and measure each risk tranche within the transferred assets (e.g., credit risk, interest rate risk, etc.) to determine the value of the risks transferred and those retained under the risks and rewards approach. For example, if the assessment of whether a transfer is a sale is based on the transfer of a majority of the risks and rewards, the risk-and-rewards model was particularly difficult to implement if only the rewards are transferred the risks are retained, or vice versa. That is, what portion of the transfer is looked upon to determine whether or not a sale has occurred? If the risks are to be accounted for separately from the rewards it seems that it would be very difficult to measure what is retained.
- A Board member pointed out that the sale of a portfolio with a written put option would qualify for derecognition under the control approach but would fail sale under the risks and rewards model. Under that conclusion, credit card securitization transactions would not qualify for sale accounting under the risks and rewards model.
- A participant pointed out that it would be difficult for the Board to develop an operational risks and rewards model in the short term.

Control-Based Model: Issues Raised by Participants

- Some participants believed that the Board should adopt a control-based model, based on the US model in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, rather than move to the continuing involvement model.
- Some would like the Board to develop a model based on control, but exclude the requirement under U.S. GAAP to assess the transferee's position. That is, they would not be troubled by a circumstance in which the transferor is deemed to lose control over the assets and no single entity gains control as a result. An analogous result can occur when a parent sells a subsidiary's shares. A Board member responded that that analysis raises the question about what is controlled—that is, is it control over the entity or control over the asset—ultimately someone must be responsible for the assets.
- Others countered that if assets are given up but significant risks are retained, it is problematic to conclude that there is no entity in control. It might be interesting to review legal cases to identify whether an entity was considered to be responsible but was not considered to be in control.

Pass-through arrangements

- The IASB clarified that the pass-through criteria were intended to describe a purely agency relationship between the transferor and the assets and, therefore, would be limited.
- Many requested clarification of the guidance on pass-through arrangements. Participants noted that it was not clear what the objective of the guidance on pass-throughs was and whether it was intended to apply to SPEs.

For example, if an SPE was involved and the original transferor qualified for sale accounting, the SPE might qualify as a pass-through and therefore it would not carry any assets. However that same SPE might be required to be consolidated under SIC 12. Some are troubled by an SPE not having any assets on its balance sheet. Board members noted that a mortgage servicer might be equivalent to a pass-through and it also would not have the asset on its books. However participants nonetheless expressed that it was not clear whether SPEs should look to the pass-through guidance or the guidance in SIC 12, or both. Some suggested that the solution was to tighten up the guidance in IAS 39 and apply SIC 12 broadly to all entities. Some felt that if the pass-through guidance was not changed, SIC 12 would require consolidation in most cases.

- Some requested guidance to spell out more definitively what an SPE could do and still meet the pass-through criteria. For example, could it have limited powers to reinvest for short periods or to hold funds when receipt dates and payment dates differed.

2. DERIVATIVES, HEDGING, AND MACRO-HEDGING

General

Although most constituents generally agreed with the general principles that derivatives should be measured at fair value and that ineffectiveness related to a hedge should be recognized in earnings, most desired a change to the current hedge accounting rules in IAS 39. The main message was that the Board needed to make IAS 39 hedging provisions easier to apply, in particular, with respect to designation and effectiveness testing, where the one-to-one or transaction-by-transaction basis was time and resource consuming and did not reflect the methodologies and systems currently used in practice. Various proposals were put forward to help ease those aspects.

There was some discussion of whether to only allow one type of hedging or to otherwise limit cash flow hedging to circumstances in which a fair value hedge could not be achieved. However, it was not always clear what the objective of those suggestions were, and most expressed a preference for keeping both cash flow and fair value hedging.

During sessions with retail banks, a great deal of time was spent with participants explaining to the Board the relationship between the banking book and the trading book and how interest rate risk was managed. Participants also discussed their confidence that their current risk management systems and controls could accurately assess and measure ineffectiveness in a way that would be consistent with the Board's principles. The Board expressed a desire to learn more about these systems and controls and a number of participants agreed to meet with the Board at a later date for a technical discussion and to provide evidence of their claims.

Problems with current guidance

Most participants agreed that derivatives generally should be measured at fair value and that ineffectiveness should be recognized in the profit and loss statement. However, there appeared to be different views on how those principles could effectively be maintained while accomplishing the hedging strategy desired.

- A number of participants complained that the approach to derivatives and hedging was purely rule-based and that the Board should instead articulate and emphasize principles and leave it to preparers and auditor judgment in how to meet those principles. The Board needs to find an appropriate balance between rules and principles. They noted that of the 200 IGC interpretations over 70 related to hedge accounting.
- The complexities of tracing to individual items the gains or losses associated with the hedging relationship, and the time and resources necessary to undertake the requirements for testing for effectiveness on a transaction-by-transaction basis were key areas in which constituents had difficulty with the rules in IAS 39. If the Board could ease those burdens while maintaining the objectives of the underlying principles, then IAS 39 would be more operational.
- Adopting the rules in IAS 39 would require new systems and controls, which would be costly to implement and would result in no operational or economic benefit other than the ability to be in compliance with the accounting requirement. Participants disagreed that accounting standards should result in changes to systems, but rather thought that accounting should strive to bring transparency to the way the business is already managed. As a result, they would like to see an approach that leverages off existing risk management controls and systems. Some Board members expressed sympathy for that view, but pointed out that, sometimes,

significant changes required by accounting standards helped to improve the way businesses are managed. That was the case, for example, when accounting standard setters required businesses to account for pension and other post-employment benefit liabilities.

- Those that had implemented FASB Statement No. 133 indicated that under those rules, which are similar to IAS 39, they were able to continue hedge accounting for virtually all of the same types of exposures as they had prior to adoption of the standard. They agreed that additional cost and documentation was required and the volatility in earnings and equity increased, but generally there was sufficient flexibility to achieve most hedging strategies.
- Some corporate treasury representatives expressed concern about the inability to undertake current hedging strategies under IAS 39. In particular, corporate often issued fixed rate debt, which it swapped to floating for the life of the debt but also layered on one or more short-term floating to fixed swaps. They believe that this hedging strategy is perfectly effective and should be presumed so. However, IAS 39 would require effectiveness testing and would not allow the designation of the second derivative. Although they could structure their hedges with different instruments and qualify for hedge accounting under IAS 39, the cost to do so in terms of transaction costs associated with undertaking those positions would be much higher than under their current strategies. That is a real cost with no perceived economic or operational benefit.
- Some felt that strict application of the rules in IAS 39 did not provide useful information to users or a fair presentation of how the business's risk management strategies were carried out and effective. Generally that comment led to a disagreement with presenting only one side of the hedge relationship for cash flow hedges of forecast transaction. A number of participants were in agreement that, although the IAS 39 cash flow hedging approach as illustrated in IGC 121-2 could be applied to hedge a net portfolio exposure, the result of that approach is an unacceptable amount of volatility in equity. Participants explained their view that such volatility did not provide a transparent representation of their risk management strategies because only one side of the hedging relationship was being accounted for. In their view, this contradicts the fundamental objective of hedging. Specifically, the recognition of only one side of the hedge relationship and the volatility thus created is believed to provide misleading information to financial statement users with respect to the effectiveness of the hedge. For banks, volatility in equity is difficult to explain to the users because they are not interested in accounting reasons but in determining what is the bank's net risk position. Corporates and investment banks were less concerned with this issue. From a corporate perspective, the ability to defer in equity gains and losses related to hedges of forecast transactions was generally considered a reasonable approach.
- It was noted that the amounts recognized in equity end up getting recycled into earnings, the appropriateness of which was questioned by some participants. A Board member clarified that it really was deferral in comprehensive income, not temporary equity. He added that such volatility is also created by available-for-sale securities.
- For some countries, it was noted that there is a real issue with respect to cash flow hedge accounting and the impact on equity with respect to laws on the distribution of earnings to shareholders. The volatility in equity may be misleading or at least is perceived to be inconsistent with what the laws indicate is available for distribution.
- Many indicated that their main problem was not with the principles but with the disconnect between what is effective hedging from an economic standpoint and what IAS 39 requires mechanically for designation and recognition of ineffectiveness. Some suggested that another principle that the Board should consider adding to IAS 39 is that there should be no impact on earnings or equity if a hedge is deemed effective. However, no one was able to offer an approach that would meet that objective for cash flow hedges without either measuring derivatives at something other than fair value or recognizing something in the balance sheet that does not meet the definition of an asset or liability.
- Some suggested that the ability to designate any item to fair value as proposed in the amendments would resolve some hedging issues. Other participants responded that full fair value of the hedged item required recognition of changes in fair value associated with all risks, not just those for which hedge accounting was desired. Therefore, the full fair value of both sides of the hedging relationship did not achieve their objectives.
- Under IAS 39, some are concerned that entities with the same net risk position would have different accounting depending on whether they are using derivatives or not, and whether they have a simple capital structure versus a complex capital structure.
- A number of participants expressed a desire for the "short cut method" as is allowed under U.S. GAAP. They expressed the view that many hours and resources were spent looking for ineffectiveness that turns out to be very small number. Thus the costs outweigh the benefits. The Board indicated that certainly all standards are

subject to materiality. Further, even qualifying for the short-cut method did not avoid the need for testing effectiveness, as many thought it did.

- It was suggested that as long as there is a mixed measurement attribute model, there would be no ideal solution. As a result, some participants proposed that gains and losses on cash flow hedges could be put on the balance sheet. It was noted that items that did not meet the definition of an asset or a liability already were on the balance sheet as a result of the continuing involvement approach to derecognition. Board members responded to note that recognizing losses as assets and gains as liabilities on the balance sheet seemed a fundamental contradiction and would not be a transparent portrayal of the firm's position. In particular, the only thing that a deferred loss indicated was that net income in a future period would be lower by at least the amount of that loss. It did not seem appropriate to account for that as if it was an asset.
- The IOSCO representative made clear that although IOSCO members supported making the rules on hedging easier to apply, the end result must be to require a measurement of effectiveness, ineffectiveness should go to earnings in the current period, and only assets and liabilities should be on the balance sheet.
- Some suggested that instead of all derivatives being measured at fair value, hedging derivatives should be accounted for on the same basis as the hedged item. They supported that view on the basis that the same nonderivative financial instruments may be accounted for differently depending on whether they are designated as trading, available-for-sale, or held-to-maturity. The Board expressed concern that without fair value for all derivatives, there is no discipline around measurement and the determination of ineffectiveness.

Macro or Net position hedging

- A number of banking constituents desire the ability to hedge a net interest rate position based on a portfolio of assets and liabilities. There were various views on how to achieve a hedge of a net position without earnings or equity volatility.
- Some indicated that they were satisfied with the proposed amendments to IAS 39 because the ability to designate any item as trading allowed them to recognize offsetting gains and losses without all the documentation and tracking required otherwise. Others disagreed that the fair value option was helpful because that required the full fair value change in earnings, whereas they desired to hedge only a specified risk component. They stated that specific individual assets and liabilities are not hedged and fair value is meaningless on the banking book. The problem is they want to hedge the net margin on the trading book. Therefore, they would like to recognize the gain or loss in the net position related only to changes in interest rates.
- A number of corporate representatives indicated that the Board's guidance needed to consider more thoroughly the treasury-center concept and the hedge of net positions and to revise IAS 39 to better accommodate hedging at the treasury level. There was support from this group for macro-hedging with netting of derivative positions layered on the net hedged position. The Board noted that the problem with that approach is the mechanics of ensuring that effectiveness is appropriately tested and ineffectiveness is appropriately traced to the underlying hedged items. Participants offered to consider those issues and get back to the Board with suggested approaches.
- Some suggested that the Board should consider allowing nonderivatives to be hedging instruments to help alleviate some of the problems.
- A further issue applying to corporate treasury perhaps more so than banking treasury was that the treasury would hedge a net position that is a mix of cash flow, fair value, and net investment hedge positions. Thus, the financial statement presentation of parts of the overall gain or loss on the net treasury position would need to be split between the income statement and equity.
- Some suggested that the Board allow designation of a net position as a fair value hedge and allow the derivative gain or loss to be offset by the calculation of the change in fair value of that net position over the period. Board members expressed concern about how effectiveness could be assessed and recognized under that approach. More importantly, it was not clear what the mechanics would be in subsequent accounting for the gain or loss associated with the net position – how would it be derecognized from the balance sheet once the underlying items matured or were extinguished.
- A number of perspectives exist as to how effectiveness should be assessed if IAS 39 allowed designation of the net interest rate position as the hedged item. Some participants desire an approach that would allow them to assess effectiveness within a range; others would like to recognize the net position in the balance sheet and amortize amounts not offset by the derivative; and still others would like the derivative gain or loss to drive the amount recognized for the hedged item rather than measure both sides of the hedging relationship (a type of

short-cut method). Those approaches are quite different from what IAS 39 now requires, which is a dollar for dollar recognition of ineffectiveness.

- The Board indicated that it is open to including in IAS 39 the opportunity for macro-hedging as long as an approach can be developed that is consistent with the principles it has laid out. In particular, the Board would accept such an approach if it could be assured that all ineffectiveness (not just amounts outside of a range) is recognized in earnings, and that there is some mechanism by which the gain or loss associated with individual items in the portfolio could be appropriately allocated or otherwise unwound when an item was derecognized or the hedging relationship was discontinued. In addition, effectiveness would have to be assessed rather frequently. The Board has been studying the issue of macro-hedging internally and with others to discover such an approach. The problem is compounded by the fact that not everyone agrees on what macro-hedging is and what the bookkeeping entries are to ensure that effectiveness is measured and recognized in earnings. The Board invited additional input, and some constituents expressed that they would develop papers addressing those issues and meet with the Board at a later date.

Internal contracts

The discussion of internal contracts was sometimes confused. For some, the objective seemed to be to communicate to the Board that internal contracts provided sufficient documentation and evidence to support designation of a net position as a hedge. The Board's concern was that this would lead to the recognition of "gains" or "losses" on transactions between divisions or subsidiaries of the same entity. Ultimately everyone expressed agreement that no profit or loss should be recognized on internal contracts as they are required to be eliminated in consolidation. The ultimate solution likely will flow from the Board's decisions about the ability to hedge a net position. Nonetheless it seems that the wording of the standard with respect to internal contracts may be confusing to some.

- Many participants seemed to be discussing internal contracts in the context of a macro-hedging approach (i.e., that the internal contract represented the net position of the banking book, and therefore represented the hedged item from the trading book perspective). The key message from participants was that internal contracts are viewed from a regulatory perspective on par with external contracts and, as a result are viewed as offsetting positions taken in the trading book. Banks use internal contracts to identify net risk positions on the banking book and would like those contracts to be allowed to be part of the documentation for hedging designation. However, the net positions represented by internal contracts are not sufficient to qualify under IAS 39 for hedging purposes. Recognizing internal contracts as sufficient documentation would also facilitate designation of a net position if the Board agrees that is possible. For management purposes, those contracts are viewed on a fair value basis. One participant indicated that when IAS 39 first became effective, a new entity was created to be counterparty for all internal banking contracts so as to manage the internal contracts between the banking and trading books.
- Corporate treasurers expressed similar views that internal contracts were used to identify and designate hedged items within treasury activities. They also were used to offset exposures between divisions or subsidiaries within the entity. Thus, it is believed that effectiveness is implicit in treasury hedging strategy and provides an appropriate way to track the hedge without the item-by-item association of gains and losses.
- Some were concerned that it was not clear how IAS 39 hedging guidance interacted with the treasury function. An IASB staff pointed out that IGC 134-1-b should provide guidance to assist constituents in understanding the relationship at least for foreign currency. Some expressed that that guidance should be brought into the standard itself. Others believed that confusion arose because the guidance in IGCs 134-b and 134-1-c were not wholly consistent with guidance in IAS 39.
- Some were confused about whether internal hedging relationships could be preserved for purposes of segment reporting. The Board indicated that it believed there was nothing to preclude that in the guidance in paragraph 126B of the exposure draft.

3. PROVISIONING (IMPAIRMENT)

Participants generally were in favor of a portfolio-based approach and said that such guidance is very necessary. Some believed that what the standard currently illustrates could be viewed as an expected loss approach. They indicated that it would be helpful if the standard stated an explicit principle that the approach is an incurred loss approach and then went on to describe what the carrying value of an asset should be once an impairment loss is recognized. They believed that the standard should only provide minimal implementation guidance, and perhaps

identify more than one methodology that might be used to achieve the objective of providing for incurred losses. It would be important to ensure that one could neither anticipate gains nor defer losses under the approach.

The following points were raised:

- There are practical problems with the proposed approach as currently drafted; for example, significant systems issues may arise for collecting and analyzing the information for developing estimates.
- Some believe that an item assessed individually for impairment should be excluded from a portfolio assessment. Others suggested that if a loan asset is individually assessed for impairment with full market information, it should not be included in a subsequent portfolio measure. However, if only partial information was available about the asset, then its inclusion in a portfolio assessment might be warranted even if it was not deemed impaired upon individual assessment.
- The example provided in the appendix seem inconsistent with incurred loss approach.
- There were mixed views about developing an approach consistent with Basle. Some thought that the approach to impairment should be linked to the Basle approach. Others indicated that the objectives of the Basle approach were different—that is, that approach was not purely an incurred loss approach. It was noted that IAS 39 would be followed by entities other than banks. Therefore any approach that the Board requires would need to be able to be applied by a wide variety of enterprises.
- Some expressed that the long-term goal should be an expected loss model. However, for now the board should explain what type of model IAS 39 is, clarify whether future events should be included in the calculation, and lay out general principles without much detailed guidance on how to develop estimates consistent with the principles.
- The Board needs to articulate what causes an impairment and whether it should always be tied to a credit event or whether a general change in interest rate risk would affect valuation – thus, would an economic loss be an impairment. Fair value would include both.
- Some Board members expressed the view that there should not be any provision for loan losses unless something happens after the initial recognition of the loan. Some indicated that while the view that no loss should be recognized at inception is considered appealing, it is quite possible to incur a loss at the inception of a loan. For example, an entity might draw on a line of credit that had been extended prior to a decline in its credit rating. A similar loan would not otherwise have been made to that entity. Another example might be loan commitments that ultimately result in a loan being issued at below-market rates. It was not clear whether those would be accounted for appropriately under IAS 39.
- Some were unclear of what constituted impairment of marketable securities and would like additional clarifying guidance from the Board on that issue.
- Many expressed that the Board should provide more detailed guidance on when reversal of impairment losses would be appropriate.

4. DEBT-EQUITY

A number of sessions did not cover this topic. Further, since it was often left to last, when it was covered only a few comments were made. The key points were:

- This issue is very important to some because of the tax implications of cash flows related to items classified as debt versus those classified as equity.
- A number of constituents disagreed with the Board's approach to debt-equity classification. They believed that if an obligation is required to be settled in shares, it is not a liability. That is consistent with the conceptual framework because no assets are transferred at settlement. Others indicated that they would support equity classification for only those obligations that required a fixed number of shares. If equity settlement is optional or if the number of shares to be issued could vary, they would support liability classification.
- Some were concerned with the bifurcation of liability and equity components, particularly for complex instruments that also contained embedded derivatives, for example, complex convertible debt instruments. They did not feel that it was possible to separate components in a meaningful way, nor were they convinced that the information was helpful to financial statement users. Such instruments generally are priced in the market taking into account the effect of interdependencies of the various components.
- Concern also was expressed over the presentation requirement for puttable instruments to be classified as liabilities when those instruments are the only form of equity of the entity. Some participants thought this approach was quite misleading for mutual funds or cooperative associations that often included the put option in their ownership interests, especially if there were only limited conditions under which an instrument could be

put back to the issuer. The Board expressed a desire to better understand the conditionality provisions for certain puttable instruments.

- A number of participants expressed the need for the Board to provide more guidance on economic compulsion and when a conclusion of economic compulsion is appropriate. They felt that the removal of the example in IAS 39 on that topic was inappropriate and suggested that an expansion of the example would be a better solution.
- Some suggested that the Board make none of the proposed changes that would conflict with the conceptual framework but instead wait until it can develop a longer term consistent solution. Others suggested that the Board seek to define what is the residual interest and based the distinction in the final standard on that approach. The Board indicated that the basic principles underlying the debt-equity approach already existed in IAS 39 and the guidance issued by the Standing Interpretations Committee, which was now being incorporated into IAS 32. Therefore, this was not perceived to be amending guidance that was already in place, but rather, clarifying how it should be applied.
- It was noted that the approach did not deal with an instrument under which the terms could provide for either a fixed number of shares or a variable number of shares depending on identified events as with certain types of forward contract. It was not clear whether this should be considered a compound instrument or a liability.
- Issues were raised about the earnings per share impact of the proposals. Participants suggested that the Board provide a table or other guidance in IAS 33 to indicate what forms of equity derivatives should be treated as potential shares or shares outstanding.

5. OPTION TO FAIR VALUE INDIVIDUAL FINANCIAL INSTRUMENTS

The key points covered in discussions of this topic generally related to the need for additional guidance on fair value and the potential problems with the fair value hierarchy. There were some who thought the Board should limit the ability to make fair value designations rather than provide a free choice. There were others that wanted a relaxation of the rules to permit designation to take place over a one-year period from the effectiveness of the standard. Finally, the requirement to value based on the price of individual units, rather than on a portfolio basis was raised as an issue for some.

- A number of participants expressed to the Board that they believed the option to fair value should be limited to only certain items, such as the following:
 - Items that have an offset in the trading account
 - Items with observable fair values
 - Items with embedded derivatives
 - Items that are within a whole class of instruments and only the whole class (not individual items) could be allowed to be designated
 - Those types of instruments for which a policy is set forth up front providing the basis for designation
- A number of constituents took issue with the placement of valuation models within the fair value hierarchy. They indicated that the hierarchy was too rigid and theoretical. The question arose of why the guidance would trust valuation models in the absence of a market price but would not trust valuation models for day-one accounting if no consideration was exchanged for a contract and there was no market price. However, there remained questions about profit recognition in market arbitrage transactions.
- In some countries, there are no market prices, and banks rely on valuation models for most of their valuations. In those cases, there is likely to be some variability between entities for determining fair values. They would like additional guidance on the development of fair value estimates with models to reduce the variations that otherwise might occur.
- Some are troubled by the interaction of the fair value guidance related to requiring that fair value be determined as the number of units times the price and the interaction with fair valuing one's own debt. Some believe that the inherent "value" of a decline in one's own credit risk cannot be captured in the market and therefore a market price is not appropriate. Other aspects of the same issue arose for entities in the business of selling derivatives. For them, valuation on a portfolio basis was seen to be more sensible. The market inputs used in their valuation models were based on portfolio valuation or other forms of aggregating exposures, rather than fair valuing individual derivatives.
- It was suggested that the guidance in the final standard try to look at fair values more broadly and recognize and indicate that there may be multiple fair values in multiple markets. In addition, there should not be a difference

between IAS and U.S. guidance in this areas. The Board should keep up with the developments on the FASB project on fair value and maintain consistency.

- Some would like to see a discount for illiquidity.
- Concern was expressed that the option to designate any item to fair value should have some discipline in order to avoid cherry-picking. The option has obvious consequences for comparability. Some suggested that the Board provide a one-year delay in the requirement to select the items to be irrevocably designated to fair value.
- It was noted that the option is helpful as an alternative to bifurcating embedded derivatives. It also eased the burden of rules and documentation related to hedging.
- Participants generally were concerned about the income statement implications of inclusion of an entity's own credit risk in the determination of fair value of liabilities.