ACCOUNTING FOR FINANCIAL INSTRUMENTS
CONCEPTUAL PAPER

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ibfed International Banking Federation

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Executive Summary

This document sets out the position of the International Banking Federation[1] on the extent to which the fair value measurement meets the needs of the user community and the objectives of financial reporting.

The objective of financial reporting is to create a communication framework to assist users in making economic decisions, to assess the accountability of management for entrusted resources and to provide information about an entity's financial positions and its ability to generate cash flow. The essential criteria for meeting these objectives are that the provided information must be relevant, reliable, understandable and comparable.

A key question addressed in this paper is whether the measurement of all financial instruments in external primary financial statements is more relevant if prepared on a fair value basis than if prepared under the current mixed measurement model.

Both the mixed measurement and fair value accounting models are evaluated against the qualitative characteristics that make information "useful". We concluded that:

- Fair value measurement provides an appropriate accounting base for financial instruments held for trading purposes or otherwise managed on a fair value basis. However, full fair value measurement of financial instruments would overstate the extent to which instruments are held for trading or managed on a fair value basis within the business and the extent to which deep and liquid markets exist. These are highly significant factors in determining the relevance of fair value in financial reporting.

- A mixed measurement model provides investors with better information for evaluating financial institutions. It requires fair value measurement for assets and liabilities managed on a fair value basis and recognizes that not all financial instruments – let alone non-financial assets and liabilities – are managed on a fair value basis or are even capable of reliable fair value measurement. Where an entity does not manage instruments on a fair value basis, amortised cost is the more appropriate way to estimate future cash flows. Fair value information is already disclosed in footnotes, which are an integral part of financial statements and is a more suitable format for providing the information to investors.

- Reality is more complex than can be communicated in a fair value model. Relevant performance reporting will never be achieved if the framework for financial reporting sticks rigidly to either an amortised cost model or a fair value model. A mixed measurement model represents a principles-based approach to measurement by acknowledging the fact that different entities may follow different business models. Instead of the IASB determining that one approach offers a superior model to that of others, the aim should be for the accounting standards to accommodate the various business models and circumstances in which financial instruments are used. As widely recognized at the IASB Roundtables on measurement, a mixed model is more likely to result in useful reporting.

1. The International Banking Federation (IBFed) is the representative body for a group of key banking associations. The members of the IBFed are the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the Japanese Bankers Association and the European Banking Federation. The objective of IBFed is to increase the effectiveness of the financial services industry's response to multilateral and national government issues affecting their common interests.

1. The Objectives of Financial Statements & Users' Needs

Before commenting further on relevance of fair value measurement of financial instruments and its usefulness for users, it is important to briefly look at objectives of financial reporting as well as to identify the users of financial statements.

A. OBJECTIVES OF FINANCIAL STATEMENTS

The objectives of general purpose financial reporting for all entities, including banking institutions, is to create a communication framework that:

- provides information that is useful to present and potential investors, creditors and other users in making economic decisions.

- provides information that is useful to present and potential investors, creditors and other users in assessing the accountability of management for the resources entrusted and the entity's ability to make distributions under the legal framework in which it operates.

- provides information about the entity's financial performance and financial position that is useful to present and potential investors, creditors and other users in evaluating the entity's ability to generate cash, including information about the timing and uncertainty of cash generation.

Financial reporting has been created by convention over time and cannot meet all the information needs of all users. Users will need to supplement the information in financial statements with information that is provided by the entity in the form of management commentary or from external sources. In addition, there are inherent limitations to financial statements, which are a conventionalized representation of the financial effect of transactions. The financial reporting process involves allocations of the effect of continuous operations to discrete reporting periods, as financial statements are prepared as of a particular date. Therefore, the statements do not reflect future events or transactions or all potential changes in the economic environment.

The objectives above can only be satisfied if the information included in financial statements possesses relevance, reliability, understandability, and comparability.

The IBFed considers that reliability and relevance have equal prominence. Information that is irrelevant cannot be relied upon and information that is unreliable cannot be relevant. An appropriate balance is required.

While it must be assumed that users of financial statements are knowledgeable and capable of exercising diligence in assessing information, it is important that information presented is understandable. Since financial statements follow a communication convention, reflecting the complexity of transactions must be balanced with understandability.

Comparability means not only being able to compare different entities but also being able to compare the same entity over different reporting periods. Comparability between different entities must be balanced with the proper reflection of the substance of the transactions undertaken and the nature of the business in each entity's financial statements. Comparability over different reporting periods must be balanced with achieving improvements to financial reporting.

Any change in financial reporting must consider the balance among materiality, costs and benefits.

This paper reviews the objectives of financial reporting in relation to the issue of fair value.

B. WHAT SHOULD BE THE AIM OF PERFORMANCE REPORTING?

Performance reporting should provide information that helps users understand an entity's present and past financial position, and includes all reported changes in value of net assets.

Management is responsible for all the performance of the entity and the measurement of assets and liabilities is an important component in evaluating management's performance – as is the

method of displaying changes in value. Different types of changes in value have different information content, which should be provided. That is, both the external factors as well as the results of management decisions need to be displayed in the performance statements, but in a way that reflects their different information content.

When displaying performance, some factors effecting the value change are due to changes in external factors while others are more directly a result of transactions undertaken by the entity. Both should be clearly displayed in the performance statement.

The aim of the performance reporting should not be to smooth actual value changes. However, some value changes may be artificial or irrelevant. In our view, performance reporting provides information that assists users in:

- understanding current condition
- evaluating past performance
- analysing future performance

To be able to judge if an entity has performed better or worse than its peer group as a basis for an investment decision, there is a need to distinguish between value changes that have an ultimate impact on the underlying generation of revenue and short-term fluctuations that are not relevant to understanding cash flows.

C. IDENTIFICATION OF THE USERS OF FINANCIAL STATEMENTS

Shareholders, investors, analysts, management, lenders, employees, state organisations, financial regulators and the public are the users of our financial statements.

☐ *Long-term investors and equity analysts*

Long-term investors and equity analysts make decisions based on a long-term intention. They are looking for information that will allow them to assess the company's long-term progress, including the entity's ability to generate future cash flows. Key measures for evaluating the return of their investments include future share price, return on invested capital and dividends.

■ *Future share prices*

Investors and analysts are most interested in traditional accrual based earnings as an important factor in predicting future share prices. Many companies have introduced value–based management techniques to ensure that their decisions create value for their shareholders. These techniques are usually based on predictions of future cash flows at the business level or cash generating units. Some companies are disclosing information on their value-based management programs and presenting value-based performance measures to their investors in annual reports and investor relations presentations.

■ *Return on invested capital*

Return on capital remains an important performance measure that is widely used inside financial institutions and in communication with investors. Increased use of fair value measures will make such measures less informative because they become distorted by fair value changes unrelated to the performance of management and the success of managers in productively utilizing the assets that have been entrusted to them.

■ *Dividends*

For jurisdictions where there are capital maintenance and distribution rules that result in legally distributable profits differing from accounting profits, the increasing use of fair value accounting may result in greater divergence between accounting profit and profit available for distribution to shareholders. Standard setters need to be sensitive to the interaction between accounting and company law in different jurisdictions.

☐ *Lenders and debt analysts*

Lenders and debt analysts also make decisions based on long-term intentions. Lenders and debt analysts need to assess the entity's ability to generate future cash flows to know the ability of the entity to pay its current and future debt.

☐ *Short-term investors*

Short-term investors make decisions based

on an immediate, short-term perspective. Their influence can drive a company toward excessive short-term behaviours, which can conflict with the company's longer-term interests.

☐ *Management*

Management needs to be considered as users of financial information in the same way as investors and creditors. While management can produce any additional information they wish for their own purposes, financial reporting as a communication tool is aimed to address common information needs. Information that is not used by management is likely to be less relevant, reliable and understandable than information that is used internally on a daily basis. Basing a measurement on information that is used in managing the business is key to ensuring that the external reporting produced is relevant, reliable and understandable.

Management is accountable for the sound use of the resources that have been entrusted to them. It is important that they can report to their shareholders on past transactions and events of the period and on what they have done, in order to fulfil their fiduciary duties and stewardship responsibilities to shareholders. Therefore, management and shareholders need a communication framework for financial reporting that is relevant, reliable and reflects the company's business model in a way that both can understand.

☐ *Other categories of users*

Other categories of users include employees, state organisations, financial institution regulators, and the public. Employees are essentially concerned about the entity's ability to generate cash flows. State organisations and financial institution regulators are a distinct user group as they have the opportunity to obtain information they need through specific prudential reporting.

The broad variety of financial institutions' users demonstrates the need to provide general purpose financial statements rather than financial statements that are based on a limited model, such as a full fair value model.

2. Will Full Fair Value Accounting for Financial Instruments Fulfill the Objectives of Financial Reporting & Users' Needs?

A model for measuring financial instruments must be judged by the extent to which it is suited to achieving the objectives of financial reporting. A pivotal question is whether the measurement of all financial instruments in external primary financial statements is more relevant if prepared on a fair value basis than if prepared under a mixed measurement model. In determining the answer to this question, we should be guided by whether:

A) full fair value faithfully represents the business activity;
B) the financial statements being presented on a full fair value basis provide a better communication framework for preparers to provide users with financial information;
C) full fair value of financial instruments fulfils the aim of performance reporting;
D) full fair value of financial instruments would provide more reliable information to users of financial statements;
E) fair value alone provides sufficient information to influence decision making;
F) fair value of all financial instruments reduces complexity and enhances the understandability of financial reporting;
G) fair value of all financial instruments increases transparency;
H) full fair value enhances comparability.

The remaining sections of this paper explore the above topics.

A) WOULD FULL FAIR VALUE OF FINANCIAL INSTRUMENTS FAITHFULLY REPRESENT THE BUSINESS ACTIVITY?

To represent the business faithfully, financial statements need to reflect the nature of different classes of assets and liabilities and the substance of transactions undertaken and reflect what has actually happened in the business.

Fair value of financial instruments can provide useful information. In circumstances where the financial instrument is managed on fair value basis, this information alone is sufficient for management to explain the business model and performance for users to fully understand the future expected cash flows. For example, marking to market or marking to model reflects both the business model and the expected future cash flows for financial instruments that are actively traded. However, the current fair value and the change in fair value between reporting periods do not always faithfully represent transactions in financial instruments undertaken or their contribution to sustainable earnings where the business activity is not based around short-term trading or the instruments are not managed on a fair value basis.

☐ *Financial instruments managed on the basis of fair value*

Fair value has more predictive value than historical amortised cost for those items held with the aim to earn the return through managing them on a fair value basis. In a business model where the underlying strategy is to draw a benefit from short-term variations in the value of the instruments and where the entity is actively engaging in opening and closing market risk positions, it is appropriate for the entity to fair value such instruments. In this context, cash flows that can be generated are indeed mainly determined by the prevailing terms and rates on the financial markets. The fair value is, in this case, the best reflection of the expected future cash flows. It also predicts the ability of the entity to take advantage of opportunities or to react to adverse situations. It is, therefore, an appropriate measurement for financial instruments in such circumstances.

As fair value is the best reflection of future cash flows for instruments in these circumstances, it is also relevant information for primary financial statements users. Investors can rely on such information in order to assess the return of their investments in the entity, as changes in the fair value of instruments managed on a fair value basis can affect dividends paid as well as the value of their investments. For lenders assessing loans granted to businesses with a fair value business model, fair value is representative of the resources that will be available for the entity to pay its debts, as according to the entity strategy the fair value of the instruments will be translated in to actual cash flows.

☐ *Financial instruments not managed on the basis of fair value*

The fair value of financial instruments that are not managed on a fair value basis encompasses the market's view of the current value of the expected future cash flows. While this information is important to some users of financial statements, it is not sufficient for an understanding of the transactions undertaken by the business and how they will be reflected in the future cash flows, including both the amount and the timing of such cash flows.

If the instrument is held for use in the business to generate cash flows and there is no current or future intention to sell, the aim is to achieve a stable income flow earned on an ongoing basis over a certain period. In this case, there is no intention to profit from the expected short-term market movements. The asset will be held until maturity (or at least until prepayment without change of the terms), and this means that the future cash flows are readily identifiable. Holding a financial instrument to maturity is akin to a company's stock in trade where it is considered inappropriate to recognize any increase in market value until the item is sold and the revenue is earned (although it is appropriate to recognize impairment).

The fair value measurement of the instrument has information content in that it is a measurement of opportunity cost and is an estimation of a price that, in thin or non-existent markets, may not reflect the underlying cash flows expected to be received. However, movements in fair value do not predict the future cash flow performance of these instruments, unless the banking institution intends to sell the instrument and can find a willing counterparty. Where such instruments are not held for sale, performance information should reflect what the business actually does and how it is managed. Only information that will assist in understanding the timing of the potential cash flows, credit risk and probability of default will be relevant and useful for the users of financial statements. Amortised cost, including any impairment and taking into account the additional details in the notes, provides investors with more relevant information on potential cash-flow performance than fair value alone can do.

On the other hand, requiring the use of fair value and reflecting the market's perceptions of changes in value through the income statements for portfolios that are not traded would amount to displaying them at a value that does not reflect the cash flow income that will be achieved in practice. The change in the value of the net assets does not reflect what is expected to happen in terms of future cash flows. While management may consider the current fair value based on the current market conditions, and this information has uses, it cannot be said to contribute to an understanding of the actual cash flows achieved by entering into the transactions. The many users of financial statements who rely on earnings information are not best served by using a full fair value accounting model, which would only provide fair value information.

Moreover, the interests of users are better served through the primary financial statements being presented on the basis that best reflects the earnings flows that different classes of instrument will achieve, with fair values disclosed where this does not provide the most relevant basis for measurement.

☐ *Different business models*

In addition to having strategies for using financial instruments in the business, banking institutions have different strategies for mitigating risks. While some risk mitigation techniques are focused on reducing volatility in the fair values reflected on the balance sheet, other techniques are focused on ensuring stability of cash flows and income. A full fair value model may greatly reduce the special accounting necessary to reflect risk mitigation techniques, but it would also likely decrease the transparency of the results of risk mitigation strategies in the financial statements. Users of financial statements who rely on earnings information are not best served by eliminating the effect of cash flow hedge accounting for those banking institutions that are managed on that basis.

B) WOULD FINANCIAL STATEMENTS PRESENTED ON A FULL FAIR VALUE BASIS PROVIDE A BETTER COMMUNICATION FRAMEWORK FOR PREPARERS TO PROVIDE USERS WITH FINANCIAL INFORMATION?

The relevance of the management perspective has been acknowledged by standard setters and regulators. For instance, the requirements for management commentary and segment reporting stress that the management's view can provide information that can assist decision making.

In our view, financial statements have both a decision-usefulness and a stewardship/ accountability objective. Stewardship derives from agency theory and represents the mission given by the investors to the management to use the entrusted capital and to explain how these resources are managed. Management and shareholders/long term investors must have a common language that enables the management to explain to shareholders what the management has done with the capital invested by shareholders.

Transparency requires that the information that is used by management should be provided to the market. Where portfolios are managed on an amortised cost basis and reported to management in that way, the information about earnings as they accrue under the reporting model is relevant to users' understanding of how the business is run and how and when cash flows are expected to emerge.

Those managements that rely on earnings and costs to manage and understand the performance of their businesses would also find it difficult to use financial statements prepared on a fair value basis to discuss and explain how the business has or has not followed its strategy. If full fair value financial statements are not seen by management and its users as providing sufficient information for meaningful communication between the two groups, there is a danger that financial statements would be relegated to the status of a compliance document. Management and users might then feel compelled to develop alternative communication statements outside financial reporting that better meet their needs. This is not conducive to standard setting or the accounting profession as a whole. Therefore, unless and until there is widespread consensus from both management and users that fair value alone provides sufficient information, the financial reporting model must be a mixed measurement model.

C) WOULD FULL FAIR VALUE OF FINANCIAL INSTRUMENTS FULFIL THE AIM OF PERFORMANCE REPORTING?

To conclude whether full fair value of financial instruments fulfils the aim of financial reporting, we will discuss performance reporting, focusing on financial instruments structured in a way in which current accounting standards require banking institutions to account for financial instruments. The same principles should apply for other assets.

☐ *Loans and receivables*

A lending transaction is classified as a "loan and receivable" because it is held to generate income through receiving interest over time until final maturity or until called. The expected cash flows are known, as they are contractual. This is why amortised cost, including loss allowances, which represent the best estimate of losses inherent in the portfolio as of the reporting date, provides transparent information to financial statement users to allow them to estimate the future income statement impact. Fair value has less predictive value in this case since the fair value may not represent the expected future cash flows.

☐ *Held-to-maturity*

The same points apply as for Loans and Receivables.

☐ *Designated at fair value through profit or loss*

There are two circumstances when it is appropriate to present a financial instrument at fair value with changes in value reported in profit or loss:

- when it is trading in nature
- when otherwise managed on a fair value basis

When the instrument is held for trading purposes, it is possible it may be held until maturity, although this is not a defining characteristic. While in practice the outcome may be the holding of instruments until final maturity, for example OTC-derivative contracts and European-styled cleared derivative contracts, the purpose of these

instruments is to earn return by trading in the underlying risk. Since the entity is trading, expected changes in different external factors and the value changes are being realised, and the appropriate measure of financial position is fair value. Even if the instrument has not been traded, since there is a high probability that the unrealised changes in value will be realised, the appropriate measure of financial position is fair value rather than amortised cost. For those financial statement users who wish to predict future incomes for the trading portfolio, realised and unrealised value changes reflect the trading position.

Designation at fair value through profit or loss without a clear trading purpose is less straightforward. There may be many different reasons for choosing this category. An example is an alternative to hedge accounting or an alternative to avoid artificial effects in earnings when there is a reason to believe that liabilities or assets may be realised before final maturity even without having an intent to trade. Instruments may be held for mixed purposes.

In practice, retail banking products are normally funded by a Treasury or Trading unit, although different organisations operate different business models. If there were a one-to-one relationship between assets and liabilities, performance reporting would be fairly simple. However, in practice the internal funding and risk management for retail banking products may be built up by several different external transactions in a mix of derivative contracts and liabilities.

Because there is a mix of different instruments held for different purposes, it is obvious that neither the exclusive use of fair value nor amortised cost is appropriate. As there is a mix of holding to final maturity and short-term profit taking, it may, therefore, be appropriate to use either fair value or amortised cost. As noted below, the current accounting addresses the mixed purpose issue with three categories:

- held to maturity (amortised cost)
- trading (fair value on the balance sheet and income statement)
- available-for-sale (fair value on the balance sheet)

Another way of representing the economics is to study the basic building blocks of the combined transactions. When doing that analysis for interest bearing assets and liabilities, the conclusions normally are that:

- the interest element of the retail banking product is held to maturity;
- the Treasury or Trading unit manages the benchmark interest rate risk as trading positions.

This logic results in recognising that certain measurement alternatives have different information content users who wish to predict future transactions. Financial instruments are complex instruments containing different risks being managed in different ways with different intents. A way of presenting past performance as a basis for predicting future performance is to measure the different components separately at amortised cost and/or at fair value based on the business model. This is reflected in hedge accounting where gains and losses are matched in income or deferred in equity to be matched in income at a later stage.

☐ *Available-for-sale (AFS)*

The available-for-sale category contains issues similar to the above categories of financial instruments designated at fair value through profit or loss. The points made in the previous sections are therefore applicable:

- For instruments that will be held to earn income over time, amortised cost is the most relevant measurement basis.
- For instruments that will earn a return through managing them on a fair value basis, fair value is the most relevant measurement basis.

Equally relevant is the problem of multiple purposes as was described previously. The problem of multiple purposes seems to have been resolved already in the accounting literature, since the change in amortised cost on interest bearing instruments classified as available-for-sale assets is presented in the income statement while the unrealised change in value is recognised directly in equity.

In this section, we have concluded that fair value is irrelevant when evaluating present performance and estimating future

performance if the financial instruments being assessed are held to generate predictable future cash flows. When instruments are held to maturity, temporary changes in fair value do not reflect the current operations of the business nor assist in predicting future cash flows; amortised cost is by far preferable in that respect. However, when the entity is actively engaging in opening and closing market risk positions such as trading activities, changes in fair value represent the most relevant way of estimating both past performance and possible future performance. We also conclude that, while not perfect, the current accounting literature position with regard to AFS and hedge accounting is better able to deal with mixed business purposes than is full fair value of financial instruments.

D) WOULD FULL FAIR VALUE ACCOUNTING FOR ALL FINANCIAL INSTRUMENTS PROVIDE INFORMATION THAT IS MORE RELIABLE TO THE USERS OF FINANCIAL STATEMENTS?

For liquid instruments traded on an active market, fair value can be reliably determined. It is equal to the quotation price. For instruments not quoted on an active market, but managed on a fair value basis, sophisticated evaluation and modelling techniques have been employed to estimate fair value.

However, if the valuation models are to be employed only for external reporting, the relevance of the fair value information of the instrument that is not managed on the fair value basis is questionable even if the valuation process would result in reliable fair value.

E) WOULD FULL FAIR VALUE OF FINANCIAL INSTRUMENTS ALONE PROVIDE SUFFICIENT INFORMATION TO INFLUENCE DECISION MAKING?

As discussed above, where financial instruments are managed on a fair value basis, it is logical to conclude that fair value information and the fair value movements provide appropriate information to influence decision making by users of financial statements. Users are provided with the same information that management considers important, and this information is the best indication of the expected future cash flows. Where financial instruments are not managed on a fair value basis, it is not possible to reach the same conclusion. As it is neither possible nor desirable to sell instruments immediately, just providing market exit price cannot be faithfully representative. In particular, gross movements in market exit price are not useful in determining how earnings will emerge from the business. Those users of financial statements who rely on earnings to form the basis of their analysis would lose important information on a full fair value basis.

It may be argued that fair value provides a better measure of performance and stewardship than cost-based measures because fair value reflects all economic events occurring up to the end of the reporting period. Some have suggested that only fair value provides an up-to-date measure of an enterprise's position and performance, and that any measurement based on amortised cost must inevitably be out-of-date.

While fair value information about individual financial instruments can be useful and up-to-date measurements can assist in buy/hold decisions about such instruments, it is not clear that a collective portrayal of fair values for all financial instruments provides such useful or complete information about the enterprise as a whole.

F) WOULD FULL FAIR VALUE REDUCE COMPLEXITY AND ENHANCE UNDERSTANDABILITY?

We are not convinced that users are interested in having a single fair value amount representing the cash flows. We are not aware that the majority of banking institution analysts would request a full fair value measurement model for primary financial statements. Many commentators recognise that placing all assets and liabilities at exit value will not help to provide a faithfully representational value of the entity as a whole.

Information provided to users should enable them to evaluate the banking institution's potential to generate future cash flows. The key point is that these cash flows relate to the banking institution as a whole. The

total value of the banking institution cannot normally be determined by adding together fair values of individual assets or liabilities.

It is more useful to value assets and liabilities on a basis that reflects their use in business. If all instruments are measured at fair value, the income statement will not provide an appropriate basis to explain the performance of an entity and will not increase the understandability of financial statements.

Full fair value is unlikely to increase understandability especially for instruments that are neither traded in a liquid market nor held with the intention to trade, nor managed based on fair value.

It may be confusing to include in the income statement fair value movements resulting from market price movement if the aim of the instrument is to earn revenue on a long-term basis and the short-term movements do not have an impact on the future cash flows in such a way that they would influence the set business strategy. Gains and losses will be recognized following changes in market rates and not when income has been earned or a loss suffered.

Far from removing complexity, full fair value measurement is likely to result in users being given more complex information that would need supplementing with disclosures based on the information about transactional cash flows, which is of interest. Inclusion of information based on fair value would result in increased need for highly complex additional disclosures explaining the various estimations being used as well as factors causing the changes in fair value. We believe that the balance sheet and income statement should be based on amortised cost if these better reflect the earning flows in the perspective of different periods, with fair value provided as supplementary information in the framework of disclosure in the notes to financial statements. The current accounting model requires footnote disclosures for financial instruments, which presents fair value information. The use of this fair value information by users of financial statements should be assessed before any changes are made to financial instrument measurement accounting.

We do not believe the mixed measurement model to be the source of complexity. The complexity arises from the business itself; therefore, it cannot be expected that an accounting model that is simple for standard setters to describe (but difficult practically to implement) would reflect the complex reality behind it. On the contrary, we are convinced that only the mixed measurement model allows for appropriate accounting to reflect the complex economic reality.

The advantage of the current mixed measurement model is that it is well established and understood and reflects the commercial substance underlying different business models and different internal risk management strategies. Financial statements prepared using the mixed measurement model of accounting are well understood by users, who have developed sound and extensive financial management processes that rely on this information as a basis for economic decision making.

G) WOULD FAIR VALUE OF ALL FINANCIAL INSTRUMENTS INCREASE TRANSPARENCY?

Opponents of the existing mixed measurement system often argue that it allows management to influence disclosed earnings either by the selective realisation of gains or the establishment of excessive provisions. However, annual financial statements, business reports and accounts of the management of financial instruments are subject to regular internal and external auditing. The banking risk management practices are scrutinized by banking supervisory authorities. The mixed measurement model allows the users of financial statements to see risks borne by entities and risk mitigation transactions. Full fair value accounting for financial instruments does not provide users or management with a better tool for transparency than the mixed measurement model.

H) WOULD FULL FAIR VALUE ENHANCE COMPARABILITY?

If one assumes that measuring all financial instruments at fair value results in the same fair value being consistently determined by different entities for the same financial

instrument, then the full fair value measurement would increase comparability. However, that is not the case. Even if it were the case, such comparable values would not give sensible and meaningful information, as in most circumstances fair value would not reflect how the instrument is used in the business model. Thus, the resulting fair value would not reflect the reality behind the particular business model, and the practical outcome of the comparable information would be questioned. The same financial instruments can be employed in different cash flow/revenue generating processes depending on the business model applied, leading to different expectations. This difference should be represented in financial statements.

For instance, an investment bank, which focuses on trading, acquires a debt instrument in order to gain a profit from changes in its price or in underlying risk factors, whereas a retail banking institution can acquire the same financial instrument in order to receive a stable flow of interest revenue as well as the notional amount at maturity. As the business strategy being pursued is different, the employment of different measurement criteria for the same instrument does not diminish comparability. On the contrary, it allows users of financial statements to understand how the entity actually works. This opportunity would be impeded by employment of a full fair value basis.

Additionally, financial statements of even two identical entities will likely result in different fair values. Fair value measurement is much more complex than what would appear to be the simple theory that assumes: deep, liquid and efficient markets; the existence of ideal or close-to ideal market conditions; and, knowledgeable, independent and economically rational parties. In representations to the IASB on its Fair Value Measurements paper, for example, many constituents questioned whether the notion of a market participant's view is realistic. Basing the entirety of financial instrument measurement on the view of a hypothetical market participant in a theoretical market that ignores market limitations can only result in information that is neither relevant nor representationally faithful. In addition, because of this, comparability inevitably must be very weak.

Conclusion

Assessing the full fair value accounting approach to financial instruments against the multiple objectives of financial reporting, we come to the unambiguous conclusion that the objectives of financial reporting will not be met by moving to a full fair value measurement model for financial instruments when the instruments or their components are not managed on the same basis. A mixed measurement model is therefore necessary to represent faithfully an entity's business model and the way it generates earnings.

Financial instruments are held for a variety of reasons. As concluded in the previous section, neither the fair value model nor the amortised cost model can be presented as a universal solution. We believe that a differentiated approach is best suited to achieving the objectives of the framework. There is a need to continue to measure some financial instruments at amortised cost while others may be measured at fair value in order to reflect the underlying economic substance and business strategy of the company.

A mixed measurement model best reflects how businesses operate as it enables the fair value measurement of assets and liabilities managed on a fair value basis. Where the entity does not manage the instruments on a fair value basis, amortised cost represents the most appropriate way to estimate future cash flows.

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