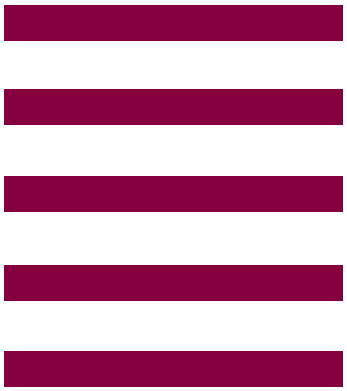
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

Principles not Rules:

Report on Proceedings of Financial Instrument Workshops



Published April 2006

The Institute of Chartered Accountants of Scotland

ISBN 1-904574-22-X

This document is published by the Technical Policy Board of The Institute of Chartered Accountants of Scotland. This paper reports on the discussions and conclusions of two workshops on financial instruments and the views expressed do not necessarily represent the views of the Working Group, the Critical Review Group, the Technical Policy Board or of the Council of the Institute.

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The Institute of Chartered Accountants of Scotland

21 Haymarket Yards, Edinburgh EH12 5BH

Tel: 0131 347 0237

Fax: 0131 347 0111

E-mail: mcrickett@icas.org.uk

Acknowledgements

The Institute's Technical Policy Board and the Principles versus Rules Working Group would like to thank the workshop participants who are listed below.

IAS 39 'Deconstruct' Workshop Participants

Alex Brougham	European Head of Accounting Policy, Morgan Stanley (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Kumar Dasgupta	Associate Director, Technical Accounting Group, Barclays Capital
Martin O'Donovan	Technical Officer, The Association of Corporate Treasurers
Andrew Spooner	Director, Deloitte
Sandra Thompson	Director, Global Accounting Consulting Services, PricewaterhouseCoopers
Sam Wilkins	Manager of Treasury Accounting and Control, ScottishPower

Financial Instruments 'Blank Sheet' Workshop Participants

Marjorie Marker	Managing Director, Corporate Risk Management & Derivatives, Barclays Capital (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Mark Kirkland	Senior Vice President, Global Head of Financial Risk & Cash Services, Philips
Louise McSweeney	Head of Client Accounting, Technical Accounting Group, Barclays Capital
Colin Martin	Director, Financial Management, Financial Services Advisory, KPMG
Gary Romain	UK Head of Technical Accounting, Barclays Capital
Shannon Warren	Managing Director, Accounting Policy, JPMorgan Chase & Co.
Chris Weidler	Head of US GAAP Accounting, Technical Accounting Group, Barclays Capital
Paul Wilkinson	Group Treasurer, Tomkins Plc

It should be noted that the Workshop participants were acting in their personal capacity and were not representing the organisations for which they work.

Contents

SECTION ONE - INTRODUCTION AND SUMMARY

Introduction

As part of the *Principles versus Rules* project, it was decided to focus specifically on an area of much recent controversy, financial instrument accounting. This part of the project can be seen as having two key purposes:

- to explore whether, or to what extent, the current version of IAS 39 can be distilled into higher level principles; and
- to explore what an alternative model for financial instruments might look like if one were to start afresh.

To achieve the above, two 'brainstorming' sessions were held by two different groups of financial instrument accounting experts. The first group focused on IAS 39 (the 'deconstruct' workshop) whereas the second explored the subject from a 'blue sky' perspective (the 'blank sheet' workshop). The first group made reference to the material prepared by the IASB for the IAS 32 and IAS 39 roundtable discussions in 2003.

Summary

Section two describes the thought process that went into the attempt to deconstruct IAS 39 into principles. Because IAS 39 is a mixed measurement model, the group found it extremely difficult to develop a coherent and consistent set of principles from IAS 39. This is manifested in the large number of exceptions in IAS 39 compared to the principles identified (as set out in section three of this document). For illustrative purposes, Appendix I to this document identifies various exceptions relevant to just two areas: recognition and derecognition; and measurement of financial assets and liabilities. A complete listing of exceptions for all areas in IAS 39 would run to hundreds of pages.

The IAS 39 group's broader discussion of principles and rules was also revealing. One key point is that the group found it difficult to express formally how a rule differs from a principle. However, the group also felt that the distinction may not matter in the sense that there is always going to be some kind of spectrum which ranges from high-level principles to more detailed guidance or rules. By implication, the group clearly accepted that one cannot have principles alone without any additional guidance at all. The group was also clear on another critical point: it is not the role of accounting standards to anticipate abuse and incorporate rules to prevent such abuse.

Section four describes the thought process which went into the development of a new model for financial instruments from a 'blue sky' perspective. This discussion was far more wide-ranging and involved several iterations to arrive at the model described in section five. The group ultimately settled on a model in which all financial instruments are reported at fair value, both initially and subsequently. However, the group was also clear that there remains work to do to ensure that this measurement approach is fairly presented in performance reporting terms. Furthermore, the group started with the premise that the model should be consistent with the overarching concepts contained in a Framework or Concepts Statement.

The second group's broader discussion of principles and rules was relatively consistent with the IAS 39 group. The group felt that there should be a clear hierarchy of overarching concepts, principles that reflected the overarching concepts and then guidance to support the principles. The group also agreed that the model should not contain anti-abuse or policing provisions.

In summary, the 'brainstorming' sessions illustrated the difficulty of developing a principles-based approach where the model is based on mixed measurement and is supported by many complex rules. On the other hand, while it is not trivial to develop a principles-based approach where the model is based on full fair value model, it is more conceptually possible and will result in far fewer exceptions.

The final report Principles Not Rules, which incorporates some of the findings of these sessions, is available from ICAS or at www.icas.org.uk.

SECTION TWO - DECONSTRUCTING IAS 39 INTO PRINCIPLES - THE THOUGHT PROCESS

The distinction between principles and rules

The initial discussion of the group revolved around the distinction between 'principles' and 'rules'. The group agreed that principles are high-level, general statements which leave room for judgement. They are based on the objectives of financial reporting and do not contain bright lines. However, it is difficult to define a principle with any degree of clarity. While it is relatively easy to identify a rule it is often difficult to identify a principle.

The group realised that it did not come to a conclusive decision as to what a principle is and how it would differ from a rule or a concept. Given the importance of the issue the group recommended that the question "what is a principle and what are its distinguishing characteristics" be addressed in future.

As principles are high-level statements a principles-only standard would not be sufficiently detailed to ensure any degree of real comparability, especially in a global context given the variety of cultures that apply International Financial Reporting Standards (IFRS). The objective therefore was to arrive at a principles-based standard and not a principles-only standard. The group was of the view that standards that are principles based may be less subject to abuse.

One view was that there is a spectrum between high-level principles and detailed rules. Cultural and legal background determines to a large extent where we operate within this spectrum.

The group concluded that robust accounting is a function of:

- accounting standards;
- preparers applying accounting standards sensibly/ fairly; and
- auditors and regulators enforcing the principles where required.

The group believed that it is not the role of accounting standards to anticipate abuse and incorporate rules to prevent such abuse.

In view of this the group concluded that a principles-based approach is practicable if:

- companies comply with the spirit of the principles; and
- principles are enforced in spirit by auditors and regulators.

Identifying the principles in IAS 39

In determining the principles in IAS 39 the group looked for consistency between the various requirements in the Standard, for example, consistency of principles in recognition and de-recognition of financial assets and liabilities. There was a view that scope and definitions could never be based on principles.

However, each time a principle was developed it was necessary to include exceptions to arrive at the requirements in IAS 39. Given the number of exceptions for any given principle in IAS 39 the group found it difficult to conclude whether the requirements were based on principles with exceptions or whether they were a collection of rules. It became clear that it is difficult to develop a coherent and consistent set of principles in an accounting standard that is based on mixed measurement and supported by many complex rules.

SECTION THREE - DECONSTRUCTING IAS 39 - THE PRINCIPLES IDENTIFIED

Scope

- The Standard applies to cash and contracts for cash.

Measurement

- All financial assets and financial liabilities that result from transactions shall be measured at initial recognition at their fair value.
- Subsequent measurement shall reflect the nature of the instrument and/or the purpose for which it is held.
- All derivatives should be at fair value – this was considered to be a rule rather than a principle.

Impairment

- If a past event results in a decrease in the expected future cash flows from a financial asset, then the asset shall be re-measured to reflect the revised expectations.

Hedge accounting

- When a financial asset or financial liability is in a hedging relationship:
  - to the extent the hedging relationship is not effective, ineffectiveness is recognised immediately in the income statement;
  - to the extent the hedging relationship is effective, the offsetting gains and losses on the hedging instrument and the hedged item are recognised in the income statement at the same time;
  - only items which meet the definitions of assets and liabilities are recognised as such in the balance sheet; and
  - all intra-group items are eliminated on consolidation.

Recognition

- An entity shall recognise a financial asset or a financial liability on its balance sheet when the entity becomes a party to the contractual provisions of the instrument (IAS 39.14).

Derecognition – assets

- An entity shall derecognise a financial asset:
  - when the contractual rights to the cash flows from the financial asset expire (IAS 39.17(a)); or
  - to the extent that the risks and rewards of ownership of the financial asset have been transferred.
- **Exception** (to the second principle above) – If an entity neither retains nor transfers substantially all the risks and rewards of ownership of the financial asset, but transfers control, the entity shall derecognise the asset.
- **Note:** The need for such a substantial exception caused the group to question whether it had correctly identified the second derecognition principle. An alternative second principle could be "in a way that reflects the extent to which the risks and rewards of ownership of the financial asset have been transferred and/or whether control of the financial asset has been transferred". The group was concerned that this alternative is too vague to be a principle.

Derecognition – liabilities

- An entity shall derecognise a financial liability when the entity ceases to be a party to the contractual provisions of the instrument, *ie*. when the contractual obligation is discharged, cancelled or expires (IAS 39.39).

SECTION FOUR - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - THE THOUGHT PROCESS

The distinction between principles and rules

The group initially focused on the difference between a principle and a rule. Common defining themes emerged and the group quickly concluded that nomenclature was not important, rather, what was required was a clear hierarchy of overarching principles (*eg*. the conceptual framework), principles that reflected the overarching principles and then guidance to support the principles. What needed to be clearer was the hierarchy and what guidance related to what principle. There was some support for the ability to override provisions lower down in the hierarchy by use of provisions higher up in the hierarchy.

An accounting standard should therefore be written so as to satisfy the high level concepts contained in the relevant Framework or Concept Statement, such as reliability, usefulness and consistency. Once it is determined which measurement and recognition approach best satisfies these concepts, the degree of guidance and examples required will necessarily vary. Such guidance should be drafted so as to maximise the extent to which the high level concepts are met and manage conflicts between those concepts. It was thus agreed that:

- there is a place for both principles and more detailed guidance, along with explanations and examples;
- conflicts between different guidelines and principles should be avoided; and
- where guidance is necessary to assist the preparer and aid consistency, the necessary principles and examples should be included. However, overly inflexible or prescriptive requirements are inappropriate. Obviously striking the right balance between the two is not easy.

The group also unanimously agreed that there were currently too many 'rules' which were there for anti-abuse purposes. These should not feature so frequently in a standard on financial instruments but should be part of the regulator's powers.

Identifying financial instrument principles

Initial measurement of financial instruments

The group quickly agreed that initial measurement on the balance sheet should be at fair value but the group could not quickly agree on what should happen when fair value was not equal to exchange value. This was left open.

Subsequent measurement of financial instruments

The group debated at length on subsequent measurement and views were expressed on whether corporates and financial institutions should have different measurement models. Those who worked more with corporates were more supportive of a cost-based model for corporates.

All agreed that substance and management intent were important in subsequent measurement but that policing and auditing management intent might be difficult. All agreed that auditor power and independence would need to be re-visited if this was a workable model.

Some consensus was finally reached and a new model for financial instruments outlined. A critical issue in the success of this model concerns recycling:

SECTION FOUR - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - THE THOUGHT PROCESS (Continued)

- after much debate, the group could not agree precise details on the recycling model but did agree that more guidance on Income Statement geography and the performance statement project might be key to the model. The lack of agreement on recycling was probably the cause of most tensions and debate in the group; and
- all agreed that the hedge accounting criteria should be less onerous and that management intent/substance of an economic hedge should play a larger role in permitting hedge accounting than strict quantitative rules

Derecognition

Initially the group was supportive of a model under which an entity accounted for what it had retained so that the fact that an entity owned certain assets before acquiring its retained interest should not differ to the accounting if the retained interest had been bought in the market place. However the group could not then agree on how and when profit should be recognised. This was another area of tension and hot debate in the group.

A brief discussion revealed that symmetric accounting for assets and liabilities would not work and that legal extinguishment is more relevant for liabilities.

SECTION FIVE - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - A NEW MODEL

General Comments

- The model should be consistent with overarching principles contained in a Framework or Concepts Statement.
- The model should not contain anti-abuse or policing provisions. This should be dealt with outside the standard-setting process.
- Broad principles should be supported by guidance which: provide a resolution where the overall principle conflicts with various overarching principles from the Concepts Statement; aid implementation; or give alternate treatments based on the substance and purpose of a transaction.
- The new model is based on the current income statement recognition model.

Model

- **Initial Recognition:**
  - ➢ All financial instruments should be initially reported on the balance sheet at fair value.
  - ➢ Additional guidance would be required in situations where the fair value does not equal the exchange value.
- **Subsequent Measurement:**
  - ➢ All financial instruments should be reported each period on the balance sheet at their fair value.
  - ➢ The change in fair value should be reported in period income on the Income Statement for financial instruments which are part of a trading portfolio as indicated by the way they are managed. This would include derivatives which are not part of a valid hedge relationship.
  - ➢ The change in fair value should be reported in Equity or Other Comprehensive Income for all other financial instruments.
    - For these instruments, the recognition of income effects should reflect the substance and purpose for holding these financial instruments. For example, the interest income recognised from interest producing assets should be recognised in earnings on an accrual basis.
    - Hedge accounting guidance and criteria would need to be developed. The intention would be to enable such derivatives to be marked through Equity or Other Comprehensive Income. If the derivatives could not be shown to be part of a valid hedge relationship, they would be marked to fair value through earnings.
    - Impairment recognition is based on loss in fair value. Guidance relating to financial institutions and loan loss reserves would need to be developed.
- **Derecognition of Financial Liabilities:**
  - ➢ This would be based on release from primary legal liability.
- **Derecognition of Financial Assets:**
  - ➢ The criteria for derecognition for most financial assets would be risks and rewards, when it is essentially an "all or nothing" situation. That is, derecognise assets when all risks and rewards are passed to the buyer; continue to recognise assets when all the risks and rewards of ownership are retained by the seller.

SECTION FIVE - DEVELOPING PRINCIPLES FOR FINANCIAL INSTRUMENTS - A NEW MODEL (Continued)

- The difficult question concerns the criteria for derecognition on partial sales where some of the risks or some of the rewards are passed.
  - While the criteria were not set, it was generally agreed that the entity should account for the risks and rewards it has retained. Whether to take the full gain on removing all the assets and replacing them with cash and a retained interest either at fair value or at allocated cost was not conclusively decided.

Unresolved Issues

- Greater guidance is required on the presentation of items in the Income Statement to promote consistent reporting between companies. In addition, it was suggested that the Income Statement should focus on industry sectors to make performance of the different sectors more transparent.
- Consideration should be given to how a revised performance reporting model would affect the new approach.
- Non-financial exposures which are part of a trading activity should be marked to fair value through earnings, similar to the approach suggested above for financial instruments.
- The question was also raised whether there should be different approaches for different industries or operating segments, *eg.* a different model for financial institutions *versus* manufacturers.
- The question also arose as to the treatment of derivatives used to create synthetic long positions, that is, whether these positions should be accounted for in a manner similar to a cash long position or as a derivative that is marked to market through earnings. An example would be writing credit default protection which puts the writer in the same position as holding the underlying bond. There were concerns expressed that the accounting for both the cash long and the derivative should be the same but the open question was how to recognise income and impairment on the derivative. One suggestion was to accrue the income on the premium, similar to recognising interest income on the long holding, and provide for losses similar to IAS 37 on contingent liabilities, as opposed to a mark to market model.

APPENDIX I
EXCEPTIONS TO IAS 39 PRINCIPLES IDENTIFIED
EXTRACT FOR ILLUSTRATIVE PURPOSES

The following pages illustrate both the complexity of IAS 39 and the exceptions which exist in relation to the high level principles identified in section three. This section is illustrative only and not exhaustive.

In relation to hedge accounting, it can be seen that IAS 39's provisions in this area modify the accounting which would otherwise prevail. Thus, for example, IAS 39 specifies that loans and receivables shall be measured at amortised cost using the effective interest method. However, if such loans are hedged for interest rate risk and fair value hedge accounting is applied, then the carrying value of the loans is adjusted for the fair value movement which is due to changes in interest rate risk. In so doing, hedge accounting modifies amortised cost accounting and instead permits the loans to be measured on a "partial" fair value basis. This appendix also gives an indication of the complex and onerous nature of the conditions which require to be met in order to satisfy hedge accounting criteria and thus permit this alternative accounting approach to be applied.

In relation to recognition and derecognition, it can be seen that IAS 39 sets out numerous and detailed provisions in respect of particular scenarios.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Measurement		
All financial assets and financial liabilities that result from transactions shall be measured at initial recognition at their fair value. Subsequent measurement shall reflect the nature of the instrument and/or the purpose for which it is held.	When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets: (a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;	**Hedge accounting** Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item. Hedging relationships are of three types: (a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. (b) cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss. (c) hedge of a net investment in a foreign operation as defined in IAS 21. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Measurement (continued)		
	(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and (c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost. After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.	**Hedge accounting** (continued) A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of the following conditions are met: (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk; (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105–AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship; (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss; (d) The effectiveness of the hedge can be reliably measured, *ie.* the fair value or cash flows of the hedged item which are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured; and (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Initial Recognition		
An entity shall recognise a financial asset or a financial liability on its balance sheet when the entity becomes a party to the contractual provisions of the instrument.	An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.	**Regular way** A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting. A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets. For this purpose assets which are held for trading form a separate category from assets designated at fair value through profit and loss. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in equity for assets classified as available for sale.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets		
Derecognise when the contractual rights to the cash flows from the financial asset expire. Derecognise to the extent the risks and rewards of ownership of an instrument have been transferred.	An entity shall derecognise a financial asset when, and only when: (a) the contractual rights to the cash flows from the financial asset expire; and (b) it transfers the financial asset and the transfer qualifies for derecognition. If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer. If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.	**Regular way sale** Same as the previous section on recognition. **Transfer of a financial asset** An entity shall derecognise a financial asset when, and only when it transfers the financial asset as set out in paragraphs 18 and 19. **Pass-through conditions** When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met: (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition; (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows; and (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets (continued)		
		Control If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. If the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.
		Continuing Involvement If the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example: (a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount'); (b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price; and

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) (c) when the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b). When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is: (a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value. The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability. For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset. If an entity's continuing involvement is in only a part of a financial asset (*eg.* when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) The difference between: (a) the carrying amount allocated to the part that is no longer recognised; and (b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part which continues to be recognised and the part which is no longer recognised on the basis of the relative fair values of those parts. The following are examples of how an entity measures a transferred asset and the associated liability. All assets If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis and the carrying value of the asset is reduced by any impairment losses.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) Assets measured at amortised cost If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (*ie*. the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss. Assets measured at fair value If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 – CU5) and the carrying amount of the transferred asset is CU80 (*ie.* its fair value).

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Assets (continued)		
		Continuing Involvement (continued) Assets measured at fair value (continued) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price, because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price). If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset which is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) – CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

Principle Identified	Words In The Standard Reflecting The Identified Principles	Exceptions
Derecognition - Financial Liabilities		
Derecognise when the entity ceases to be a party to the contractual provisions of the instrument.	An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished - *ie*. when the obligation specified in the contract is discharged or cancelled or expires	An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

APPENDIX II

Working Group Members

Hugh Shields (Chairman)
(Director and Head of Financial Reporting, Barclays Capital)

Alex Arthur
(University of Aberdeen)

Michelle Crickett (Secretary)
(Assistant Director, Accounting and Auditing, ICAS)

Professor Christine Helliar
(University of Dundee and ICAS Director of Research)

Professor Pauline Weetman
(University of Strathclyde)

David Wood
(Executive Director, Technical Policy, ICAS)

Critical Review Group Members

David Cairns
(International Financial Reporting Consultant and Visiting Professor, London School of Economics)

Keith Cochrane
(Director of Finance, ScottishPower)

Isobel Sharp
(Partner, Deloitte & Touche LLP and ICAS Junior Vice-President)

Professor Stephen Zeff
(Rice University)

Geoffrey Mitchell
(Director, Barclays Bank plc)