International Accounting Standards Committee®

Press Release

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IASC INVITES COMMENTS ON PROPOSALS FOR ACCOUNTING FOR FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

The International Accounting Standards Committee, together with other members of the Financial Instruments Joint Working Group of Standard Setters (JWG), today published for public comment the JWG's 'Draft Standard and Basis for Conclusions – Accounting for Financial Instruments and Similar Items' (the 'Draft Standard').

The document represents the views of JWG members, who are representatives or members of accounting standard setters or professional organisations in ten jurisdictions. Although the Board of IASC has discussed most aspects of the Draft Standard, the views expressed in the Draft Standard do not necessarily reflect the views of the Board. In addition, while written in the form of a draft standard, the document is not an IASC draft standard or exposure draft. IASC is treating the Draft Standard as a discussion paper. An exposure draft may follow, but this will be issued only after further deliberations in light of comments received on the Draft Standard.

The Draft Standard represents an important milestone in the Board's project on Financial Instruments. The primary objective of the Draft Standard is to reflect, in an enterprise's balance sheet and income statement, the effects of events on the fair value of the enterprise's financial instruments, and certain similar items, in the periods in which those events occur. It establishes principles for recognition, measurement, presentation and disclosure of financial instruments and similar items in the financial statements of all enterprises. The proposals would affect existing accounting practice in many areas, including those related to the use of hedge accounting.

A 1997 IASC Discussion Paper examined the major recognition and measurement issues for financial instruments. Among other things, it proposed that all financial instruments should be measured at fair value. In light of comments received on the Discussion Paper, the Board decided to proceed with the project on accounting for financial instruments in two phases:

- A project to meet the urgent need for a standard on the recognition and measurement of financial instruments; and

- A comprehensive longer-term project in partnership with national standard setters.

IASC completed the first phase in December 1998 when it approved IAS 39, Financial Instruments: Recognition and Measurement. IAS 39 represented a move toward the Discussion Paper's proposal to require fair value accounting for all financial instruments.

To further the longer-term project the Board agreed late in 1997 to participate in the JWG. The Chair of the JWG is a representative of IASC. It is hoped that future work on financial instruments will be carried out together with other standard setters in order to achieve a single method of accounting for financial instruments.

Commenting on the publication, the JWG Chair, Alex Milburn, said: "The Draft Standard proposes some far reaching changes. The large majority of the JWG believe that these will significantly improve financial reporting and can be implemented with appropriate preparation. It is our hope that this Draft Standard will provide the basis for informed comment from interested parties, for rigorous analysis and field testing and, ultimately, for an internationally agreed standard for accounting for virtually all financial instruments and similar items of all enterprises."

Thomas E Jones, IASC Chairman, said "Having worked in a multinational bank for many years, I am convinced that the importance of having a global accounting standard for financial instruments can not be overemphasized. This is a clear case of needing global standards for a global marketplace – and when it comes to financial instruments, such as bonds, derivatives and equities, the market truly is a global market."

Sir Bryan Carsberg, IASC Secretary General added "IASC's project on financial instruments has been in process for over ten years, demonstrating that the topic is one of great complexity and innovation. The comments received on this 'Draft Standard' will be of vital assistance to the new IASC Board, which will have the responsibility of taking the project to the next level. The work will be an early application of the new IASC Board's 'liaison' relationship with other national standard setters as we all seek to develop a truly global accounting standard for financial instruments.''

Sir Bryan also thanked the members of the JWG, and particularly the Chairman. ''Alex Milburn and his staff have given tremendous leadership to this project. He has had to work with standard setting bodies in many different countries, each with their own concerns and priorities. The Draft Standard represents a significant achievement''.

ENDS.

Copies of the Financial Instruments Joint Working Group of Standard Setters' Draft Standard and Basis for Conclusions: *Accounting for Financial Instruments and Similar Items,* (ISBN 0 905625 90 0), price £25 each (US$42), may be obtained directly from IASC's Publications Department, 166 Fleet Street, London EC4A 2DY, United Kingdom, Telephone: +44 (020) 7427-5927, Fax: +44 (020) 7353-0562, E-mail: publications@iasc.org.uk, Internet Web Site: http://www.iasc.org.uk

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Notes for Editors

A. The Draft Standard is founded on four basic principles.

1. Fair Value Measurement Principle

The JWG accepted the Discussion Paper conclusion that fair value is the most relevant measurement attribute for all financial instruments, and has concluded that sufficiently reliable estimates of the fair value of financial instruments are obtainable for financial reporting purposes, with the exception of certain private equity investments.

The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies. Such a valuation technique should incorporate estimates and assumptions that are consistent with available information that market participants would use in setting an exit price for the instrument.

The estimated market exit price for a financial liability is to reflect the effects of the same market factors as for a financial asset, including the credit risk inherent in the liability.

The Draft Standard addresses circumstances requiring special consideration in using observed market prices to determine fair value. These include:

(a) situations in which observable market prices may not be determined by normal market interactions (for example, where the observed market price would have been different if not for other transactions or contracts between the transacting parties);

(b) where observable market transactions are only infrequently available;

(c) where there are prices in more than one market for a financial instrument;

(d) where an enterprise holds a large block of a financial instrument and observable market exit prices are only available for small blocks; and

(e) where the observable market exit price includes value that is not directly attributable to the financial instrument. A prominent example is demand deposit liabilities. Observable market exit prices for these liabilities include the value of benefits expected to result from future deposits and from other services that can be expected to arise from the customer relationship. The Draft Standard would require that such value not be included in the fair value of deposit liabilities because the objective is to estimate the value of the existing financial instrument.

The Draft Standard sets out basic standards for selecting valuation techniques and for the use of estimates and assumptions. Present value concepts are central to the development of valuation techniques.

The JWG believes that an important underpinning for ensuring that fair value estimates and assumptions are made on a reliable and internally consistent basis lies in an enterprise establishing fair value measurement policies and procedures that are appropriate to its financial activities.

2. Income Recognition Principle

All gains and losses resulting from measuring financial instruments at fair value are to be recognised in the income statement in the reporting periods in which they arise, with one exception. The exception is that, in accordance with existing foreign currency translation standards, exchange translation gains and losses relating to certain foreign operations are to be separately presented outside the income statement.

The Draft Standard would require the presentation of interest revenue and interest expense calculated on a fair value basis, and information about gains and losses by general classes of financial risks. The JWG concluded that the traditional historical cost ‘‘effective interest’’ method is not appropriate for the analysis of income determined on a fair value basis for interest-bearing financial instruments.

3. Recognition and Derecognition Principle

An enterprise would be required to recognise a financial instrument when it has the contractual rights or obligations that result in an asset or a liability and to derecognise a financial instrument or a component thereof when it no longer has the pertinent rights or obligations.

The Draft Standard would require a components approach to transfers involving financial assets. Difficult issues arise in applying this approach to complex transfer transactions (such as securitisations, sale and repurchase and stock lending arrangements, and certain factoring situations) where the transferor has a continuing involvement in the transferred assets. The Draft Standard would require that a transferor, generally, continue to recognise a transferred financial asset, or part thereof, to the extent that the transferor has a conditional or unconditional obligation to repay the consideration received or a call option over a transferred component, unless the transferee has the ability to transfer that asset to a third party.

4. Disclosure Principle

The JWG believes that financial statement presentation and disclosure should be sufficient to enable evaluation of risk positions and performance in respect of each of an enterprise's significant financial risks. To accomplish this objective the Draft Standard would require:

(a) a description of each of the financial risks that was significant to an enterprise in the reporting period and the enterprise's objectives and policies for managing those risks;

(b) information about the balance sheet risk positions and financial performance effects for each of these significant risks; and

(c) information about the methods and key assumptions used to estimate the fair value of financial instruments.

A number of the Draft Standard disclosures are already required by accounting standards in many jurisdictions. The adoption of a comprehensive fair value measurement system provides a richer and more consistent foundation for disclosures that facilitate the predictive and accountability purposes of financial reporting.

Hedges

Following from the first three principles above, the Draft Standard does not permit special accounting for financial instruments that are entered into as part of risk management activities. In other words, financial instruments that are used for hedging purposes (for example, used as hedges of risks expected to arise from anticipated future transactions) are to be recognised and measured at fair value, with gains and losses recognised immediately in the income statement, just as for all other financial instruments.

B. Membership of the Joint Working Group

The Financial Instruments Joint Working Group of Standard Setters includes representatives of IASC and representatives or members of accounting standard setting bodies or professional organisations in Australia, Canada, France, Germany, Japan, New Zealand, the Nordic Countries, the United Kingdom and the United States.