FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

APPLICATION SUPPLEMENT

This section comprises additional material that explains how certain aspects of the Draft Standard apply. It is an integral part of the Draft Standard and should be applied in the same manner as the principles in the Draft Standard.

Contents

Application Supplement – Contents

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Scope

Licence Fees, Royalties and Similar Items

196. In accordance with paragraph 1(g), contractual rights or contractual obligations that are contingent on the future use of, or right to use, non-financial items are excluded from the scope of this Draft Standard. When an enterprise transfers the rights to cash flows from such contracts to another party in exchange for a residual interest in a securitisation trust, or similar enterprise, the residual interest is a financial instrument and is, therefore, subject to the requirements of this Draft Standard.

Certain Contracts to Buy or Sell Non-financial Items That Can Be Settled Net by a Financial Instrument [see Draft Standard, paragraph 2(a)]

Settled Net

197. "Settled net by a financial instrument" means settling a contract by delivering a financial instrument in an amount reflecting the difference between the fair value of a non-financial item and the fair value of the consideration to be exchanged for the non-financial item. A contract can be settled net by a financial instrument if any of the following circumstances exist:

   (a) the terms of the contract explicitly or implicitly permit either party to settle net by a financial instrument;

   (b) there is an established market mechanism, or side agreement, outside the contract that facilitates settlement net by a financial instrument; or

   (c) the non-financial item that is the subject of the contract has interchangeable (fungible) units, which are exactly the same as those for which an active market exists. (For example, natural gas deliverable at Sabine Pipe Line Co.'s Henry Hub in Louisiana, USA, is considered to be the same as Henry Hub natural gas traded on the New York Mercantile Exchange (NYMEX)).

198. An established market mechanism includes any pre-existing institutional arrangement that permits either party to eliminate its net position and, thereby, to be relieved of all rights and obligations under the contract without incurring a prohibitive penalty or other cost. For example, an enterprise entering into a contract to purchase a commodity on a futures exchange has the ability to enter into an offsetting contract on that exchange so that the enterprise is no longer obligated to receive a physical delivery of the commodity. Similarly, the existence of brokers who stand ready to buy and sell commodity contracts that relieve the enterprise of its rights and obligations under the contract for a non-prohibitive fee also constitutes an established market mechanism. In contrast, an off-exchange contract to sell

the purchased commodity to a third party would not result in settlement net since this does not relieve the enterprise of its rights and obligations under the original contract.

199. A side agreement for delivery to a third party, at which time the contracting parties settle payment, does not constitute settlement net of the original contract. The fact that delivery is to a third party does not affect the original contract between the purchaser and the supplier.

200. The existence of a clause stipulating that in the event of non-performance a penalty or other cost will be payable in an amount that is fixed at the inception of the contract does not constitute settlement net by a financial instrument. However, a payment that is directly based on changes in the price of the items that are the subject of the contract does constitute settlement net by a financial instrument, unless there is an additional penalty or other cost that is prohibitive. The presence of a nominal handling fee, in addition to the settlement payment, would not be considered to be a prohibitive penalty or cost.

201. A penalty or other cost is considered prohibitive if it is an amount that is expected to be significant enough throughout the remaining term of the contract to make the possibility that the non-financial item will not be delivered remote. The assessment of whether a penalty or other cost is prohibitive would be carried out only at the contract's inception.

202. A requirement that one or both parties to a contract may assign its rights or obligations to a third party only after obtaining permission from the counter-party does not, of itself, preclude the contract from meeting the criteria for settlement net. An assessment of the substance of the assignment clause is necessary. If the chance that the counter-party will withhold permission to assign the contract is remote, the mere existence of the clause would not preclude the contract from meeting the criteria for settlement net. However, if there is more than a remote chance that the counter-party will withhold permission to assign the contract, it is precluded from meeting the criteria for settlement net.

203. If parties to a contract agree to settle net subsequent to the contract's inception, the contract would be accounted for in accordance with this Draft Standard from the time such an agreement is made. An enterprise would also consider what effect this has on its policy for normal purchases or sales (see paragraph 206, below).

Normal Purchase or Sale

204. Except as noted in paragraph 205, a contract meets an enterprise's normal purchase or sale requirements if it provides for the purchase or sale of a non-financial item that will be delivered in quantities expected to be used or sold by the reporting enterprise over a reasonable period in the normal course of its business. In such circumstances, an enterprise would account for that contract in accordance with accounting standards applicable to the non-financial item. An enterprise would have a consistent policy in place for concluding that a contract meets these conditions. This policy need not specify each individual contract

to which it relates but would be stated in a manner such that it is clear at the inception of any contract whether that contract is for such purposes.

205. The following contracts are not considered to be for normal purchase or sale requirements:

(a) a contract that requires periodic cash settlement of changes in value or that is otherwise settled net periodically, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a non-financial item;

(b) a contract that will probably be settled net;

(c) a contract containing an option enabling the counterparty to force net cash settlement. In such circumstances, the enterprise would not have the ability to ensure delivery;

(d) a contract that has a price based on changes in the fair value of a variable that is unrelated to the item being sold or purchased (such as an equity index);

(e) a contract denominated in a foreign currency that is neither the currency of the primary economic environment in which any substantial party to the contract operates, nor the currency in which the price of the non-financial item that is acquired or delivered is routinely denominated in international commerce (for example, the US$ for crude oil transactions); and

(f) a contract for delivery of a non-financial item, with immediate repurchase or sale, and a contract settled by offsetting with the same counterparty (sometimes referred to as a "bookout"), unless the enterprise's business is that of buying or selling non-financial items (for example, a commodity trader).

206. Management's purpose in entering into a contract for physical delivery to meet the normal purchase or sale requirements of the enterprise would be evident from the nature of its business operations and its purchase and sale practices within current business conditions. If an enterprise settles net contracts that it has previously treated as being for normal purchases or sales, or settles net contracts with similar terms and conditions, this would call into question whether future contracts of a similar nature are for normal purchases or sales.

207. A contract that otherwise meets the characteristics of a normal purchase or sale but that requires delivery to a third party does not of itself preclude an enterprise from treating that contract as a normal purchase or sale.

Servicing Assets and Servicing Liabilities [see Draft Standard, paragraph 2(b)]

208. Servicing of financial assets includes collecting principal, interest, fees, expected late charges, escrow payments and ancillary charges from borrowers; paying taxes and insurance from funds held in escrow; monitoring delinquencies; executing foreclosures if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting payments to holders of beneficial interests in the financial assets.

209. Servicing assets or servicing liabilities arising on the origination of financial assets would be included on the balance sheet as part of the asset being serviced and would not be recognised separately until the financial asset is derecognised, in whole or in part. An enterprise that undertakes a contract to service financial assets that are not recognised in its financial statements would recognise a separate servicing asset or servicing liability.

210. Contractual rights of a servicer to receive an interest-only strip, or other cash flows from the serviced asset, in excess of contractually specified servicing fees need not be recognised and measured separately from the servicing asset or servicing liability, given that both will be measured at fair value. However, the servicer may wish to present them separately for a number of reasons. For example, there may be regulatory reasons for reporting those items separately.

Leases

211. To determine how the Draft Standard applies to contractual rights and obligations arising from leases, an enterprise considers whether there are sets of rights and obligations within the lease contract that need to be separated in accordance with the Draft Standard's requirements for hybrid contracts (see paragraphs 4-6). The enterprise applies standards for lease accounting[12] to determine whether it must recognise any financial assets or financial liabilities. The Draft Standard is applied only to financial assets and financial liabilities recognised in accordance with the requirements for hybrid contracts or those for lease accounting. Thus, when an enterprise accounts for a lease contract as a finance lease, the lessor's receivable from the lessee and the lessee's liability to the lessor are financial instruments and, therefore, are subject to the requirements of this Draft Standard.

212. An unguaranteed residual value taken into account in determining a lessor's finance lease receivable is not a financial instrument. It would, therefore, be accounted for separately from the finance lease receivable in accordance with the requirements for hybrid contracts in paragraphs 4-6 and 74-76. A guarantee by a lessee to a lessor of a specified residual value of a leased asset that arises from a lease accounted for as a finance lease would be

[12] The IASC requires leases to be accounted for in accordance with IAS 17, Leases.

recognised and measured as part of the financial instrument, in accordance with this Draft Standard.

213. Lease payments might be contingent on the future use of leased property. For example, the amount of lease payments on a retail store might depend on future sales volumes. Such rights and obligations are excluded from the scope of the Draft Standard by paragraph 1(g).

Recognition and Derecognition

Recognition

Forward Contracts and Other Executory Contracts

214. When an enterprise enters into an agreement to purchase a financial asset at a future date, it does not immediately have the asset that is the subject of the contract. Instead, it has a contractual right to obtain the asset that is conditional upon performance by the counterparty. Similarly, until it obtains the asset, it does not have a contractual obligation to pay for it, merely an obligation that is again conditional upon performance by the counterparty. In other words, it has a forward purchase contract—a contractual commitment to purchase a specified financial instrument on a future date at a specified price in exchange for a payment. Therefore, as the recognition principles set out in paragraph 31 require an enterprise to recognise contractual rights as a financial asset only when it actually has those rights, the enterprise will not recognise the asset that is the subject of the contract until it has obtained the asset. Similarly, as the recognition principles set out in paragraph 31 require an enterprise to recognise contractual obligations as a financial liability only when it has those obligations, the enterprise's obligation to pay for the asset will not be recognised until it is actually assumed.

215. A forward purchase contract is an example of a financial instrument that is an executory contract. The conditional rights and obligations that arise from financial instruments that are executory contracts will usually be recognised as a single asset or liability rather than as separate financial assets and financial liabilities.

216. The terms of executory contracts are often negotiated so that, at first, the fair values of the conditional rights and obligations underlying an executory contract will be equal, so that the fair value of the contract as a whole at that date is zero. Subsequently, the balance between the fair values may change, so the fair value of the contract may become positive (which would mean that the contract is an asset) or negative (meaning the contract is a liability).

Regular Way Security Transactions

217. A regular way security transaction is a transaction that involves the purchase or sale of a financial asset on terms that require its delivery, and therefore completion (or settlement) of the transaction, within the period established by regulations and conventions in the market place or by the exchange on which the transaction is executed. A regular way security transaction therefore involves acquiring a forward contract. Parties entering into such a transaction will initially recognise, as a single asset or liability, just the contractual commitment involved. Then, on delivery, the acquirer will recognise the security

purchased as a financial asset and the obligation to pay for the security as a financial liability.[13]

Security Interests

218. Another example of a financial instrument that involves conditional contractual rights and obligations is a security interest. A security interest arises if one party (the obligated party) gives another party (the secured party) rights to a financial asset—and perhaps some related obligations—that are wholly contingent on the obligated party defaulting on an obligation to the secured party. Those rights and obligations may include the ability of the secured party, upon default, to do one or more of the following:

(a) compel the sale of the financial asset to satisfy the liability, generally with any surplus being returned to the obligated party;

(b) acquire the financial asset and pass any value in excess of the liability to the obligated party; or

(c) relinquish the security interest in return for the obligated party's settlement of the liability.

219. The holder of a security interest in a financial asset does not have the asset in which the security interest has been given since, absent default and a resultant claim on the item, it does not have the contractual rights that make up the financial asset. Nor does the holder have the related obligations. It follows that, prior to default, the holder of a security interest recognises the rights conveyed by the security interest, together with the obligations that would arise if those rights were exercised, as a single item. Usually it would in fact be treated as part of the asset secured by that interest. Similarly, a granter of a security interest (the creditor) would recognise the interest as part of the liability secured.

Hybrid Contracts

220. In determining the recognition or derecognition treatment of a hybrid contract, an enterprise would apply the recognition and derecognition principles of the Draft Standard only to the parts of the contract that are within the scope of the Draft Standard. It would look to other relevant principles to determine the treatment of the rest of the contract.

Description Given to Assets and Liabilities on the Balance Sheet

221. Choosing the description (or label) to be applied on the balance sheet (or in the notes to the financial statements referenced from the balance sheet) to assets and liabilities is an

[13] In reality, as completion often takes the form of delivery against payment, the payment itself, rather than a liability, will usually be recognised.

important part of the recognition process. That is particularly true when the assets or liabilities involved are unusual in nature, are complex, or are connected in some way to other assets and liabilities, as will often be the case with assets and liabilities arising from transfers involving financial assets. That is because it will be the descriptions used, together with any other information provided in the notes to the financial statements, that inform users of the nature of the asset or liability involved. Therefore, in providing any sub-analysis of the balance sheet information required by paragraphs 131-135 (or of any analysis required by those paragraphs to be provided either in the balance sheet or the notes to the financial statements), it is important that assets and liabilities are appropriately labelled.

Transfers That Have Substance

222. As set out in paragraph 35, a transfer that lacks substance has no effect on the contractual rights and contractual obligations of the parties involved and is therefore not a recognition or derecognition event.

223. In a securitisation, the transferee is often an enterprise created solely for the purpose of the transaction and will therefore typically not conduct substantial business with parties other than the transferor. However, such securitisation transactions will still result in an eligible recognition or derecognition event if the financial assets (or components thereof) transferred have been isolated from the transferor, even in the event of the transferor's bankruptcy.

Derecognition

Components of Financial Assets and Financial Liabilities

224. Financial assets and financial liabilities are made up of bundles of contractual rights and contractual obligations that are financial assets and financial liabilities in their own right. The Draft Standard calls those contractual rights and obligations "components".

225. Financial instruments usually have a number of components. Some will be the contractual rights to future economic benefits or contractual obligations to transfer economic benefits that make up the financial instrument. The rest will be rights and obligations related to the economic benefits. Examples of this second type of component include:

    (a) the right to continue to hold the contractual rights to future economic benefits;

    (b) the obligation to transfer future economic benefits (i.e., a forward contract);

    (c) the right to exchange (including sell or pledge) or distribute the economic benefits or the obligation not to;

(d) the right to use a contractual right to settle a liability; and

(e) the right to acquire the economic benefits or the obligation to transfer them if requested to do so (i.e., an option held or written).

226. Some components of a financial asset or financial liability might expire before the other components. Similarly, some components of a financial asset might be transferred while others are retained, or some components of a financial liability might be settled while others remain outstanding. The derecognition principles in paragraph 37 recognise this by focussing on extant contractual rights and contractual obligations, rather than on assets and liabilities.

Obtaining Release from Primary Responsibility for an Obligation

227. An enterprise will derecognise a liability only when the obligation involved expires, the liability is settled in full, or the enterprise has obtained release from the primary responsibility for the obligation. Although an enterprise could enter into an arrangement that involves a third party agreeing to assume its liability to the creditor, that arrangement would have no effect on the first enterprise's liability unless the creditor also agreed to release it from the primary responsibility for the obligation. As such, transferring an obligation is not a derecognition event absent obtaining release from primary responsibility for that obligation.

228. A debtor may transfer assets, with cash flows of timing and amounts equivalent to the liability owed, to a third party and instruct that third party to pay the cash flows collected on the assets to the creditor to settle the liability (an arrangement that is sometimes called "in-substance defeasance"). The Draft Standard does not permit the liability to be derecognised when the assets are transferred to the third party because the debtor is not relieved of its primary obligation to the creditor.

229. An enterprise will be released from primary responsibility for the obligation underlying a debt instrument if it purchases it in the market, regardless of whether the debt instrument is cancelled or held for re-issue. That is because, in such circumstances, honouring the instrument will not result in any outflow of net assets from the enterprise.

230. In some transactions, an enterprise is released from its primary responsibility for a liability under an arrangement in which it guarantees the performance of the enterprise that has taken on primary responsibility for the liability. In other words, it has accepted an obligation to pay if the enterprise assuming the primary responsibility defaults. In such circumstances, the enterprise will derecognise the original liability and recognise the guarantee as a new liability.

Derecognition and Consolidation

231. The derecognition requirements set out in the Draft Standard are not intended to alter the requirements of consolidation standards. Whether a parent enterprise would derecognise a transferred financial asset in its unconsolidated financial statements and whether the transferee in that transaction would be included within the scope of any consolidated financial statements prepared by that parent enterprise are separate issues. Only the former issue is addressed in the Draft Standard. It follows that a transfer between a parent enterprise as transferor and one of its subsidiaries as transferee could result in a financial asset being derecognised in the parent's separate (unconsolidated) financial statements but not being derecognised in the parent's consolidated financial statements.

Transfers involving Financial Assets

Introduction

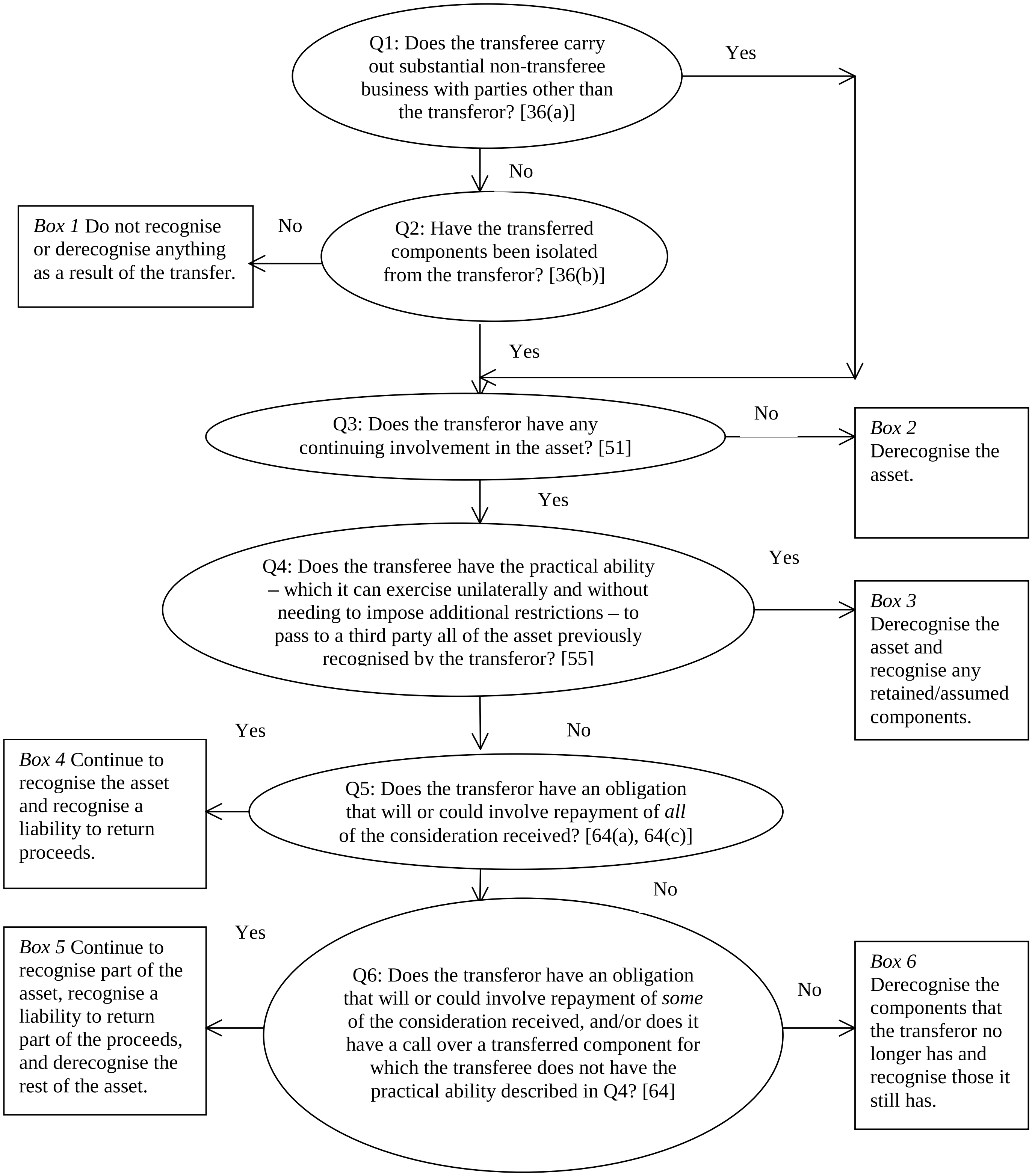
232. Paragraphs 49-68 set out the recognition and derecognition principles that would be followed by *transferors* that are accounting for transfers that have substance and involve financial assets. *Transferees* are required to follow the recognition principles set out in paragraph 31. Paragraphs 233-314 provide additional guidance on the accounting to be adopted both by transferors and by transferees.

233. Many transfer transactions involve an exchange of financial assets. Where that is the case, each transferor would apply paragraphs 49-68 separately to each transfer. For example, if Enterprise A transfers an equity security to Enterprise B and receives in return a government security, Enterprise A (the transferor in the equity transfer) will apply paragraphs 49-68 to the transfer of the equity security and Enterprise B (the transferor in the government security transfer) will apply those paragraphs to the transfer of the government security. If more than two financial assets are involved, the paragraphs will need to be applied separately to each financial asset.

Summary of the Transferor's Accounting

234. The approach to recognition and derecognition that paragraphs 49-68 require a transferor to adopt can be summarised as follows[14]:

[14] References to the Draft Standard are provided in square brackets.


Q1: Does the transferee carry out substantial non-transferee business with parties other than the transferor? [36(a)]
Yes
No
Q2: Have the transferred components been isolated from the transferor? [36(b)]
No
Box 1 Do not recognise or derecognise anything as a result of the transfer.
Yes
Q3: Does the transferor have any continuing involvement in the asset? [51]
No
Box 2 Derecognise the asset.
Yes
Q4: Does the transferee have the practical ability – which it can exercise unilaterally and without needing to impose additional restrictions – to pass to a third party all of the asset previously recognised by the transferor? [55]
Yes
Box 3 Derecognise the asset and recognise any retained/assumed components.
No
Q5: Does the transferor have an obligation that will or could involve repayment of *all* of the consideration received? [64(a), 64(c)]
Yes
Box 4 Continue to recognise the asset and recognise a liability to return proceeds.
No
Q6: Does the transferor have an obligation that will or could involve repayment of *some* of the consideration received, and/or does it have a call over a transferred component for which the transferee does not have the practical ability described in Q4? [64]
Yes
Box 5 Continue to recognise part of the asset, recognise a liability to return part of the proceeds, and derecognise the rest of the asset.
No
Box 6 Derecognise the components that the transferor no longer has and recognise those it still has.

Clean-up Call Options

235. Sub-paragraph 50(b) explains that call options of the type commonly referred to as "clean-up call options", which usually arise in the context of securitisations, would be ignored when determining which contractual rights and contractual obligations to recognise and which to derecognise. All references to options in the Draft Standard and Application Supplement are, unless stated otherwise, references to options other than clean-up options.

What is an Asset?

236. As most financial assets (and most financial liabilities) are capable of being unbundled into "smaller" assets (and liabilities) or components, it is not usually necessary to draw a distinction between an asset and a part of an asset; even a part of an asset will also be an asset in its own right. Similarly, no distinction usually needs to be drawn between an asset and a collection (or portfolio) of assets. However, the issue *is* of significance in the context of the questions asked in paragraphs 51 and 55 about financial assets that are the subject of a transfer. In particular, paragraph 51 asks whether the transferor has a continuing involvement in the financial asset that is the subject of the transfer and was previously recognised by the transferor. In this context, the identification of the asset "that is the subject of the transfer and was previously recognised by the transferor" is of considerable importance. Similarly, paragraph 55 asks whether the transferee has the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer the whole of the financial asset previously recognised by the transferor to a third party. Again, the identification of "the financial asset previously recognised by the transferor" is central to this question.

237. A loan of, say, $100 to a single debtor is clearly one asset, not one hundred assets. However, bearing in mind that financial assets comprise components that are themselves financial assets, it is not always such a simple matter to determine what is an asset (as opposed to a collection of assets, or a part of an asset) for the purposes of questions asked by paragraphs 51 and 55. The following (which uses loan assets as an example) is intended as guidance in more complex situations.

   (a) If the transfer involves a portfolio of loan assets, it will usually be appropriate to treat each loan asset as a separate asset. Therefore, if an individual loan asset has been transferred from the portfolio, the transferor does *not* have a continuing involvement in the asset previously recognised by the transferor even though it continues to hold the rest of the portfolio. Furthermore, if the transferee has the ability to transfer that loan asset to a third party, it *would* have the ability to transfer the asset previously recognised by the transferor *in its entirety*, as referred to in paragraph 55.

(b) If an interest in the portfolio as a whole is transferred, the portfolio, rather than the individual loan assets within that portfolio, is the asset for the purposes of the recognition and derecognition principles in the Draft Standard. Thus, a transferor of an interest in a portfolio of loan assets that retains, say, a residual interest *does* have a continuing involvement in the asset that it previously recognised. Similarly, even if the transferee has the ability to transfer its interest in the portfolio to a third party, it does *not* have the ability to transfer the asset previously recognised by the transferor *in its entirety* (i.e., the whole portfolio) because it is not able to transfer the part of the portfolio it does not have (i.e., the interest retained by the transferor).

(c) A common unbundling transaction is one in which an enterprise separates an interest-bearing debt security into two cash flow streams—the right to the interest payments only (the interest-only (IO) portion) and the right to the principal payments only (the principal-only (PO) portion). Then one portion (the IO portion for example) might be transferred and the other portion retained. As the transferor has retained the PO portion, it has a continuing involvement in its previously recognised asset. Similarly, even though the transferee may have the practical ability to transfer the IO portion to a third party, it does not have the practical ability to transfer the PO or, therefore, the transferor's previously recognised asset. (IO and PO strips are discussed further in paragraphs 284-287.)

Summary of the Transferee's Accounting

238. Although transferees are required to follow the recognition principles in paragraph 31 rather than those in paragraphs 49-68, their accounting will, with one exception, be the mirror image of the transferor's accounting. In other words, if the transferor is required to derecognise a particular financial asset or component thereof, the transferee will be required to recognise it, and if the transferor is required to continue recognising a particular financial asset or component, the transferee will not be permitted to recognise it. The one exception arises in paragraphs 63-67 (in other words, questions 5 and 6 in the flowchart in paragraph 234), which address the type of transfers that result in the transferor having either (or both) an obligation to repay consideration received and a call option over a transferred component. The transferor treats such a transfer as a loan secured by a financial asset or in some cases as part sale, part loan, whereas the transferee will treat such a transfer as the acquisition of the transferred asset.

239. The implications of this exception can be illustrated by considering a transfer of a security (Security X) that:

(a) does not result in the transferee having the practical ability to transfer the whole of Security X to a third party, and

(b) includes a forward contract that will require the transferor to repay all the consideration received (and, in exchange, receive back all of Security X).

Under paragraphs 63-67, the transferor is required to continue to recognise Security X and to recognise the consideration received and a liability to repay the whole of that consideration. The mirror-image of this would be for the transferee to recognise a receivable from the transferor for the amount of consideration paid (and to reduce its cash balances by that amount). However, the transferee, under paragraph 31, recognises Security X as its asset and a forward contract to exchange Security X for cash at a date in the future (as well as a reduction in its cash balances).

240. Paragraph 221 emphasised that an important part of the recognition process is the way in which an asset or liability is described or labelled on the balance sheet or in the notes to the financial statements referenced from the balance sheet. For example, in the case of the transaction described in the preceding paragraph:

(a) although Enterprise A is required to continue to recognise Security X, the nature of that asset has changed and it is important that the label used reflects that. Enterprise A will therefore use a label such as "security transferred subject to a repurchase agreement"; and

(b) although the transferee is also required to recognise Security X, the asset recognised will be described in terms such as "security held subject to a resale agreement".

241. Thus, in this example, although the accounting entries in paragraph 239 seem to suggest that both parties to the transaction will recognise the same asset, the labels used to describe the assets will highlight the differences. The same point could be made in the context of a number of other transactions discussed in the Application Supplement but, to avoid repetition, it is made here only.

Transfers Where the Transferee Has the Ability to Transfer the Asset to a Third Party

The Transferor's Previously Recognised Asset or a Transferred Component

242. The recognition and derecognition principles relating to transfers involving financial assets contain two principles that, although seeming similar, differ in important ways.

(a) Paragraph 55 asks whether the transferee has the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer the financial asset that was previously recognised by the transferor to a third party *in its entirety*.

(b) Sub-paragraph 64(b) asks whether the transferee has the practical ability to transfer some or all of the transferred components it acquired to a third party unilaterally and without having to impose additional restrictions.

243. Paragraph 55 focuses on the asset previously recognised by the transferor, and on the whole of that asset. In contrast, sub-paragraph 64(b) focuses on the components transferred and requires each to be considered in turn. For example, if an enterprise transfers part of an asset but retains the rest of it the following will be the case.

(a) The transferee will usually not have the ability to transfer to a third party the whole of the asset previously recognised by the transferor (in other words, the answer to the question asked by paragraph 55 will be "no"). The purpose of paragraph 55 is to identify transactions that do not need to be analysed in detail because it is clear that control of the whole asset has passed to the transferee. In our example, it is not clear that that has happened.

(b) The transferee may still have the ability to transfer some or all of the components transferred to it (in other words, the answer to the question asked by sub-paragraph 64(b) may still be "yes"). The purpose of sub-paragraph 64(b) is to consider whether, although control of the whole asset appears not to have been passed to the transferee, control of some of the transferred components has been passed.

"Practical Ability", "Unilaterally" and "Additional Restrictions"

244. Paragraph 55 and sub-paragraph 64(b) refer to the transferee having the practical ability—which can be exercised unilaterally and without having to impose additional restrictions—to transfer a financial asset. Paragraphs 56-61 explain in greater detail the implications of these references to "practical ability", "unilaterally" and "additional restrictions". In particular, those paragraphs explain that the focus is not just on what contractual rights the transferee has with respect to the asset (or indeed what contractual prohibitions exist) but on what the transferee is able to do in practice. A contractual prohibition on disposing of an asset (or the absence of an explicit contractual right to dispose of it) may have no effect on the transferee's practical ability if it is easy to obtain identical replacement assets. On the other hand, a contractual right to dispose of the asset is of no practical use if it cannot be exercised freely or if there is no market for the asset. For that reason, paragraph 55 and sub-paragraph 64(b) ask whether:

(a) the transferee is able to dispose of the asset independently of the actions of others—in other words, whether it has a unilateral ability. An apparent ability to dispose of something is not a practical ability if another party can prevent its being used; and

(b) the transferee is able to dispose of the asset without needing to attach restrictive conditions or “strings” to the transfer (for example, conditions as to how a loan asset is serviced or an option to repurchase the asset).

Replacement Assets

245. As explained in the preceding paragraph, in considering the practical effect of any restrictions relating to the transferee’s ability to transfer the assets to a third party, the ease with which replacement assets can be obtained is often an important factor. In essence, the issue is whether the transferee might find itself in default of any commitments or obligations to the transferor if it transfers the asset to a third party without attaching any restrictions to that transfer. For example, assume that a transferee has written a call option enabling the transferor to insist on the return of a transferred asset that is unique (and therefore irreplaceable). In such a circumstance, the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party without attaching a call option or forward purchase contract because, if the transferor exercises the call option, the transferee may be unable to get back the asset in order to deliver it to the transferor. The existence of the call option means that the transferee is not free to transfer the asset without restrictions.

246. It may be that, although the assets involved may not be capable of being easily replaced, because of market convention, other established practice or an express or implied term of the transaction, it is possible to be reasonably certain that an asset that is not identical to the asset transferred will be considered by the transferor to be an acceptable replacement for the transferred asset. If that is the case, a call option of the type described in the preceding paragraph will not prevent the transferee from transferring the asset.

Options that are Virtually Certain to be Exercised or Not to be Exercised

247. Sub-paragraphs 59(a) and (b) set out two circumstances in which the transferee will not have the practical ability to transfer the asset involved in the transfer to a third party without imposing additional restrictions on that transfer if replacement assets are not readily available:

(a) when the transferor has a call option over the asset, unless it is virtually certain that the transferor will not exercise that option; and

(b) when the transferee has a put option over the asset and it is virtually certain that the transferee will exercise that option.

Whether it is virtually certain that an option will, or will not, be exercised is a matter of judgement based on the circumstances involved.

248. One very important factor in that judgement will be price. When price is the only issue, whether an option is virtually certain to be exercised or not exercised will depend on the expected value of the underlying at the exercise date relative to the strike price. However, it would not be necessary to undertake detailed assessments of the likely value at the exercise date.

(a) In the case of a call option, if there is a genuine possibility that the option could be in the money at the exercise date, it will usually *not* be appropriate to conclude that it is virtually certain that the call option will *not* be exercised. Similarly, in the case of a put option, if there is a genuine possibility that the option could be out of the money, it will usually *not* be appropriate to conclude that it is virtually certain that the put option will be exercised.

(b) A call option may be so deep in the money at the transfer date that there is no genuine possibility that it will be out of the money at the exercise date. Similarly, a put option may be so out of the money at the transfer date that there is no genuine possibility that it will be in the money at the exercise date.

249. Other factors apart from price will also need to be taken into account in the assessment. For example, an asset underlying a call option may be one that, because of the nature of the option holder's activities or the way in which it operates, it would wish to reacquire even if the reacquisition cost appears higher than its market value to other potential buyers at that time.

Transferor's Continuing Involvement in an Asset the Transferee is Able to Transfer

250. Even though the transferee has the practical ability to transfer the asset previously recognised by the transferor in its entirety to a third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions, the transferor may still have a continuing involvement in the asset. That would be the case, for example, if one or other party has an option over a transferred asset that is easily replaceable or if a forward agreement had been entered into in respect of such an asset. Paragraph 55 requires paragraph 31 to be applied to the recognition of such continuing involvement.

Transfers Where the Transferor Has an Obligation to Repay Consideration Received or a Call Option over a Transferred Component

251. Paragraphs 63-67 identify the transfers involving financial assets that are to be treated by the transferor in whole or in part as loans secured by the transferred financial asset. Such transfers are transfers that meet all of the following criteria in the Draft Standard:

(a) the transfer has substance;

(b) the transfer leaves the transferor with a continuing involvement in the financial asset;

(c) the transferee does not have the practical ability to transfer the asset previously recognised by the transferor in its entirety to a third party or, if it does have that ability, it is not able to exercise that ability unilaterally or without needing to impose additional restrictions on the transfer;[15] and

(d) the transfer results in the transferor having either an obligation that could involve it repaying some of the consideration received or a call option over a component that is not at the disposal of the transferee to transfer to a third party.

252. Paragraph 64 prescribes how to determine the initial measure of the liability to be recognised. In essence, it will be:

(a) the maximum amount of the transfer consideration the transferor could be required to repay under any obligation that meets the criteria referred to in sub-paragraph 251(d); plus

(b) the amount of the transfer consideration received by the transferor in respect of any transferred component over which the transferor has a call option meeting the criteria referred to in sub-paragraph 251(d);

(c) adjusted to eliminate the effect of any overlap between the obligation and the call option.

Any transfer consideration that is not to be treated as having been received in the form of a loan will be sale proceeds received in exchange for the sale (in whole or in part) of the transferred asset.

253. The following example illustrates certain of the determinations that follow from these requirements. Assume Enterprise A (the transferor) holds a portfolio of receivables with a fair value of 90. It enters into a bankruptcy remote factoring arrangement[16] with Enterprise B (the transferee) that involves Enterprise B giving 80 of cash to Enterprise A in exchange for the rights to the first 80 of fair value[17] collected from the receivables. Enterprise A

[15] The similarities and differences between this test and the similarly worded test in paragraph 55 are discussed in paragraphs 242 and 243.

[16] Factoring arrangements are discussed in greater detail in paragraphs 294-304, and this particular transaction is discussed in paragraphs 302-304.

[17] Enterprise B will require rights to more than 80 of cash for it to receive a fair value return from the transaction, since the receivables will be collected over time. In practice, the agreement would typically specify that, from the cash collected from the receivables, Enterprise B would be entitled to 80 plus interest to be determined at a stipulated rate. However, the example has been simplified by incorporating the effect of both interest and the time value of money into Enterprise A’s guarantee that Enterprise B will receive 80 of fair value from the receivables. Otherwise, details of interest rates and the timing of individual cash flows would have to be provided. These details are not germane to the concepts being illustrated, since the principle is that the amounts recognised will be fair values determined after taking these factors into account.

retains the right to any cash collected from the receivables in excess of that amount, and it also agrees to make good the first 5 fair value of Enterprise B's losses if less than 80 of fair value is collected from the receivables.

254. In accordance with the Draft Standard, the transaction would be analysed as follows.

(a) As the factoring arrangement is bankruptcy remote, the transfer transaction has substance. The existence of the guarantee means that Enterprise A has a continuing involvement in the entire asset (i.e., the portfolio), so the conditions for derecognition set out in paragraph 51 are not met. Its existence also means that the transferee is not able to transfer the entire asset to a third party, so the conditions for derecognition set out in paragraph 55 are not met either. The existence of the guarantee means that Enterprise A has an obligation that could involve it in repaying some of the consideration received. In other words, the transfer meets all the criteria referred to in paragraph 251, so the transfer involves, at least in part, a loan.

(b) Enterprise A's maximum fair value exposure under the obligation is 5 at the date of the transfer, so (in accordance with paragraph 64) it would recognise a liability to repay 5 of the cash it received. It will treat the other 75 of cash received from Enterprise B as sale proceeds, and will, therefore, continue to recognise an interest in the receivables (being an interest in all the cash collected from the receivables after the first 75 of fair value has been collected) of 15.

255. So, Enterprise A retains an interest in the receivables with a fair value of 15 (not 10), although the first 5 of fair value received from this retained interest will be paid to Enterprise B to settle the liability of 5. If less than 5 of fair value is collected from the interest in receivables, Enterprise A will pay the balance from its general assets. The expectation is, however, that that will not be necessary.

256. In accordance with the Draft Standard (i.e., as described in paragraph 255), Enterprise A has an obligation to make a payment to Enterprise B (of up to 5 of fair value) from its general assets if insufficient monies are collected from the receivables. Enterprise A, therefore, is considered to have control of the receivables involved, so will recognise them (fair value 5) and the liability that is expected to be met from their proceeds (fair value 5), in addition to its other interest in the receivables (fair value 10).

257. The assets and liabilities recognised as a result of the transfer transaction will be measured at fair value like other financial instruments. It is likely that the fair value of the assets and liabilities recognised in the above example will be estimated using valuation techniques.

(a) The fair value of the receivables would typically be based on the present value of the expected cash flow streams involved. The fair value of Enterprise A's interest in the receivables will be calculated as the present value of the cash receipts, taking into account the expected timing, the uncertainties and other risks involved, and after deducting Enterprise B's entitlement to 80 of fair value from the collections.

(b) The liability of 5 (fair value) is expected to be settled in full from Enterprise A's interest in the receivables. Enterprise A's credit worthiness would be factored into the fair value of the liability only to the extent of the probability that the fair value of its residual interest in the receivables will be less than 5 (the fair value of the recourse liability), so that it will be required to make a payment to Enterprise B from its general assets.[18]

(c) Cash collections from the portfolio of receivables will change the fair value of the transferor's residual interest only to the extent that the receivables perform differently from what was originally anticipated in estimating their fair value. Similarly, the fair value of Enterprise A's liability will not change, assuming that Enterprise B's entitlement to interest specified in the transfer agreement continues to be a market return for such an investment. For example, if these assumptions are accurate, up to and including when 75 of fair value has been collected from the receivables, Enterprise A will still have an interest in receivables of 15 and a liability of 5. Cash collected thereafter will reduce the fair value of both the receivables and liability until, when 80 in fair value has been collected, the liability will be extinguished.

258. Furthermore, for the purposes of the Draft Standard's income statement presentation principles, the gains and losses arising on the assets and liabilities recognised in the above example will be determined and presented in the same way as gains and losses on any other receivables and payables. That means, for example, that they will be treated as interest-bearing assets and liabilities.

Application of the Recognition and Derecognition Requirements to Various Transfers involving Financial Assets

259. Paragraphs 260-314 below consider the implications of paragraphs 31-68 for various common types of transfers. It is assumed throughout that the transfer involved has substance.

Sale and Repurchase Arrangements

With Cash Collateral

260. Sale and repurchase arrangements can take many forms, but probably the simplest form is where an enterprise (Enterprise A):

[18] At the date of the transfer, there will be some small probability that less than 5 fair value will be collected from Enterprise A's interest in the receivables. The probability may change over time, depending on the performance of the receivables.

(a) transfers all the rights attaching to a security (Security X) to another enterprise (Enterprise B);

(b) receives in return a cash payment equal in amount to the fair value of the security at the time of the transaction; and

(c) agrees that, at a specified future date, it will give a cash payment (equal in amount to the cash payment originally received plus an amount that is equivalent to the current market rate of interest on that first cash payment) to Enterprise B in exchange for the return of the rights attaching to the security.

261. The existence of the forward repurchase agreement means that Enterprise A has a continuing involvement in the security (so paragraph 51 does not apply). However, it is not clear from the information provided in paragraph 260 whether the transferee (Enterprise B) has the practical ability to transfer to a third party all the components of the security and whether that ability can be exercised unilaterally and without the transferee needing to impose additional restrictive components on the transfer to a third party.

Transferee is able to transfer the security to a third party

262. Let us assume that Enterprise B *does* have the practical ability to transfer to a third party all the components of the security and that it is also able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. (Paragraphs 266 and 267 discuss the treatment to be adopted if this is not the case.) In these circumstances, paragraph 55 will apply and Enterprise A's (the transferor's) accounting will be as follows.

(a) It will derecognise the security in its entirety.

(b) It will recognise the other contractual rights and contractual obligations it has acquired in respect of the transferred security. Enterprise A has a right to acquire from Enterprise B the rights attaching to the security at a specified future date and an obligation to pay an amount of cash to Enterprise B in exchange. This right and obligation make up a financial instrument that is an executory contract (see paragraphs 214-216) and Enterprise A would recognise that contract in the balance sheet as a single asset or liability.

(c) The contractual rights and contractual obligations relating to the transferred security that Enterprise A will have will depend on the terms of the transaction involved. For example, it is not uncommon in such transactions for Enterprise B to agree to make cash payments to Enterprise A that are the same in amount as the dividends or interest it receives on the security. If that is the case, Enterprise A has a right to "manufactured dividends/interest receipts" which it would recognise as an asset.

263. The transferee (Enterprise B), on the other hand, will apply paragraph 31.

(a) It has all the contractual rights attaching to the security and would therefore recognise the security as an asset.

(b) It has a conditional right to receive a cash amount from Enterprise A at a specified future date and a conditional obligation to transfer the rights attaching to the security to Enterprise A in exchange. Like most financial instruments that are executory contracts, those conditional rights and obligations would be recognised in the balance sheet as a single asset or liability.

(c) It may also have an obligation to pay manufactured dividends/interest receipts to Enterprise A. The assumption of this obligation would usually not amount to a transfer of the right to the dividends/interest payments (see paragraphs 41-48), so that obligation would be recognised as a financial liability.

264. The treatment of the other "leg" of the transfer transaction (the cash that Enterprise B transferred to Enterprise A) is much simpler because the transferee (Enterprise A) is able to transfer it to a third party. Thus, Enterprise B derecognises the cash and Enterprise A recognises it.

265. To summarise, Enterprise A will derecognise the security in its entirety and will recognise instead the cash received, the forward purchase agreement and any right to manufactured dividends/interest payments. Enterprise B will reduce its cash balances by the amount paid to Enterprise A, and will recognise the security in its entirety, a forward sale agreement and any obligation to pay manufactured dividends/interest payments.

Transferee is not able to transfer the security on to a third party

266. Now assume that the transferee (Enterprise B) does not have the practical ability to transfer to a third party all the components of the security unilaterally without needing to impose additional restrictions on the transfer. (For example, the security may not be readily obtainable so, if Enterprise B transferred the security to a third party, it would have to impose restrictions on that transfer to ensure that it could honour its forward agreement with Enterprise A.) In these circumstances, paragraph 55 will not apply. However, the existence of the forward purchase agreement means that Enterprise A has an obligation that will involve the repayment of all of the consideration it received under the transaction. Paragraphs 64 and 65 thus apply, and Enterprise A would treat the transaction as a secured loan. It would therefore continue to recognise the security and would also recognise the cash received from Enterprise B and a liability to repay that cash.

267. Enterprise B (the transferee) would, on the other hand, apply paragraph 31. As already explained in paragraph 263, that means that it would recognise the security and a forward sale agreement and any obligation to pay manufactured dividends/interest payments (and would reduce its cash balances by the amount paid to Enterprise A).

With a Security Given as Collateral

268. In the sale and repurchase arrangement described in paragraph 260, Enterprise B transfers *cash* to Enterprise A in exchange for the rights attaching to the security (Security X). However, a common variant of this transaction is one in which Enterprise B transfers a *security* (Security Y)—rather than cash—to Enterprise A. Such a transaction involves two transfers and two transferors, so the requirements relating to the accounting treatment of transfers involving financial assets will need to be applied twice: to the transfer by Enterprise A of Security X, and to the transfer by Enterprise B of Security Y.

269. This has no effect on the accounting for Security X: the analysis described in paragraphs 260-267 will continue to apply. Exactly the same analysis will also be used to determine the treatment of Security Y. The key issue for both transfers will, therefore, be whether the respective transferees have the practical ability to transfer to a third party all the components of the security they have received and are able to exercise that ability unilaterally and without needing to impose additional restrictions on that transfer.

Both transferees are able to transfer the security they received to a third party

270. If the sale and repurchase arrangement involves the exchange of rights attaching to securities, typically both of the securities are actively traded and, therefore, easily replaced. As such, both transferees will usually have the practical ability to transfer the components received to a third party, unilaterally and without imposing additional restrictions on the transfer. In such circumstances:

(a) Enterprise A would derecognise Security X in its entirety and would recognise Security Y in its entirety. Enterprise B would do the opposite: recognise Security X in its entirety and derecognise Security Y in its entirety; and

(b) both enterprises would also recognise, as a single balance sheet item, the forward agreement to exchange Securities X and Y at a specified future date. They would also recognise any rights and obligations in respect of manufactured dividends/interest payments.

Only one transferee is able to transfer the security it received to a third party

271. In some sale and repurchase arrangements, only one transferee has the ability to transfer the security received as described in the preceding paragraph. For example:

(a) Enterprise A transfers all the rights attaching to an *easily replaced* security (Security X) to another enterprise (Enterprise B) and receives in return all the rights attached to a security that is *not easily replaced* (Security Y).

(b) Enterprise A also agrees that, at a specified future date, it will give the rights attaching to Security Y back to Enterprise B in exchange for the return of the rights attaching to Security X.[19]

272. The existence of the forward agreement described in sub-paragraph 271(b) means that both transferors have a continuing involvement in the asset each transferred.

273. Security X is an easily replaced security, and transferees usually have the practical ability—which can be exercised unilaterally and without needing to impose additional restrictions—to transfer to a third party the whole of securities that are easily replaced. In our example, we will assume that the transferee of Security X (Enterprise B) does have that ability. That means that paragraph 55 applies. Enterprise A would therefore derecognise Security X in its entirety. Enterprise B (the transferee in the transfer involving Security X) will apply paragraph 31 and, as a result, would recognise Security X in its entirety.

274. Security Y is not an easily replaced security. In view of the forward agreement, this means that the transferee (Enterprise A) does not have the practical ability to transfer the security to a third party. Paragraph 55 would therefore not apply to this "leg" of the transfer. However, the existence of the forward means that the transferor of Security Y (Enterprise B) has an obligation that will involve the repayment of all the consideration it received for Security Y. Enterprise B is therefore required by paragraphs 64 and 65 to continue to recognise Security Y. It is also required to recognise a liability to Enterprise A to repay the consideration it has received under the transaction (i.e., Security X). Enterprise A (the transferee), applying paragraph 31, would recognise Security Y and would also recognise a forward agreement to exchange Security Y for Security X.

275. Therefore, to summarise:

(a) Enterprise A would derecognise Security X and would recognise Security Y and a forward to reacquire Security X in exchange for giving up Security Y.

(b) Enterprise B would continue to recognise Security Y and would recognise Security X and a payable (to be met by transferring Security X to Enterprise A in exchange for nothing other than the release from the obligation).

Stock Lending (Sometimes Called Securities Lending)

276. Although the motivation that lies behind a stock lending transaction differs from the motivation that lies behind most sale and repurchase arrangements and the transactions differ from sale and repurchase arrangements in form and sometimes in risk protection,

[19] There may also be rights and obligations relating to manufactured dividends/interest payments and to maintained collateral but, as they will not affect the accounting treatment of the two securities, they are ignored in this example.

they are similar in substance. The Draft Standard therefore does not distinguish between transactions that are stock lending and transactions that are sale and repurchase arrangements.

277. The analysis set out in paragraphs 260-275 in the context of sale and repurchase arrangements therefore applies equally to stock lending transactions.

(a) If Enterprise A transfers *an easily replaced* security to Enterprise B in exchange for cash under a stock lending agreement, Enterprise A would derecognise the security and instead recognise the cash, a forward contract to reacquire the security, and any rights to receive manufactured dividends/interest payments. Enterprise B, on the other hand, would reduce its cash balances and would recognise the security, a forward contract to return the security, and any obligations to pay manufactured dividends/interest payments (this treatment is explained in paragraphs 260-265).

(b) If Enterprise A transfers a security *that is not easily replaced* to Enterprise B in exchange for cash under a stock lending agreement, Enterprise A would continue to recognise the security and would also recognise the cash received and a liability to pay that cash back to Enterprise B. Enterprise B would reduce its cash balances by the amount paid out, and would recognise the security, a forward sale agreement and any obligation to pay manufactured dividends/interest payments (this treatment is explained in paragraphs 266 and 267).

(c) If Enterprise A transfers *an easily replaced* security (Security X) to Enterprise B in exchange for another *easily replaced* security (Security Y) under a stock lending agreement, Enterprise A would derecognise Security X and instead recognise Security Y together with a forward contract to exchange the securities. Similarly, Enterprise B would derecognise Security Y and instead recognise Security X together with a forward contract to exchange the securities (this treatment is explained in paragraph 268-270).

(d) If Enterprise A transfers *an easily replaced* security (Security X) to Enterprise B in exchange for a security *that is not easily replaced* (Security Y) under a stock lending agreement, Enterprise A would derecognise Security X and would instead recognise Security Y and a forward agreement to reacquire Security X in exchange for giving up Security Y. Enterprise B, on the other hand, would continue to recognise Security Y and would recognise Security X and a payable to Enterprise A (this treatment is explained in paragraphs 271-275).

Transfers Where the Transferor Retains a Call Option to Reacquire the Rights or the Transferee Retains a Put Option to Return the Rights

Call Options

278. Consider a transaction in which an enterprise transfers the rights attaching to a financial asset—say, a security—to another enterprise in exchange for cash. The transferor also acquires a call option that enables it to insist that the security be returned on a specified future date in exchange for a cash payment on that date.

(a) The existence of the option means that the transferor has a continuing involvement in the security.

(b) Whether the transferee will have the practical ability—which can be exercised unilaterally and without the need to impose additional restrictions on the transfer—to transfer all of the previously recognised components of the security to a third party will depend on the terms of the transaction and call option. It will also depend on the availability of replacement assets (if the transferee disposes of the security and the transferor then exercises its option to reacquire). Sub-paragraph 59(a) sets out the circumstances in which the call option will prevent the transferee from having the practical ability to transfer the asset.

279. Assume that the transferee does have the practical ability to transfer the security to a third party. In such a circumstance, the transferor will derecognise the security and recognise instead the cash received and the call option. Similarly, the transferee will reduce its cash balances by the amount it has paid and will also recognise the security and the call option written.

280. If the transferee does not have the practical ability (which can be exercised unilaterally and without the need to impose additional restrictions on the transfer) to transfer all of the previously recognised components of the security to a third party, the existence of the call option means that, under sub-paragraph 64(b) and paragraph 65, the transferor will continue to recognise the security and will also recognise the cash received from the transferee and a liability for the amount of the original transfer consideration received. The transferee will reduce its cash balances by the amount paid and will recognise the security and the call option written.

Put Options

281. Now consider a transaction in which an enterprise (the transferor) transfers the rights attaching to a financial asset to another enterprise (the transferee) in exchange for cash and the transferee also acquires the right to insist that the transferor takes those rights back on a specified future date in exchange for a cash payment on that date that is equal in amount to the consideration received by the transferor plus interest (a put option that the transferor

has written). The existence of the put option means that the transferor has a continuing involvement in the asset and also an obligation that could involve it repaying all the consideration received. As such, the key issue is again the one raised in sub-paragraph 278(b) above: does the transferee have the practical ability to transfer the asset to a third party unilaterally and without needing to impose any additional restrictions on the transfer. As was the case with the call option, this will depend on a number of factors, including the terms of the transaction and the option and the availability of replacement assets. Paragraph 59(b) sets out the circumstances in which the put option will prevent the transferee from having that ability. In those circumstances, the transaction is considered a type of sale and repurchase arrangement, so the discussion in paragraphs 260-275 will apply.

Transfers with Some or All Gains and Losses Passed Back to the Transferor

282. Consider a transaction in which an enterprise transfers some or all the rights attaching to a financial asset to another enterprise in exchange for a cash payment. The transferee also agrees to transfer to the transferor some or all of the gains arising from those rights (in other words, cash flows derived from the asset in excess of a specified amount), while the transferor agrees to reimburse the transferee for some or all of the losses arising from those rights (in other words, amounts by which the cash flows derived from the asset fall short of a specified amount).

283. The transferor clearly has a continuing involvement in the asset. Whether the transferee has the practical ability—which can be exercised unilaterally and without the need to impose additional restrictions on the transfer—to transfer the asset that was previously recognised by the transferor to a third party will therefore need to be determined. If it does have that ability, the transferor will derecognise the asset and will instead recognise the cash received and its rights and obligations in respect of gains and losses arising from the transferred asset. However, if the transferee does not have the practical ability to transfer the asset, the fact that the transferor has agreed to reimburse the transferee for some or all of its losses means that the transferor has an obligation that will or could involve the repayment of some or all of the consideration received. Therefore, at least part of the transfer will be treated as a loan.

Income and Principal Strips

284. Assume that an enterprise (the transferor) holds a debt security on which it receives two cash flow streams: an interest income stream and a repayment of principal stream. The transferor then transfers the rights to the interest income stream to a second enterprise (the transferee) in exchange for a cash payment. The transferor retains no continuing involvement in that cash flow stream. Assume, also, that the transferee is free to deal with the transferred asset (i.e., the interest income stream) in whatever way it chooses. The transferor's rights to the principal stream are unaffected by the transaction. (When cash

flow streams are separated in this way, they are commonly called interest-only (IO) and principal-only (PO) strips.)

285. Although the transferor does not have a continuing involvement in *the interest income stream*, it still has (as explained in sub-paragraph 237(c)) a continuing involvement in *its previously recognised financial asset* (i.e., the debt security as a whole) through its interest in the principal stream. As such, the conditions for derecognition set out in paragraph 51 are not met. Similarly, as also explained in sub-paragraph 237(c), although the transferee has the practical ability to transfer *the interest income stream*, it does not have the practical ability to transfer *the entire debt security*. Therefore, the condition for derecognition set out in paragraph 55 is also not met.

286. On the other hand, as the transfer has not resulted in the transferor having an obligation that might involve repaying some of the transfer consideration or a call option over the interest income stream, the conditions set out in paragraph 64 for treating some or all of the transaction as a loan are not met either. In such circumstances, paragraphs 31 and 37 will need to be applied, which means that the transferor will derecognise the interest income stream but continue to recognise the principal stream, while the transferee will recognise the interest income stream.

287. The example in paragraph 284 relates to the transfer of rights to an interest income stream. Although such transfers usually involve a change in the recipient of the cash flows involved (i.e., the transferor ceases to receive the cash flows and the transferee starts to receive the cash flows), another way of transferring the rights would be for the transferor to assume a contractual obligation of the kind described in paragraphs 41-48.[20]

Loan Transfers

288. Some kinds of receivables cannot be "sold" in the same way as other types of assets, but they can be transferred by means of novation, assignment or certain types of back-to-back arrangements.

(a) A novation involves the cancellation of the original lender's (the transferor's) rights and obligations under the loan agreement and the creation of identical rights and obligations for the transferee.

(b) Under an assignment, the original lender (the transferor) agrees with another enterprise (the transferee) to transfer its rights (to principal and interest payments) relating to the receivables to that transferee. There are different types of assignment. For example, some require the whole of the loan (rather than just part) to be involved

[20] The application of paragraphs 41-48 to sub-participations is addressed in paragraphs 309-312.

in the transaction; and some require notice of the assignment to be given to the borrower.

(c) With back-to-back arrangements, the lender (the transferor) enters into a non-recourse back-to-back agreement with a third party (the transferee), under which the latter deposits with the lender an amount equal to the whole or part of the loan and in return receives from the lender all or a share of the cash flows arising on the loan.

Novations

289. Under a novation, the transferor will have no continuing involvement in the receivables unless there is a side agreement involved, such as a guarantee or other form of recourse arrangement, a forward purchase agreement or option of one kind or another. If there is no such side agreement and therefore no continuing involvement, the transferor will derecognise the receivables in their entirety and the transferee will recognise them in their entirety.

290. If there is a side agreement, the accounting treatment will depend on whether the transferee has the practical ability—which can be exercised unilaterally and without imposing additional restrictions on the transfer—to transfer the receivables to a third party. Whether it has that ability will usually depend partly on the nature of the receivables and partly on the terms of the side agreement.

291. If the transferee does not have the practical ability to transfer the receivables to a third party unilaterally and without the need to impose additional restrictions on the transfer, the accounting treatment will depend on whether any of the terms of the side agreement mean that the transferor has either an obligation that will or could involve the repayment of some or all of the consideration received in exchange for effecting the novation or a call option over some or all of the receivables involved.

Assignments

292. Assignments may or may not leave the transferor with a continuing involvement in the receivables depending on whether there are any residual interests, recourse provisions, buyback provisions, etc. involved. This issue is discussed below in the context of debt factorings and securitisations, most of which involve an assignment.

Back-to-back Arrangements

293. As already explained, with back-to-back arrangements, the transferor enters into an agreement that involves accepting one or more contractual obligations that are equal and opposite to some of its existing contractual rights—and thereby effectively transferring those rights to another party. (Legally, all the contractual rights and obligations will remain

outstanding.) Such arrangements are considered in detail in this Application Supplement in the context of sub-participations (see paragraphs 309-312).

Factoring Arrangements

294. A factoring transaction involves one enterprise (Enterprise A) transferring rights to some or all of the cash collected from some financial assets (usually receivables) to a second enterprise (the factor, known here as Enterprise B) in exchange for a cash payment. In addition, Enterprise A may retain the right to cash collected from the financial assets in excess of a specified sum (i.e., a residual interest), and may guarantee—by one means or another—the performance of some or all of the receivables.

295. If Enterprise A has neither retained a residual interest in the receivables it previously recognised nor given a guarantee concerning their performance, it will have no continuing involvement in the receivables. In such circumstances, it will derecognise the receivables in their entirety and the transferee will recognise them in their entirety.

296. However, the transferor usually retains a residual interest in the receivables and, as such, has a continuing involvement. If that is the case, it will be necessary to determine whether the transferee is able to transfer the factored financial assets to a third party, unilaterally and without the need to impose additional restrictions on the transfer. Generally speaking, the transferee will *not* have that ability (because it is unable to transfer the residual interest that the transferor has retained).

297. Assuming that to be the case, the transferor's treatment of the transaction will be determined by considering the recourse arrangements involved and, in particular, by considering what, if any, obligation the transferor has as a result of those arrangements. The transferee, however, will in all cases recognise the contractual rights it has to cash flows, any guarantee it has received in respect of those rights and any obligation it has to the transferor in respect of the residual interest.

Factoring with No Guarantee Given as to Performance

298. Assume that Enterprise A has not given any kind of guarantee about the performance of the receivables (i.e., the receivables have been factored without recourse). An example of such a factoring transaction is as follows.

    (a) Enterprise A has receivables with a fair value of 90.

(b) Enterprise A transfers the receivables to Enterprise B in exchange for 80 of cash and the right to any cash collected from the receivables in excess of 80 of fair value to which Enterprise B is entitled.[21]

(c) Enterprise A does not agree to make good any of Enterprise B's losses.

299. The transferor (Enterprise A) has not given any kind of guarantee about the performance of the receivables, so it does not have an obligation that will or could involve the repayment of some of the cash received from Enterprise B. Nor does it have any call option over the transferred components. In such circumstances, Enterprise A will be required by paragraph 68 to derecognise all the receivables and to recognise instead the cash of 80 and a residual interest in the receivables with a fair value of 10. Enterprise B will also apply paragraph 68 and will, as a result, reduce its cash balance by 80 and recognise receivables with a fair value of 90 and an obligation of 10 to Enterprise A for the residual interest.

Full Recourse Factoring (including Protection Against Catastrophic Loss)

300. Now consider a transaction that is identical to the transaction just discussed except that Enterprise A has agreed to reimburse Enterprise B in cash for any shortfall between the fair value of the amount collected in total from the receivables and the cash amount Enterprise B paid Enterprise A for its right to 80 of fair value from the receivables. Under this arrangement, Enterprise A will make no payment if the receivables perform exactly as expected because the guarantee does not require Enterprise A to pay anything unless the fair value of the amount collected is less than 80 and the expectation is that fair value of 90 will be collected. On the other hand, Enterprise A's maximum possible exposure to Enterprise B is to repay 80 of fair value. Enterprise A therefore has an obligation that could involve it in repaying all the consideration it has received. Enterprise A will therefore not derecognise any of the receivables. Instead, it will increase its cash balances by 80 and will recognise a liability to repay that 80 of fair value.

301. Enterprise B will apply paragraph 31 and will therefore recognise the receivables of 90, the guarantee (fair value 0) and an obligation of 10 to Enterprise A for the residual interest. The receivables and guarantee will usually be shown together. Enterprise B will also reduce its cash balances by 80.

Factoring with a Limited Guarantee Given as to Performance

302. Now consider a transaction somewhere between the extremes described in paragraphs 298 and 299 (no recourse) and paragraphs 300 and 301 (recourse for everything); a transaction in which Enterprise A guarantees the performance of the factored receivables but that guarantee is capped (i.e., a factoring with partial recourse). For example:

[21] As discussed in the second footnote to paragraph 253, Enterprise B would expect a fair value return on its investment in the receivables. This example has been simplified in the same way.

(a) Enterprise A has receivables with a fair value of 90.

(b) Enterprise A transfers the receivables to Enterprise B in exchange for 80 of cash and the right to any cash collected from the receivables in excess of 80 of fair value to which Enterprise B is entitled.

(c) Enterprise A agrees to make good the first 5 fair value of Enterprise B's losses if less than 80 of fair value is collected from the receivables.

303. The existence of the guarantee and residual interest means that Enterprise A has a continuing involvement in the assets, and Enterprise A's retention of the residual interest means Enterprise B is not able to transfer all the receivables to a third party. However, the existence of the guarantee means that Enterprise A has an obligation that could involve repaying at least some of the consideration received. As Enterprise A will reimburse the first 5 fair value of the losses only, it does *not* have an obligation that could involve it repaying *all* the consideration it received in the transfer. It would therefore derecognise some, but not all, of the receivables.

(a) It will recognise cash of 80.

(b) It will also recognise a liability to repay 5 of fair value, being its maximum possible exposure under the recourse arrangements.

(c) It will treat the other 75 of cash received from Enterprise B as proceeds from the sale of the receivables. 75 of receivables will therefore be derecognised.

(d) It will continue to recognise the remaining receivables of 5 (90 less 10 less 75) and will also recognise a residual interest in the receivables of 10 (90 less 80). Usually the receivables of 5 and the residual interest of 10 would be shown together on the balance sheet.

304. Therefore, to summarise, Enterprise A will apply paragraphs 49-68 and that will result in it showing cash (80), residual interest plus receivables (15), and a secured liability (5). Enterprise B, on the other hand, will apply paragraph 31 and will, as a result, recognise receivables of 90, the guarantee, and an obligation of 10 to Enterprise A for the residual interest. It will also reduce its cash balances by 80. The receivables and guarantee will usually be shown together on the balance sheet.

Securitisations

305. The term "securitisation" is generally used to describe the process by which some or all of a portfolio of financial assets is converted into asset-backed securities and some or all of those securities are then transferred in exchange for cash. The following outlines a typical securitisation transaction.

(a) The transferee has been set up solely for the purpose of being the transferee. However, if the transfer has substance, that will have no effect on the way in which the securitisation is accounted for under the Draft Standard.

(b) The transferee finances the transfer by the issue to investors of commercial paper, loan notes, participation or pass-through certificates, or similar securities. The transferee's shares or residual beneficial interests (if any) are usually held by a party other than the transferor (charitable trusts have often been used for this purpose) and its major financial and operating policies are usually predetermined to a greater or lesser degree by the agreements that establish the securitisation.

(c) Arrangements may be made to protect some or all of the investors from losses occurring on the assets by a process termed "credit enhancement". This may take the form of third party credit insurance, a cash collateral account, a third party guarantee of the transferee's obligations or an issue of subordinated beneficial interests (perhaps to the transferor). Analogous arrangements are sometimes made to protect investors against other kinds of risks. All the arrangements provide a cushion against losses up to some limit.

(d) The transferor is often granted rights to cash remaining after payment of amounts due on the debt securities and other expenses of the transferee. These rights are generally intended at least in part to compensate the transferor for assuming some of the risk of credit or other losses. The mechanisms used to grant these rights include servicing or other fees, deferred sale consideration, "super interest" on amounts owed to the transferor (for example, subordinated debt), dividend payments and swap payments.

(e) The transferor may continue to service the assets (i.e., to collect amounts due from borrowers, set interest rates etc).

(f) The transferee invests cash accumulations from the transferred assets until payments on the debt securities are made. Any difference between the interest rate obtained on the investments and that payable on the debt securities will normally affect the transferor's residual interest under (d) above. The terms of the debt securities may provide for them to be redeemed as assets are realised, thus minimising this reinvestment period. Alternatively, cash accumulations may be invested in a "guaranteed investment contract" that pays a guaranteed rate of interest (which may be determined by reference to a variable benchmark rate such as LIBOR) sufficient to meet interest payments on the debt securities. Another alternative, used particularly for securitisations of short-term receivables arising under an on-going facility (for example, credit card balances), is a provision for cash receipts (here from card repayments) to be used to acquire similar assets (for example, new balances on the same credit card accounts). This reinvestment in similar assets will occur for a specified period only, after which time cash accumulations will either be used to redeem the debt securities or be reinvested in other more liquid assets until the debt securities are repaid.

(g) In certain specified circumstances (for example, if tax changes affect the payment of interest to the debt security holders or if the principal amount of debt securities outstanding declines to a specified level), the transferee may have an option to redeem the notes. Similarly, the transferor may have an option to call back (or the transferee may have an option to put back to the transferor) what remains of the securitised assets if their level falls below the point at which the securitisation vehicle ceases to be economically viable. Such options are often referred to as "clean-up call options" (see paragraph 235). Such redemption may be funded by the transferor, in which case the transferor will receive back the securitised assets.

306. Consider the following securitisation transaction. The originator of loans with a fair value of 90 (Enterprise A) transfers the loans to a special-purpose entity (the transferee, Enterprise B) in exchange for cash of 80 and a subordinated interest in the loans. Enterprise B obtains the cash by issuing senior asset-backed securities to various investors for 80. Enterprise A provides no guarantee about the performance of the loans.

(a) The existence of the subordinated interest means that Enterprise A still has a continuing involvement in the loans.

(b) If Enterprise B has the practical ability to transfer the loans to a third party and can exercise that ability unilaterally and without needing to add restrictions to the transfer, Enterprise A will derecognise the loans and will recognise a subordinated residual interest in the loans of 10 and cash of 80. In such a circumstance, Enterprise B will recognise 90 of loans and an obligation of 10 to Enterprise A in respect of its subordinated interest. It will also reduce its cash balances by 80.

(c) Assume, however, that Enterprise B has no ability to transfer the loans. As Enterprise A has neither an obligation that will or could result in the repayment of any of the consideration received nor a call option over any of the transferred components, it derecognises the components it no longer has (i.e., the loans of 90) and recognises those it has (i.e., subordinated residual interest in the loans (10) and cash (80)). The transferee's accounting will also be the same as in (b).

307. Consider now a variation of the securitisation described above. This time as part of the securitisation transaction, the transferor (Enterprise A) acquires a call option enabling it to insist on the return of some of the loan balances. (This is sometimes called a "removal of accounts provision" or a ROAP). The amount of loan balances that can be recalled in this way is restricted to 10 percent of the original value of the loans securitised. The transferor is entitled to choose the identity of the loan balances to be recalled, thus enabling it to call back any of the transferred loans. Enterprise A will still have a continuing involvement in

the loans and, if Enterprise B has the practical ability referred to in sub-paragraph 306(b), the accounting will be as described in that paragraph except that both parties will also recognise the call options. However, assume Enterprise B does not have that ability. In this transaction, the transferor is deemed (by sub-paragraph 60(b)) to have a call option over the whole of the portfolio of loans transferred to Enterprise B. As such, it will continue to recognise all the loans, will recognise the cash received (80) and will recognise a liability to repay all that cash. Enterprise B will recognise loans (90), an obligation to Enterprise A (10), and the call option, and will reduce its cash balances by 80. Once Enterprise A has exercised its call option to the full 10 percent maximum, the option ceases to exist and Enterprise A ceases to have control of the remainder of the transferred loans. Accordingly, It would derecognise the remainder of the transferred loans and recognise its subordinated residual interest.

308. Consider a further variation. The securitisation is as described in paragraph 307, except that the transferor has no discretion as to the identity of the actual loan balances repurchased (because they are to be selected at random). Although Enterprise A has a call option, under paragraph 60(c) it is not a call option over a transferred component, asset or group or pool of assets. As such, Enterprise A will apply paragraph 68, rather than paragraphs 64 and 65, and will derecognise the loans and recognise a subordinated residual interest in the loans of 10 and cash of 80. Enterprise B's accounting will be as described in the preceding paragraph.

Sub-participations

309. Assume that an enterprise (Enterprise A) makes an interest-bearing 5 year loan with a fair value of 100 to a borrower. It then enters into an agreement with another enterprise (Enterprise B) in which, in exchange for a cash payment of 10, it agrees to pass to Enterprise B 10 percent of all cash collected on its loan to the borrower. Enterprise A provides no guarantees about the performance of the loan and accepts no obligation to make any payments to Enterprise B other than 10 percent of exactly what has been received from the borrower.

310. The first issue that needs to be addressed in order to account for the transaction with Enterprise B is to determine whether the transaction amounts to a transfer of some of Enterprise A's rights to cash flows from the borrower. Paragraphs 41-48 are relevant here. If those criteria are met, Enterprise A has transferred 10 percent of the loan and has retained 90 percent of it. (If the criteria are not met, no transfer is involved and Enterprise A will continue to recognise a loan asset of 100, and will also recognise 10 of cash and a loan from Enterprise B of 10.)

311. It is then necessary to determine how to account for that transfer. The transferor still has a continuing involvement in its previously recognised financial asset because it still has an interest in 90 percent of the original loan. Furthermore, Enterprise B does not have the

practical ability—which it can exercise unilaterally and without needing to add restrictions to the transfer—to transfer to a third party 100 percent of the original loan to the borrower. Finally, Enterprise A does not have an obligation that will or could involve repaying any of the consideration. It has merely an obligation to pay Enterprise B exactly 10 percent of what has been received from the borrower. Nor does it have a call option over any of the transferred assets or over the transferred components.

312. In such circumstances, paragraph 68 requires both Enterprise A and Enterprise B to recognise the contractual rights and obligations each has and to derecognise those each does not have. In other words, Enterprise A will continue to recognise 90 percent of the original loan (while derecognising 10 percent of it) and will recognise an increase of 10 in its cash balances. Enterprise B will reduce its cash balances by 10 and will recognise a loan asset of 10.

Servicing Arrangements

313. In some ways, sub-participations can appear to be similar to servicing arrangements: one party collects the cash flows from a financial asset and passes them on to another party without adding to or subtracting from the cash flows that were received. There is, however, an important difference in that, in a sub-participation "the collector" has the contractual rights to receive and keep those cash flows (together with a contractual obligation to pay cash flows of the same amount to the "eventual recipient") and those rights and obligations are separate. A servicer does not have the right to keep the cash flows nor that contractual obligation, merely a servicing agreement that obliges it to collect cash flows as the agent of the eventual recipient and to pass them on. Paragraphs 41-48 do not therefore apply to servicing arrangements.

314. Servicing is an inherent part of all financial assets but, in accordance with paragraph 3, servicing rights and assets are recognised and accounted for separately from the assets involved only when a transfer or other transaction causes the assets to be held by one party and serviced by another. Thereafter, the recognition and derecognition principles set out in the Draft Standard apply to the assets and the servicing (or, to be precise, the servicing asset or servicing liability) separately.

Measurement

Initial Measurement

315. A financial instrument is measured at its estimated market exit price at all measurement dates including the date it is first recognised. A financial instrument's market exit price on the date it is acquired or incurred may differ from the fair value of the consideration exchanged for a financial instrument (its entry price) because the exit market is different from the entry market. For example, if the instrument originates in a transaction with a customer and the enterprise holds a portfolio of similar instruments, its price as a part of the portfolio may be more advantageous than its price as an individual instrument.

316. If a financial asset is acquired or a financial liability is incurred in exchange for a financial or a non-financial item, the face amount of the financial instrument is not necessarily its fair value. For example, if an enterprise sells an asset in exchange for a note receivable with no stated interest, the face amount of the note is not its fair value. The note would be reported at its fair value. If the note's fair value is not equal to the carrying amount of the asset sold, the enterprise would recognise the difference between the fair value of the note and the carrying amount of the asset sold as a gain or loss in the income statement in the period of the transaction.

317. If a financial instrument is exchanged for cash and other benefits or sacrifices, those other benefits or sacrifices would be separately distinguished and accounted for. For example:

    (a) If an enterprise receives an interest-free loan from a government agency, the fair value of the loan is not equal to its face amount. In the absence of evidence to the contrary, the difference between the fair value of the note and the cash received would be accounted for as a government grant.

    (b) If an enterprise extends an interest-free loan to an employee, the fair value of the loan is not equal to its face amount. In the absence of evidence to the contrary, the difference between the fair value of the loan and the cash paid to the employee would be accounted for as employee compensation.

Hybrid Contracts

318. For practical reasons, the market exit price of a financial instrument that is part of a hybrid contract that is to be separately accounted for would be estimated as if it were free-standing. Therefore, on initial recognition, the reported amount of the remaining non-financial portion of the hybrid contract will be the difference between the fair value of the hybrid instrument as a whole and the fair value of the financial instrument as a free-standing financial instrument. To illustrate, if a reporting enterprise issues debt convertible

into its own common shares, the fair value of the debt would be determined as if it did not include a conversion option. The enterprise would determine the fair value of the consideration exchanged, and the difference between the reported amount of the debt and the fair value of the hybrid instrument as a whole would become the initial measure of the equity conversion option. At future measurement dates, the financial instrument would be reported at its fair value as if it were free-standing, and the conversion option would continue to be reported at its initial value.

319. Paragraph 76 requires that, if an enterprise cannot reliably identify and measure the separate sets of financial instrument rights and obligations in a hybrid contract, it should account for the entire contract as if it were a financial instrument falling within the scope of the Draft Standard. However, an enterprise would always separately identify any component of a hybrid contract that comprises equity of the enterprise and exclude it from being accounted for in accordance with the Draft Standard.

Adjustments for the Passage of Time and Changes in Market Conditions

320. A market exit price from a transaction that took place other than at the measurement date would be adjusted to reflect changes due to the passage of time. It would also be adjusted if changes in market conditions indicate that transactions occurring at the end of the reporting period likely would not have occurred at that price. An example would be an observable price of an interest-sensitive instrument in a transaction that occurred before a change in market interest rates took place. That price would be adjusted to reflect the interest for the period between the transaction and the measurement date, the effect on fair value of the change in rates, and any cash distribution in that period.

321. Principal-to-principal or brokered trades, significant announcements, or other events may have occurred after the close of the market in which a financial instrument is traded. An enterprise would not be expected to seek out information about after-hours trading, but it would take into account information that is available. One example would be a large change in price on another market after the close of the principal market in which a financial instrument trades but before the end of the reporting period. Awareness of changes is particularly important for instruments traded in foreign markets that close before the end of the business day in the reporting jurisdiction.

322. Accounting standards in some jurisdictions provide for adjustment of amounts recognised in financial statements to reflect events after the balance sheet date if such subsequent events confirm conditions that existed at the balance sheet date. It would normally be presumed that changes in market prices after the reporting date do not confirm conditions existing at that date but reflect circumstances that have arisen in the following period.[22]

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[22] See, for example, paragraph 10 of IAS 10, Events After the Balance Sheet Date.

Using Price Information about Similar Financial Instruments

323. Estimating the fair value of a financial instrument based on the market price of a similar financial instrument involves the following process:

(a) Identify the significant risk attributes and projected cash flows of the enterprise's financial instrument.

(b) Identify another financial instrument for which a market price is available that has risk attributes and projected cash flows that are similar to the financial instrument the enterprise is trying to measure.

(c) Quantify the effects on fair value of differences in cash flows and risks between the two financial instruments (including differences in marketability), and adjust the market price of the similar instrument for those effects to estimate the fair value of the enterprise's financial instrument.

324. For example, an enterprise may hold a private placement corporate bond for which there is no observable market price. The enterprise may be able to identify actively traded corporate bonds that appear to be similar to its bond. The characteristics of the enterprise's bond would be identified and compared to those of the identified actively traded bond. The major elements on which the two bonds would be compared are:

(a) The pattern of contracted cash flows, including prepayment expectations.

(b) The currency in which the bonds are payable.

(c) The credit risk rating and the factors on which changes in the credit risk rating are dependent. For example, the fair values of bonds issued by enterprises with different industry and geographical bases would be expected to respond differently to changes in market factors. However, the two issuers need not necessarily be in the same industry or geographic region if the difference would not be expected to affect fair value.

(d) Any other terms or conditions that could affect the fair value of the bonds.

325. By definition, similar financial instruments are not identical, and some of the differences will cause the fair values of the instruments to be different. For similar financial instruments to be used in estimating fair value, sub-paragraphs 77(c) and 77(d) require that measurement of the effect of the differences be practicable. That is, the effect on fair value of any significant differences between two similar financial instruments must be reasonably determinable. In the above example, the initial net effects of differences may be discerned by comparing the fair values of the two instruments at the date of the acquisition of the non-traded bond by the reporting enterprise, assuming that its fair value on acquisition was directly determinable from the consideration paid.

326. In this example, the fair value of an enterprise's private placement bond may be less than that of the market-traded bond because it is less marketable. It may be reasonable to assume that any premium for marketability differences between the effective interest rates of the two bonds at the date the enterprise acquired its bond remains unchanged from period to period, except if an observable event that could be expected to significantly affect marketability takes place.

327. Virtually no two equity investments can be expected to qualify as similar financial instruments under paragraph 77(c) because each equity investment is unique in significant respects. For example, even if two enterprises are similar with respect to size, products and clientele, there will be differences in their management, employee personnel and other intangible factors that could lead to very different future cash flow patterns and potential variability. Thus, with the exception of equity instruments that are contractually structured to replicate other equity instruments, it will not be appropriate to estimate fair values of equity investments directly by comparison to the market prices of other traded equity instruments. However, observable prices of traded equity instruments may be helpful as an input or check on estimations developed using internal valuation techniques such as multiples of earnings or discounted cash flow analysis (see also paragraphs 357 and 358 on non-traded equity instruments).

Prices Not Determined by Normal Market Interactions

328. Paragraph 88(a) states that an observed exit price for a financial instrument would not be used as the primary basis for determining its fair value if it reflects transactions between enterprises, one or more of which were experiencing severe financial difficulties. A sale of a financial instrument to meet a court order in a bankruptcy situation is an example of a transaction motivated by something other than normal business considerations. An enterprise trying to measure that instrument would need another source of reliable information about fair value, such as a less recent transaction not motivated by bankruptcy.

329. In contrast, if the entire market for a particular financial instrument is affected by a lack of liquidity or financial difficulties of many participants, the observed prices are evidence of fair value. For example, all recent transactions in a particular financial instrument may have involved sellers who were forced by circumstances to accept any available offers, while other enterprises who believe future prices will improve choose to wait. An enterprise holding an identical financial instrument would estimate its fair value on the basis of the observed recent market exit prices unless it could demonstrate that it could access a more advantageous market (see paragraphs 95-99). The determining factor is the price the reporting enterprise would have received or paid on the measurement date. The fact that the reporting enterprise expects prices to be more favourable later is not evidence of fair value on the measurement date.

330. Paragraph 88(b) states that an observed exit price would not provide evidence of fair value if the observed exit price would have been different if not for other transactions, contracts or agreements between the transacting parties. For example, if Enterprise A sells Enterprise B a bond with a fair value of 100, and, in a separate transaction, B sells A a different bond with a fair value of 80, only the net 20 affects the income statement of the two enterprises. If the two parties chose to add 100 to the stated price of each instrument, the prices would be 200 and 180 and the net effect still would be 20, but the prices would not represent market exit prices. In that example, the exit price in each transaction would have been different if the other transaction had not occurred.

Prices That Include Value That Is Not Directly Attributable to the Financial Instrument

331. Paragraph 92 provides that expected benefits or sacrifices that are not directly attributable to existing contractual rights or obligations of a financial instrument at a measurement date would not enter into the estimation of the fair value of that financial instrument at that date.

Credit Card Contracts

332. In some countries there are observable transactions that involve portfolios of credit card contracts. The observed transaction price for such a portfolio covers two financial instruments—the cardholders' options to borrow (written by the card issuer) and the card issuer's receivables from cardholders—as well as non-contractual benefits of the credit card relationship.

The Cardholders' Options to Borrow

333. The card issuer may expect to receive significant future benefits because a proportion of cardholders can be expected to use their credit cards to borrow when the exercise price is to the advantage of the issuer, that is, at interest rates that are unfavourable to the borrowers in comparison with other sources of financing. The fair value of the written option to the issuer is to be estimated on the basis that the issuer has no contractual rights to such future benefits. In other words, the fair value of the option will be based on the assumption that the holders will exercise their options to borrow only when the options are in the money (that is, when the rates and terms are favourable to the holders in relation to market rates and terms available to them on the measurement date). Thus, any future benefits that are expected to be received as a result of cardholders exercising their options to borrow when it is to the advantage of the issuer are to be recognised only when those future transactions take place—that is, when the cardholder actually exercises the option to borrow (in which case the card issuer has a receivable from the cardholder).

334. There are unlikely to be any observable transactions for cardholders' options, or any similar options, because such options are normally traded only as part of a package that also

includes the card issuer's receivables and expected non-contractual benefits of the cardholder relationship. Thus, the card issuer will generally have to develop its own technique to estimate their fair values. The basic elements of such a valuation technique would include: (a) the term of the option (which will be the term to the date of expiry of the card unless the cardholder has an option to extend the term without consent of the card issuer), (b) the fair value of in the money loans expected to be made to cardholders (taking into account the current level of interest rates commensurate with the credit quality of the cardholders), (c) the exercise price for these loans (effectively the interest rates and conditions on which the cardholders can borrow), (d) the volatility of the fair values of the loans to the cardholders (which would depend to a significant extent on the potential for changes in market interest rates and the credit quality of the cardholders), and (e) costs to fulfil the obligations under the options that market participants would take into account in setting a price.

The Card Issuer's Loan Receivable

335. A prepayment option that is embedded in a loan asset is to be treated differently from a free-standing option to borrow. The fair value of the card issuer's loan receivable is determined on the basis of estimated market expectations of the probable timings and amounts to be received (taking into account the probable effects of defaults and the borrower's behaviour with respect to its repayment options). Thus, expectations with respect to the exercise or non-exercise of the borrower's option to prepay or delay payment, with consequent effects on the timing and amounts of cash flows, are to be taken into account when these options are embedded in the contract underlying a loan receivable. Card issuers often sell these receivables in securitisations and similar transactions. The fair value of credit card receivables may therefore be inferred from prices in observable market transactions involving similar loans. If there are no observable prices of similar receivables, fair value will be estimated using a valuation technique (see paragraphs 359-369 for guidance on using valuation techniques to estimate the fair value of loan assets).

Demand Deposit Liabilities

336. A demand deposit represents a promise by the depository institution to deliver cash either to the depositor or to third parties designated by the depositor. It imposes a contractual obligation that is a financial instrument. The depositor can demand settlement at any time, and the depository institution generally has the right to return the depositor's money (even though that right is seldom exercised).

337. The fair value to the depository institution of a demand deposit depends on the market's expectations of the timing and amounts of withdrawals of the existing balance at the measurement date, the level of interest rates on other borrowings with similar terms, the costs of servicing the deposit, and the institution's own credit risk (that is, the risk of

default taking into account expectations with respect to government and similar insurance, see paragraphs 373-375).

338. Demand deposit liabilities are on occasion transferred in portfolios along with items that are not financial instruments. The price at which portfolios of demand deposits are transferred generally includes not only the existing deposit balances but also future benefits expected to result from future transactions with the customers that are expected to occur because of the deposit relationship. These include the benefits of future interest free or low interest use of funds expected to be deposited in the future, rentals of customer lists and incremental cash flows from sales of products and services other than those set out in the deposit agreement. Such anticipated future benefits are not considered to be directly attributable to the rights and obligations that constitute the demand deposit liabilities existing at a measurement date, and accordingly would not enter into the estimation of their fair value.

339. An estimated market exit price for demand deposit liabilities might be imputed or modelled from observable market entry prices negotiated between depository institutions and depositors, or on the basis of a computation of the present value of projected cash flows reflecting market conditions and expectations at the reporting date.

(a) The entry market price for a demand deposit obligation is the exercise price of the depositor's option to demand its money. The exercise price is the face amount of the deposit plus the fair value of any accrued interest and services owing under the particular contract. This will be the exit price to the depositor (see paragraphs 100-101, on the effect of an embedded option on the enterprise holding the option).

(b) The exit price to the depository institution is likely to be less than the entry price because an enterprise accepting a transfer of the deposit obligation would expect that not all depositors will withdraw their money immediately. Valuation techniques to estimate the present value of projected cash flows related to the deposits would incorporate the expected amounts and timing of withdrawals of existing balances, based on past experience and market conditions at the reporting date. Expected future deposits would not be incorporated in these projected cash flows. Paragraph 112 provides that an enterprise may use its own assumptions in a fair value pricing model that are compatible with a fair value estimate as long as there are no data indicating that market participants would use different assumptions. The projected cash flows would be discounted at a rate equal to the interest rate that would be used by market participants at the reporting date to price loans of similar risk and term. In addition, significant net costs that can be expected to be necessary to service the deposits would also be considered in the present value computation. An enterprise's methods would be consistently applied.

Prices from More than One Market for the Same Instrument

340. Paragraph 95 states that, if an enterprise has access to more than one exit market for a financial instrument, and prices in those markets are different, the instrument's fair value would be based on the most advantageous market exit price. For example, the observable market exit price for a portfolio of promissory notes as a whole may be higher than the total of the market exit prices of the individual notes after taking into account any significant differences in costs that would have to be incurred to sell the notes. An enterprise need not conduct an exhaustive search for markets to which it could have access, but it would be expected to make reasonable efforts to become aware of significant differences in prices in known markets to which it has access.

341. Paragraph 96 requires that any significant difference in costs that would have to be incurred to sell a financial asset or obtain relief from a financial liability would be taken into account in determining the most advantageous price. These costs would include any incremental costs that would have to be incurred to access a market for a financial instrument. To illustrate the application of the requirement of paragraph 96, suppose that on a measurement date the market exit price of a financial asset in market A was 100 and in market B was 110, and that the costs to sell the asset in market A are 2 and in market B are 15. In this example the most advantageous price is that of market A. Thus, the financial asset would be reported at the market exit price of 100. This price would not be adjusted for the costs that the enterprise would expect to incur to sell the financial asset (see paragraph 72).

Effect of an Embedded Option on the Enterprise Holding the Option

342. The application of paragraphs 100-101 may be illustrated by an example. Suppose Enterprise A extends a five year loan to Enterprise B at the beginning of year 1 for 1000, which was its fair value at that date. Contractual interest of 80 is payable at the end of each year. Enterprise B has the contractual right to pay off the loan at any time for an amount equal to the contractual principal plus a pro rata portion of the next contractual interest coupon. Suppose that at the end of one year, immediately after the first interest payment is made, the market exit price of the loan held as an asset is 1,008. That price would be based on an average of the present values that would result from payments at different possible dates weighted according to the estimated probabilities that payment will occur on each of those dates.[23] In contrast, the fair value to Enterprise B would be 1,000, which is the amount at which it could prepay the loan on that date. In general, if the market price of a loan held as an asset is greater than the exercise price of the prepayment option (as it is in

[23] If no observable market exit price were available, a valuation technique would be used to estimate that price. Various lenders have developed techniques for estimating the fair value of financial instruments with early repayment provisions that reflect prepayment possibilities.

this example), the debtor's most advantageous market exit price would be the exercise price of the prepayment option.

343. As an extension of the above example, some loan agreements provide that a penalty be imposed (a) upon the borrower (Enterprise B) if it elects to repay the loan before maturity or (b) upon the lender if it initiates a demand for repayment prior to maturity. To illustrate, assume the facts in the above example except that there is a 50 charge to Enterprise B for early repayment and that the market price of the loan is 1036 because the penalty reduces the probability of prepayment. The prepayment option exercise price to Enterprise B is 1050. In this example, the exit price to both Enterprise A and Enterprise B is 1036, because it would not be advantageous for Enterprise B to exercise its option at 1050.

Estimating Fair Value without Observable Market Exit Prices

344. A valuation technique would be expected to arrive at a realistic estimate of a market exit price if (a) it reasonably mimics how the market could be expected to price the instrument, and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

345. The same information may not be available at each measurement date. For example, at the date that an enterprise makes a loan or acquires a debt instrument that is not actively traded, the enterprise usually has a transaction price that either is equal to the instrument's market exit price or can be used to estimate a market exit price. However, no new transaction information may be available at the next measurement date and, while the enterprise can determine the general level of market interest rates, it may not know what level of credit risk market participants would use in pricing the instrument on that date. An enterprise that makes loans as a primary business activity would be presumed to have in place a system to enable it to assess credit risk of its loan assets on an ongoing basis (see paragraphs 359-369). If an enterprise does not make loans as a primary business activity, it may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. The enterprise would be expected to make reasonable efforts to determine whether there is evidence that there has been a significant change in these factors. Where such evidence exists, the enterprise would consider the effects of the change in determining the fair value of the financial instrument.

Inputs to Valuation Techniques

346. An appropriate technique for estimating the market exit price of a particular financial instrument would incorporate available market information about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a

financial instrument will be based on one or more of the following (and perhaps other) factors:

(a) The time value of money (that is, interest at the basic or "risk-free" rate). Basic interest rates usually can be derived from observable government bond prices and often are quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows as a result of the "yield curve" effect. For practical reasons, an enterprise may use a well accepted and readily observable general rate, such as LIBOR/swap rate, as the benchmark rate. (Since a rate such as LIBOR is not the basic interest rate, the credit risk adjustment appropriate to the particular financial instrument would be determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a useful, stable benchmark basic interest rate for enterprises issuing financial statements in that reporting currency. Some enterprises in these countries may have better credit standings and lower borrowing rates than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

(b) Credit risk. The effect on fair value of credit risk (that is, the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded corporate bonds of varying credit quality or from observable interest rates charged by lenders for loans of various credit ratings (see paragraphs 359-369 on loan assets).

(c) Foreign currency exchange prices. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) Commodity prices. There are observable market prices for many commodities.

(e) Equity prices. Prices (and indexes of prices) of traded equity securities are readily observable in some markets. Present value based techniques may be used to estimate the current market exit price of equity instruments for which there are no observable prices. (Considerations with respect to estimating the fair value of non-traded equity instruments using such models are set out in paragraphs 357 and 358.)

(f) Probabilities that specified events will occur. Expected cash flows that depend on the outcome of specified future events (for example, the probability of occurrence of precipitation or other weather events that affect the value of a weather-based derivative) will require probability-weighted estimates of the nature illustrated in paragraphs 351 and 352.

(g) Marketability (the return market participants demand to compensate for the risk that they may not be able to sell an asset or obtain relief from a liability immediately). In some cases it may be reasonable to assume that the effects of marketability are included in the credit risk interest rate premium. In some other cases it may be reasonable to assume that there has been no significant change in the marketability of a financial instrument and the effect on the instrument's fair value during a reporting period.

(h) Volatility (that is, the frequency and magnitude of future changes in price of the financial instrument or other item that is the subject of an option). Measures of the volatility of actively traded items can normally be reasonably estimated based on historical market data. Certain considerations with respect to estimating the volatility of non-traded items are noted in paragraphs 355 and 356 on non-traded options.

The Relationship between Discount Rates and Projected Cash Flows

347. The present value of projected cash flows may be estimated using a discount rate adjustment approach or a cash flow adjustment approach.

348. Discount rate adjustment approach. Under the discount rate adjustment approach, the stream of contracted cash flows forms the basis for the present value computation, and the rate(s) used to discount those cash flows reflects the uncertainties of the cash flows. This approach is most readily applied to financial instrument contracts to receive or pay fixed cash flows at fixed future times, that is, instruments for which the only significant uncertainties in amount and timing of cash flows are due to credit risk.

349. The discount rate adjustment approach is consistent with the manner in which assets and liabilities with contractually specified cash flows are commonly described—as in "a 12 percent bond,"—and it is useful and well accepted for those instruments. However, because the discount rate adjustment approach places the emphasis on determining the interest rate, it is more difficult to apply to complex financial instruments where cash flows are conditional or optional, and where there are uncertainties in addition to credit risk that affect the amount and timing of future cash flows.

350. Cash flow adjustment approach. Under the cash flow adjustment approach, the projected cash flows for a financial instrument reflect the uncertainties in timing and amount, that is, they are weighted according to probability of their occurrence, and adjusted to reflect the market's evaluation of the non-diversifiable risk relating to the uncertainty of those cash flows. The cash flow adjustment approach has advantages over the discount rate adjustment approach if an instrument's cash flows are conditional, optional, or otherwise particularly uncertain for reasons other than credit risk.

351. To illustrate, suppose that the enterprise holds a financial asset such as a derivative that has no specified cash flows and the enterprise has estimated that there is a 10 percent probability that it will receive 100; a 60 percent probability that it will receive 200; and a

30 percent probability that it will receive 300. Further, suppose that the cash flows are expected to occur one year from the measurement date regardless of the amount. The expected cash flow is then 10 percent of 100 plus 60 percent of 200 plus 30 percent of 300, for a total of 220. The discount rate used to estimate the instrument's fair value based on that expected cash flow would then be the basic ("risk-free") rate adjusted for the premium that market participants would be expected to receive for bearing the uncertainty of expected cash flows with the same level of risk.[24]

352. The cash flow adjustment approach also can incorporate uncertainties with respect to the timing of projected cash flows. For example, if the cash flow in the previous example was certain to be 200, and there was a 50 percent chance it would be received in one year and a 50 percent chance it would be received in three years, the present value computation would weight those possibilities accordingly. Because the interest rate for a two-year instrument is not likely to be the weighted average of the rates for one-year and three-year instruments, two separate present value computations would be required. One computation would discount 200 for one year at the basic interest rate for a one-year instrument and the other would discount 200 for three years at the basic interest rate for a three-year instrument. The ultimate result would be determined by probability weighting the results of the two computations. Since the probabilities of each are 50 percent, the fair value would be the sum of 50 percent of the results of each present value computation, after adjustment for the estimated effect of any non-diversifiable risk related to the uncertainty of the timing of the cash flow.

353. The discount rate adjustment approach would be difficult to apply in the previous example because it would be difficult to find a discount rate that would reflect the uncertainties in timing.

354. The Draft Standard does not prescribe which of the two approaches to use. Nor does it preclude using a combination of the two with some risks reflected in cash flows and others in discount rates. Paragraph 113 makes the most important point, which is that the effects of each risk would be incorporated in either the projected cash flows or the discount rate but not both.

Non-traded Options and Other Derivatives

355. Option pricing models (such as the Black-Scholes model and binomial models, and models derived therefrom) are available in standard computer packages that enable computations of stock and equivalent options at a reasonable cost. Valuations using such models with

[24] In theory, the 220 could be adjusted to a certainty equivalent, that is, to the amount that a market participant would pay if it were certain of receipt. Under this Draft Standard, a risk premium and other factors would be incorporated into either the present value computation or as an adjustment of the result of the computation. If the 220 can be converted to a certainty equivalent, it will be unnecessary to consider the risk premium and other factors separately.

appropriate market-based data inputs are likely to be sufficiently reliable for financial reporting purposes in many circumstances. However, standard option pricing models require adaptations or modifications to fit custom-tailored instruments with unusual or unique characteristics and to reflect the appropriate counter-party credit risk.

356. Volatility of the variable on which an option is based is an important factor in determining the option's fair value. Estimating expected future volatility generally begins with calculating historical volatility and then considering the effects of ways in which the future is reasonably expected to differ from the past.[25]

Non-traded Equity Instruments

357. Techniques for measuring equity instruments are commonly based on discounting expected cash flows, which may be estimates of future dividend payments or of net cash flows to be generated by the issuing enterprise. Estimates are also made on the basis of multiples of earnings or the present value of expected future earnings, both of which are surrogates for expected future cash flows. It may also be necessary to consider such factors as expected future dividend payments or the net asset value of the enterprise. Fair value estimates determined using models would be checked for reasonableness by comparison to observable market prices for equity instruments of like enterprises.

358. It may be difficult to estimate the fair value of certain non-traded equity instruments on an ongoing basis, for example, those of private companies that have little history or track record. In many cases, the difficulties can be overcome, but on rare occasions making a reasonable estimate of fair value will not be practicable. Accordingly, paragraph 122 provides for an exception in those rare situations.

Loan Assets

359. The appropriate specifications of a technique for estimating fair values of loan assets will depend on the nature and extent of an enterprise’s lending activities. For example, it could be based on an internal credit-grading system with the following general attributes:

(a) A credit-grading classification scheme distinguishes significant categories of credit risk appropriate to the loans made by the enterprise. A credit-grading scheme could be based on a published external credit-rating system, or it may be internally developed.

(b) Each credit grade category defines the range of interest rate premiums over the basic market rates of interest (the market “risk-free” rates) at which loans are made under current market conditions. Such a credit-grading system would represent the interest

[25] Appendix F of FASB Statement No. 123, Accounting for Stock-Based Compensation, provides explanations and guidance with respect to computing historical volatility of stock prices in some common situations.

rate premium ranges for progressive levels of credit risk for loans that are originated or acquired by the enterprise.

(c) The interest rate range for each credit grade category is consistent with observable market rates of interest for loans of equivalent credit risk and is adjusted as basic interest rates, credit, and other relevant market conditions change.

(d) A credit granting and lending process (i) assigns an appropriate credit grade to each loan at the time it is originated or acquired and (ii) re-evaluates the credit quality of outstanding loans on a regular basis and updates the credit grade assigned to a loan if necessary.

Within such a credit-grading system, the fair value of a loan may be estimated by using the contractual timing and amounts of cash flows (adjusted for expected prepayments if the loan agreement permits prepayments) and discounting these at a rate that reflects the credit grade of the loan. In addition, the computation would reflect servicing costs, risk premiums, profit margins, and other factors that market participants would be expected to consider in setting a price.

360. It is important to ensure that the risk-adjusted discount rate assigned to a loan within the rate range of the credit rating class appropriate to its evaluated credit standing is consistent from period to period. To illustrate, suppose the spread over the basic interest rate for a particular class of credit risk was 200-300 basis points at the date a loan was originated and that the specific loan was granted at 300 basis points over the basic interest rate. Suppose that at the next measurement date, the spread over the basic interest rate for that same class of credit risk was 175-250 basis points. If the credit standing of the loan had not changed, the rate premium assigned to this loan would be 250 basis points.

361. Credit grades might be assigned by groups of reasonably homogeneous loans and fair value estimated for the groups rather than on an individual loan basis. Loans could be considered reasonably homogeneous if they are of approximately the same credit standing with similar credit risk dependencies and have similar exposures to other risks, such that they have similar patterns of cash flows that can be expected to vary in a similar fashion to changes in economic conditions.

362. Techniques for pricing loans with prepayment options or penalties for early repayment, or that contain other contracted provisions that may affect future cash flows, would consider the effect of each of those factors.

363. An enterprise's internal loan credit grading system and present value-based estimation process would be based on documented policies and procedures that are consistently applied (see paragraph 129). The nature and degree of detail of these policies and

procedures will depend on the nature and complexity of loan contracts and the size of an enterprise's lending activities.

Impaired Loan Assets

364. The same measurement principles apply to impaired loan assets as to unimpaired loan assets. Thus, it is not necessary for measurement purposes to define such a category. However, sub-paragraph 134(a)(iii) requires that impaired loan assets be disclosed, and paragraph 137(c) requires that changes in their fair values be presented separately in the income statement or the notes to the financial statements.

365. In any group of loans there is a statistical probability that some will become impaired in the future. That probability would be considered in estimating the market exit price of the group of loans. However, an individual loan asset is not impaired unless there is evidence that it is more likely than not that the lender will not receive the full amounts owing on the scheduled payment dates in accordance with the terms of the loan contract.

366. An insignificant delay or insignificant shortfall in amount of payments does not mean that a loan is impaired. A loan is not impaired during a short period of delay in payment if the creditor expects to collect all amounts due including interest at the current risk adjusted rate for the period of delay.

367. A loan asset classified as impaired is not removed from that category and considered to be unimpaired unless (a) new evidence indicates that it is no longer more likely than not that the lender will fail to receive the full amounts owing on or before the scheduled payment dates in accordance with the original contracted terms, or (b) the lender and borrower have agreed to restructured terms and it is more likely than not that all amounts owing under the new restructured terms will be collected in accordance with those terms.

368. When estimating the market exit price of an impaired loan asset (or of any loan), the enterprise would consider the effects on expected cash flows or discount rates of collateral or other factors that affect the probability of collection. Financial guarantees that are separate financial instruments would be reported separately.

369. Impaired loans might be assigned a credit grade based on the evaluated credit risk of the projected cash flows and discounted at the current estimated market rate of interest appropriate to that category of credit risk. The projected cash flows would be the cash flows that would be contracted for at that level of credit risk and expected timing of recovery. However, the enterprise may not be willing to make a new loan with a credit risk as high as an existing impaired loan and, therefore, there may be no credit grade that fits its level of risk. In that case, the fair value of an impaired loan may be estimated based on the expected timing and amounts of future cash flows taking into consideration the default condition. The discount rate would be the current market basic interest rate for debts of

similar term, adjusted for the premium that market participants would be expected to receive for bearing the uncertainty of expected cash flows with the same level of risk.

Financial Liabilities

370. If there are no observable market exit prices for an enterprise's own financial liabilities, determining the appropriate interest rate to reflect the enterprise's credit standing may require internal estimates and assumptions. At the date a financial liability is incurred, the enterprise has a transaction price that usually represents the market entry price at that date. Even though that is an entry price instead of an exit price, it will be useful in determining such factors as the interest spread over the basic interest rate. At subsequent measurement dates, the enterprise probably will not have a transaction price to observe (unless it has recently incurred a similar liability), and it may be difficult to determine the spread over the basic interest rate that market participants would demand on that measurement date. However, an enterprise may assume that the net interest rate spread over the basic interest rate has not changed unless available information indicates otherwise. The enterprise need not conduct an exhaustive search of possible changes in the net rate spreads of its financial liabilities since the last reporting date. However it would be expected to make reasonable efforts to identify and consider available information as to whether one or more of the following events have occurred since the end of the last reporting period.

(a) A significant change in the market credit risk spread for liabilities of similar credit risk. If overall interest rates have changed significantly, an enterprise would consider whether the credit spread as a proportion of the basic interest rate has changed.

(b) The enterprise has issued or settled similar liabilities at a significantly different net rate spread.

(c) The fair value of collateral, or the extent of coverage, has changed to such an extent that it could change the credit risk quality of the liability.

(d) An external rating of the credit quality of the liability or of the enterprise has changed.

(e) A major change in the enterprise’s operating activities (for example, a large business combination or major decline in revenues or operating income), or in the market value of the enterprise, or in the technological, economic or legal environment in which it operates, that could be expected to affect the credit quality of the liability.

(f) The expected variability of the projected cash outflows of a liability that are dependent on the resolution of uncertainties other than credit risk has changed to such an extent that it could have affected the net rate spread of the liability.

371. If one or more of the above events has occurred, the enterprise would evaluate whether the spread over the basic interest rate has changed. If it has, the fair value of the liability would be estimated taking into account best estimates of the effects of this change. At subsequent measurement dates, the changed net spread would be assumed not to have changed again unless one or more of the events specified in paragraph 370 has occurred in the subsequent period.

372. However, if an enterprise holds or issues a derivative financial instrument whose price depends on an underlying variable based on its own credit standing, the enterprise would not be permitted to presume that its credit standing had not changed. Estimating the value of the derivative would require the enterprise to determine its current credit standing using whatever means available. In addition, the enterprise would be required to make its best estimate of the market exit price of its other financial liabilities on the basis of the information used in estimating the market exit price of the derivative.

Financial Guarantees of an Enterprise's Financial Liabilities

373. A financial guarantee is separate from the guaranteed liability and requires the guarantor to pay the creditor if a specific event, usually the debtor's default, occurs. The debtor's obligation is not affected by the guarantee, and an enterprise assuming the liability would not consider the guarantee in determining the price it would accept for the assumption.[26] Consequently, a financial guarantee does not affect the measurement of the guaranteed liability by the issuer. For example, if a guaranteed liability's fair value is estimated using a present value technique, the effect of the financial guarantee is not considered in determining the discount rate or the projected cash flows. The financial guarantee is a contract between the guarantor and the creditor and would be reported as a liability by the guarantor and as an asset by the creditor (usually included as part of the loan asset). If the amount an enterprise receives on issuing a financial liability exceeds the fair value of that liability at that date as a result of a third party guarantee (or for any other reason), the difference would be recognised immediately as a gain in the income statement. Such income statement effect would be offset in whole or in part by any expense incurred by the enterprise to obtain the guarantee.

374. Insurance on deposits in regulated financial institutions differs from commercial financial guarantees in several ways. That insurance is a guarantee by a government or government agency of the financial institution's liabilities to depositors. It is a blanket guarantee; that is, all deposits in the institution that meet specified requirements are automatically insured. Essentially all other obligations of the institution are subordinated to the claims of the

[26] Most liabilities are not contractually assumable by another party, and the creditor may demand payment at face amount if there is no contractual assumption provision. However, as discussed in sub-paragraph 90(b), the price for extinguishing an existing liability before its contractual settlement date is not a market exit price and thus does not determine its fair value.

depositors, and the insured institutions are subject to regulations intended to improve the probability that the institution will be able to settle its liabilities at face value. Guaranteed deposit liabilities may be transferred to another institution if its deposits are also insured, and the transferred liabilities continue to be insured.

375. The effect of deposit insurance is so pervasive that depositors often act as if their deposits were 100 percent insured even if there is a limit on the maximum amount insured; interest rates on uninsured deposits may not differ significantly from rates on insured deposits. That means that market participants (both depositors and institutions assuming deposit liabilities) consider the effect of the guarantee in pricing the deposits. Consequently, deposit insurance is not separately reported but would be considered in expected cash flows or discount rates in a present value computation.

Establishing Fair Value Estimation Policies and Procedures

376. Paragraph 129 requires that an enterprise establish appropriate policies and procedures for estimating the fair value of its financial instruments. An enterprise would be expected to provide for appropriate supervision and control over its fair value estimation process. That would include identification and senior management review of especially difficult measurements as well as measurements affected by events after the close of trading in an instrument, and other unusual measurement issues. Senior management also would be responsible for effective monitoring to ensure appropriate application and continued validity of its policies to the enterprise's financial activities, instruments held and issued, and market developments. The nature and extent of these policies and procedures will vary considerably between enterprises depending on the nature and extent of financial instruments held and issued. An enterprise with only short-term trade receivables and payables, and perhaps a short-term bank loan, will not need an extensive fair value estimation system. However, many enterprises will need more extensive and rigorous processes to apply reasonably the requirements of the Draft Standard to such financial instruments as non-traded loan assets, long-term debt, and derivatives.

377. Paragraph 129 requires that an enterprise's policies for estimating the fair value of its financial instruments be consistent from period to period except when a change will result in more accurate estimates. The validity and accuracy of fair value estimates would be assessed by comparing the results of valuation techniques to observable market prices (including back testing of previous estimations and comparing to actual outcomes). If an enterprise makes a change in its valuation techniques, the resulting effects on fair value estimates would be treated as a change in estimate as of the first measurement date when the new technique was used.

Use of Pricing Services

378. An enterprise may use estimates by qualified third parties, such as bond dealers, brokers or pricing services, to determine the market exit prices of some instruments in its portfolio. If the estimates are based primarily on techniques other than comparison to observed transaction prices, those techniques are subject to the same requirements as techniques used by the enterprise itself. If significant reliance is placed on such estimates, the enterprise would have procedures in place for assuring that the estimates provided are appropriate for the particular features and terms of its financial instruments, and that material error would be prevented or corrected. An enterprise's control activities may include the following:

    (a) Periodically checking pricing service quotations with estimates made by other qualified third parties on a test basis.

    (b) Verifying the reasonableness of any changes in estimates in excess of a stipulated percentage.

    (c) Reviewing market exit prices that have not changed for a stipulated period.

    (d) Understanding the procedures and controls in place at the pricing service, and obtaining assurance that the implementation of these procedures is subject to independent checks.

    (e) Understanding the bases of pricing models that are used by the pricing service to ensure that they are appropriate to the enterprise's financial instruments, and whether the resulting prices require adjustment for the effects of any dissimilarity between the instruments.

379. In particular, an enterprise would not rely solely on the estimates of the prices of instruments provided by the institution from which they were acquired or that is the counter-party, but would have in place procedures for independent checks on those prices.

Income Statement Presentation

Change in Fair Value of Financial Instruments

380. The change in fair value of a financial asset or financial liability, after adjustment for receipts and payments, is the difference between:

    (a) its fair value at the end of the reporting period, or at the time it was derecognised during the reporting period, and

    (b) its fair value at the beginning of the reporting period, or at the time it was first recognised during the reporting period,

    adjusted to exclude any receipts or payments, such as in partially recovering the asset or partially settling the liability. The change in fair value so calculated represents the income or expense of a financial asset or financial liability for the reporting period.

381. The computation may be illustrated by the following example:

    Suppose these facts –

	Fair value at	
	31/12/99	31/12/00
Loan assets	1,800	2,100
Financial liabilities	800	900

Cash receipts in period:		
Loan assets sold (fair value received on sale)	175	
Debt issued (fair value received on issue)	150	
Principal and interest received on loan assets	200	525
Cash payments in period:		
New loans made	500	
Debt payments made	75	575
Net decrease in cash		50

Given these facts, the fair value income and expense for the period would be computed as follows:

		Loan assets		Financial liabilities
Fair value at December 31, 1999		1,800		(800)
Cash receipts and payments:				
New loans/debt issued	500		(150)	
Sales of loans	(175)			
Other cash receipts	(200)			
Debt payment			75	
		125		(75)
		1,925		(875)
Fair value at December 31, 2000		(2,100)		900
Net change:				
Fair value income on loan assets		(175)		
Fair value expense on financial liabilities				25

These results may be reconciled as follows:

Change in fair value of loan assets (2,100-1,800)	300
Change in fair value of financial liabilities (900-800)	(100)
	200
This net change is represented by	
Fair value income on loan assets	(175)
Fair value expense on financial liabilities	25
Decrease in cash	(50)
	(200)

Fair Value Interest Revenue and Expense

Current Yield to Maturity Basis

382. On the current yield to maturity (CYTM) basis, the interest rate is the average per period rate that market participants would receive on an interest-bearing financial instrument reflecting its term and risks. CYTM is, therefore, the average per period rate that equates future contracted cash flows of an interest-bearing financial instrument (taking into account, where relevant,[27] expectations of the effects of any repayment options) with its

[27] See paragraph 100 on the effect of embedded options on fair value.

fair value. For example, assume a loan contract provides for coupon payments of 80 at the end of each of the next three years plus a 1,000 payment at the end of the third year. Suppose that this loan has a fair value of 1,053 at the beginning of year 1. The average annual interest rate that equates the contracted cash flows with this fair value is 6 percent. This then is the current yield to maturity rate on this financial instrument as at the beginning of year 1.

Current Market Expectations Basis

383. Paragraph 139 provides that an enterprise may elect to use the current market expectations basis to determine interest revenue and interest expense, if the chief operating decision maker relies primarily on this basis for assessing the performance of its significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk. For the purposes of the Draft Standard, the current market expectations rate is defined as the current per period rate of interest reflected in current interest forward rates implicit in the current market interest rate yield curves. Current market expectations rates may be derived from current interest spot rates.

384. To illustrate, suppose a zero coupon bond of 1,000 is payable at the end of 3 years. If the 3-year spot rate appropriate to this bond is 6.0 percent at the beginning of year 1, the bond would be expected to have a fair value at that date of 840 [$1{,}000/(1.06)^3$] (Note that in this case the CYTM at the beginning of year 1 is 6.0 percent.). Suppose that the spot rate for a 1-year bond is 5.0 percent and for a 2-year bond is 5.5 percent. Forward interest rates may be derived from these spot rates as follows:

1 year forward rate for year 1 = 5.0%

1 year forward rate for year 2 = 6.0% ($[(1.055)^2/(1.05)]-1$)

1 year forward rate for year 3 = 7.0% ($[(1.06)^3/(1.05)(1.06)]-1$)

Thus, at the beginning of year 1, the market expectations for the interest rate in year 1 is 5.0%, and the expectations for the term of the bond would be:

Balance, beginning of year 1	840
+ interest at 5.0% for year 1	42
	882
+ interest at 6.0% for year 2	53
	935
+ interest at 7.0% for year 3	65
Balance, end of year 3	1,000

385. The effect is that the rate of interest on the current market expectations basis for a period is the current short-term rate of interest prevailing in that period, that is, the rate that would apply if the financial instrument matured at the end of the reporting period. The rate of interest applicable to year 2 in the above example would be the actual short-term rate prevailing in that year; it would only be 6 percent if the actual one-year rate in year 2 were 6 percent.[28]

Interest Calculation

386. The fair value interest rate applicable to an interest-bearing financial instrument changes with changes in the basic interest rate, the credit risk of the borrowing enterprise, and possibly other factors affecting market participants' expectations for future cash flows and their uncertainty. These changes tend to occur frequently so that a precise determination of interest on a fair value basis would require continuous re-calculations. For practical reasons, an enterprise may choose to accrue fair value interest on a quarterly basis by groups of similar interest-bearing financial instruments where rates have not undergone significant change in the quarter. This accrual could be based on multiplying the appropriate interest rate for each group at the beginning of the quarter by its average fair value during the quarter. Interest on interest-bearing financial instruments acquired or issued during a quarter could be accrued for the remaining period of the quarter at the average per period rates implicit in their fair values on initial recognition.

387. This calculation is illustrated by the following example:

	Fair value 31/12/00	Acquired/ issued in period	Interest rates	Fair value 31/03/01	Interest
Financial Assets					
Government bonds	500		1.35[29]	100	4.05
Acquisitions		100	0.50[30]	100	.50
Loan Assets					
High credit standing	1000		1.75[29]	900	16.65
Moderate credit standing	500		2.00[29]	400	9.00
Low credit standing	300		2.45[29]	300	7.35

[28] The basis for determining interest on the market expectations basis is not further discussed here, as the underlying concepts and determinants of the term structure of interest rates and forward interest rates are covered in finance texts.

[29] Current market 3-month rates of interest at the beginning of the quarter.

[30] Rates of interest implicit in fair values on initial recognition for the remaining portion of the quarter.

New loans		390	1.60[30]	400	6.25
Impaired loans	100		2.60[29]	100	2.60
					46.40
Financial Liabilities					
Unsecured debt	800		1.80[29]	800	14.40
Secured debt	1000		1.70[29]	1000	17.00
New issues		400	0.75[30]	400	3.00
					34.40

388. Where interest rates have undergone significant change during a quarterly period, or significant disposals, or changes in the credit risk of interest-bearing financial instruments have taken place near the beginning or end of the reporting period, the above calculation may need to be refined. For example, this may be accomplished by making separate calculations for the portions of the quarterly period before and after a significant rate or portfolio change.

389. Interest on a fair value basis would be calculated for all of an enterprise's interest-bearing financial assets and financial liabilities, including those that it intends to hold for short-term trading purposes.

Compound Financial Instruments

390. Some financial instruments include interest-bearing and other financial instrument rights and obligations. For example, the contract underlying a financial asset might specify an amount of principal to be repaid, with a return on principal to be determined at the greater of (a) a specified rate that is well below market rates of interest for financial assets of equivalent credit risk and term, and (b) an amount based on a stock index. The fair value would be estimated for each of the interest-bearing and equity elements in order to determine the amounts to be presented in the income statement disclosures required by the Draft Standard.

Disclosure

General Presentation Matters

391. Disclosures about financial risks and financial instruments are likely to be more readily understandable if they draw together relevant information in a combination of narrative and numerical analyses, rather than providing scattered information throughout the financial report. Sufficient information would be provided to indicate how amounts disclosed in notes to the financial statements relate to relevant line items on the balance sheet and income statement.

392. When an enterprise is party to large numbers of financial instruments with similar characteristics and no single instrument is individually significant to the future cash flows of the enterprise, disclosure would be provided by way of summarised information by reference to particular classes of financial instrument. However, when a single instrument is individually significant to the future cash flows of the enterprise, information would be disclosed about that particular instrument separately from disclosures about other financial instruments.

Significant Financial Risks

393. The purpose of the disclosures required by paragraphs 154-155 is to provide a focused description of the significant financial risks inherent in an enterprise's activities that, when considered with information provided in other parts of the financial statements, is sufficient to enable users of those financial statements to understand the nature and relative importance of the enterprise's significant financial risks. Some of this information might be contained in financial statement information that is required by other accounting standards. For example, where information on business segments is provided, that disclosure would provide information about products and services that are the source of exposures to commodity price risks. Information about geographical segments would provide some information about the sources of an enterprise's foreign currency risk exposures. Balance sheet information about how an enterprise is financed would provide some information about the source of its interest rate exposures. Balance sheet information on the nature and extent of an enterprise's lending activities would be an important part of the basis for understanding an enterprise's exposure to credit risk.

394. In describing its significant financial risks, an enterprise will usually need to elaborate on the nature of each risk involved. For example, it will usually not be sufficient to refer merely to currency risk without also explaining the principal currencies involved. Similarly, information about basic interest rate risk would identify the country or region in which each significant interest rate risk arises.

Financial Risk Position at the Reporting Date

Basic Interest Rate Risk and Currency Risk

395. The disclosure of fair value classified according to contractual interest re-pricing dates required by paragraph 170 would, at a minimum, present the fair values of financial instruments exposed to basic interest rate price risk, grouped by those that are contracted to re-price or mature (a) within three months from the reporting date, (b) more than three months and less than one year of the reporting date, (c) more than one year and less than five years from the reporting date, and (d) five years or more from the reporting date. Floating rate financial instruments would be classified according to the time when the floating rate re-sets. The contractual interest re-pricing date is the date on which the interest rate re-sets or, for instruments with no re-pricing date during their contractual term, is the maturity date. However, when a financial instrument includes prepayment conditions, the fair value would be included in the period in which the prepayment is expected to occur, using the same assumptions taken into account in determining the fair values. Individual interest rate risk positions associated with different financial instruments would not be offset unless they are permitted to be offset for balance sheet presentation purposes.

396. This disclosure is not restricted to interest-bearing financial instruments. It would also include those derivative instruments that are subject to basic interest rate risk.

397. When an enterprise has identified currency risk as a significant financial risk associated with particular financial instruments, instruments subject to currency risk would be grouped as separate classes for purposes of interest rate risk disclosures. An enterprise with financial instruments denominated in multiple currencies would analyse fair value separately for the currencies that most affect its activities. For example, disclosure of currency risk and basic interest rate risk might be provided by means of a table as follows:[31]

[31] Paragraph 170 requires that this disclosure be presented for each significant class of financial asset and financial liability. For simplicity, this example illustrates total financial assets and total financial liabilities only.

FINANCIAL ASSETS Currency	Fair value total '000	Not more than three months '000	More than three months but not more than one year '000	More than one year but not more than five years '000	More than five years '000
Sterling	3,995	2,500	1,100	395	-
US dollar	900	900	-	-	-
Japanese yen	480	480	-	-	-
Australian dollar	500	250	130	80	40
Other	480	200	-	-	280
Total	6,355	4,330	1,230	475	320
FINANCIAL LIABILITIES **Currency**					
Sterling	995	660	110	100	125
US dollar	2,615	2,200	120	295	-
Japanese yen	507	150	200	157	-
Australian dollar	450	200	140	110	-
Other	307	50	160	97	-
Total	4,874	3,260	730	759	125
NET GAP **Currency**					
Sterling	3,000	1,840	990	295	(125)
US dollar	(1,715)	(1,300)	(120)	(295)	-
Japanese yen	(27)	330	(200)	(157)	-
Australian dollar	50	50	(10)	(30)	40
Other	173	150	(160)	(97)	280
Total	1,481	1,070	500	(284)	195

398. When financial assets or financial liabilities are held or issued by a foreign entity, the reporting enterprise might present the additional information required by sub-paragraph 171(b) in the following manner:[32]

> 3,297,000 of the fair value of the enterprise's financial liabilities arises in foreign entities. Of this amount, 2,000,000 arises in foreign entities where the functional currency is the US dollar, 400,000 arises in foreign entities where the functional currency is the Japanese yen, and 400,000 arises in foreign entities where the functional currency is the Australian dollar.

399. Many enterprises manage their basic interest rate risk by managing the net gaps in the amounts, timing and uncertainties of future cash flows relating to assets and liabilities. Information about an enterprise's exposure to these cash flows will typically be portrayed by information about the terms and conditions of financial instruments (see paragraphs 164-169), as well as information about contractual re-pricing and maturity dates (see paragraph 170) and the extent to which cash flows could vary as a result of changes in risk conditions (see paragraphs 179-180). An enterprise might supplement this information with an analysis of the fair value of financial assets and financial liabilities according to the time periods in which those cash flows are contracted to occur. The time grouping for such an analysis would be the same as that adopted for disclosure of interest rate risk in accordance with paragraph 395.

32 For simplicity, the disclosure for financial liabilities, only, is shown.

Credit Risk

400. Some exposures to concentrations of credit risk will be clearly evident from the enterprise's business operations. For example, it will be clear that an enterprise selling products in only one geographical area is exposed to credit risk associated with changes in the general circumstances affecting that geographical area. In such cases, a separate description of the region that is the basis of the concentration of credit risk, in accordance with sub-paragraph 173(a), is unnecessary.

401. When financial instruments are measured at fair value on the balance sheet, the carrying amount of most financial instruments will represent the maximum credit risk exposure. However, this is not the case for instruments such as credit guarantees written, financial assets against which collateral is held, or instruments subject to master netting or set-off arrangements that are reflected in the balance sheet presentation. In these cases, the fair value will reflect the market's expectation that the enterprise will have to deliver in accordance with the guarantee, or will be able to collect the collateral to recover an asset, or the fair value will represent only a net exposure. In these cases, the maximum credit exposure is the maximum amount that an enterprise would have to deliver in accordance with the guarantee in the event of a default, the maximum amount that the enterprise would lose in the event that the counter-party to a transaction for which collateral is held fails to deliver and the collateral proves not to be collectable or worthless, and the gross amount of the financial instruments subject to master netting or set-off arrangements.

Other Significant Financial Risks

402. The Draft Standard does not specify the manner in which quantitative information about significant financial risks other than basic interest rate risk, currency risk and credit risk at the reporting date would be disclosed. For each significant financial risk, the disclosure would provide an indication of the extent to which the fair values of financial assets and financial liabilities are affected by that risk at the reporting date.

403. Disclosure of the terms and conditions of financial instruments, in accordance with paragraphs 164-169, would provide basic information about the presence of particular risks. When a financial risk affects more than one class of financial instruments, information would be provided to disclose the overall effect of that financial risk on the enterprise. For example, a commodity price risk might be present in financial liabilities (such as gold loans) as well as in financial assets based on commodity prices (such as forward contracts to sell gold that can be settled net by a financial instrument). An enterprise would disclose information about the financial instruments that are exposed to that particular risk (such as their fair values) at the reporting date in a manner such that the magnitude of the total exposure to that risk is portrayed.

404. Appropriate ways of reporting the quantitative information required by paragraph 175 will differ for different enterprises and will probably evolve over time as management approaches and measurement techniques evolve. Some possible disclosures are set out in paragraphs 405-408. However, these are not exhaustive and enterprises are encouraged to develop other ways of reporting the quantitative information.

405. Quantitative disclosure of other significant financial risks need not identify the fair value amount that relates to the particular risk, but might be provided by disclosing the fair value of the financial assets and financial liabilities that are affected by that risk.

406. For prepayment risks, the disclosure of early settlement options in paragraph 166(e) might be extended to include an explanation of the circumstances under which they can be exercised and the conditions under which they might be exercised. An enterprise might disclose the fair values of financial assets and financial liabilities that are subject to prepayment risks, together with information about the periods in which those fair values are expected to re-price or mature when they differ significantly from the contractual dates.

407. For risks related to financial options, an enterprise might disclose information about the volatility of underlying benchmarks. One means of providing this might be to disclose the standard deviation of the enterprise's return, based on historical data for the previous twelve months.[33]

408. For liquidity risk, information about terms and conditions of financial instruments will generally provide some information—in particular, the information about restrictions on the enterprise's use of certain financial instruments (see paragraphs 168 and 169). Information about the methods used to determine fair value (see paragraphs 183 and 184) also provides some indication of liquidity risk in that it identifies which financial instruments are valued by reference to observable market exit prices and which are valued by other means. This information might need to be supplemented when other factors affect the enterprise's overall ability to liquidate financial instruments.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

409. An enterprise might take one or more of a variety of approaches to providing information about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions. Possible approaches include the following.

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[33] For possible approaches to quantifying risks related to financial options see, for example, Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks, January 1996, pages 32 to 37, which discusses potential methods of measuring price risk for options.

(a) Disclosure of the effect of a hypothetical change in the prevailing level of market prices on the fair value of the enterprise's financial instruments and reported earnings and cash flows (sensitivity analysis). The hypothetical changes used would be those that the enterprise believes would be reasonably possible during the twelve months following the reporting date. For example, an enterprise might choose to indicate the effect of one or more of the following measures (assuming that the relevant change is reasonably possible):

  (i) 15 percent or 100 basis point (whichever is greater) adverse interest rate shift along the yield curve;

  (ii) 15 percent or 100 basis point (whichever is greater) adverse interest rate shift at the long end (over 7 years) or short end (under 7 years) of the yield curve relative to the rest of the curve;

  (iii) 50 basis point adverse credit spread change relative to government securities;

  (iv) 10 percent adverse change in any exchange rate in which the enterprise has 10 percent or more of its assets denominated;

  (v) 20 percent adverse change in any exchange rate in which the enterprise has 5 percent or more of its sales;

  (vi) 15 percent adverse movement in equity prices; or

  (vii) two annualised standard deviations or 20 percent (whichever is greater) price change in, for example, any physical commodity that has a material impact on the enterprise's operations.

(b) Disclosure of the expected loss from an adverse market movement with a specified probability over a specified period of time. Value-at-risk methodologies are a means of calculating such information.

Other risk measurement techniques are becoming established and might be used, as long as they are accompanied by the disclosures in paragraph 180.

410. An enterprise might choose to use a different approach for each financial risk. An enterprise might, for example, choose to disclose the results of sensitivity analysis for currency risk, notwithstanding that it uses a different methodology for its interest rate risk disclosure.

411. Many risk measurement techniques used are complex, so that a full description of them would involve providing a considerable amount of technical information. However,

disclosure of the methodology and the main parameters and assumptions used will help users to understand the extent to which the measures disclosed by different enterprises might be comparable. In the case of value-at-risk, for example, the information disclosed will usually include the holding period and confidence limits. It might also include the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations and what volatility and correlation assumptions (or, alternatively, Monte Carlo probability distribution simulations) are used.

Disclosure Example

412. An example of how the disclosures required by this Draft Standard, as they relate to an enterprise's foreign currency risk, might be provided follows (The disclosures required by paragraphs 164-169, concerning the terms and conditions of financial instruments, are not illustrated. The example assumes that the enterprise chooses to provide additional disclosures about its risk management activities associated with transactions expected to occur in future reporting periods, as encouraged in paragraph 182).

Example

<u>Foreign currency risk management policy.</u> UK Company uses forward currency exchange contracts, swaps, options and debt to reduce its exposure to fluctuations in currency exchange rates arising from export sales priced in US dollars and certain accounts and notes receivable denominated in US dollars. Export sales account for approximately 20 percent of the company's overall sales volume.

The company's objective is to maintain an immaterial net balance sheet foreign currency risk exposure at any given time, except with respect to positions taken to manage future foreign currency risks relating to certain highly probable future transactions. The company reviews its net balance sheet foreign currency exposure at each month end to assess the effectiveness of its risk management strategy.

<u>Foreign currency risk position.</u> At December 31, 2000, the company had a US dollar asset risk exposure (comprising US dollar denominated receivables and foreign currency swaps) of £130,000 (December 31, 1999 £80,000) and a US dollar liability risk exposure (comprising debt and foreign currency swaps) of £110,000, (December 31, 1999 £55,000), excluding positions taken to manage anticipated future transactions (see below). A net foreign currency loss of £2,000 (1999—£750) was recognised in the income statement in the year in respect of US dollar denominated financial assets and financial liabilities that were not managing foreign currency risks relating to future transactions.

<u>Future transactions</u>. The company acquires foreign currency put options and forward exchange contracts to manage a portion of the foreign currency risk in anticipated sales

denominated in US dollars. These contracts are entered into to help protect the company against the risk that the future cash inflows expected to result from such sales will be adversely affected by changes in exchange rates. Based on the company's expectations of future exchange rates, it enters into contracts to offset the foreign currency risk in 25 percent to 75 percent of anticipated sales for the following 6-8 months.

At December 31, 2000, the company had foreign exchange forward contracts to sell $1,500,000 over an average period of 4.5 months (December 31, 1999—$950,000 over an average period of 3.5 months) that were entered into to manage the foreign currency risk in anticipated sales. These forward contracts had a negative fair value of £100,000 at that date. This amount was recognised as a loss in the income statement of the current period (at December 31, 1999 forward contracts had a positive fair value of £25,000). All of the loss recognised in the current period's income statement is expected to represent an effective hedge of the foreign currency risk in anticipated sales denominated in US dollars.

Foreign exchange forward contracts held at the end of 1999 and identified as managing future US dollar risks relating to 2000 sales revenues were settled in January 2000 when management determined that its expectation was that future US dollar rates were likely to increase, rather than decrease.