Financial Instruments
JWG
Joint Working Group
of standard setters

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

BASIS FOR CONCLUSIONS

This Basis for Conclusions summarises considerations that members of the JWG deemed significant in reaching the conclusions in this Draft Standard. It includes reasons for adopting certain accounting methods while rejecting others.

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Basis for Conclusions - Contents

1. Objective

1.1 The JWG's objective has been to develop a Draft Standard and Application Supplement on financial instruments and similar items that are (a) comprehensive; (b) consistent with both relevant conceptual framework concepts for financial reporting and accepted economic principles evident in capital markets and finance theory; and (c) capable of reasonable implementation.

Comprehensive Approach

1.2 The IASC Discussion Paper[1] that has been the primary basis for the JWG's considerations recommended that the objective of accounting standard setters should be to develop a comprehensive set of standards for financial instruments. This means a set of standards for the recognition, derecognition, measurement, income statement presentation, and disclosure of all financial instruments for all enterprises. The IASC Discussion Paper demonstrated that principles in each of these areas of accounting and disclosure have important interdependencies, so that it is highly desirable to address them together, rather than on a piecemeal basis. In contrast, existing standards and practices have been developed on a piecemeal basis. The result has been major gaps and inconsistencies.

Conceptual Framework

1.3 A fundamental conclusion of the IASC Discussion Paper was that a sound and relevant conceptual framework for accounting for financial instruments must bridge two conceptual bases—that of financial accounting and that which underlies modern capital markets. It demonstrated that the latter conceptual basis has important implications for the recognition and measurement of financial instruments and for the disclosure of financial information to support investment and financial risk management purposes. Major developments have taken place in recent years in capital markets, in finance theory, in information technology, in the use of innovative derivative and other financial instruments, and in financial risk management approaches. The IASC Discussion Paper proposed fundamental changes to accounting for financial instruments to recognise the implications of these developments for improving the usefulness of accounting information.

Implementation

1.4 The Draft Standard attempts to strike a reasonable balance between conceptual ideals and practical cost-benefit considerations. See also paragraphs 1.38-1.43.

[1] IASC, Accounting for Financial Assets and Financial Liabilities, March 1997.

Fundamental Principles Underlying the Draft Standard

1.5 The following four principles provide the cornerstones for this Draft Standard.

(a) Fair value is the most useful measure of financial instruments and similar items within the scope of this Draft Standard.

(b) All changes, after adjustment for receipts and payments, in the fair value of financial instruments and similar items within the scope of this Draft Standard are increases or decreases in the income of the reporting enterprise and should be recognised in its income statement in the periods in which they arise.[2]

(c) Only items that are assets or liabilities should be recognised and measured as such in financial statements.

(d) Financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies.

Fair Value Measurement Principle

1.6 Fair value is the most useful measure of financial instruments and similar items within the scope of this Draft Standard.

1.7 The two most important qualitative characteristics of accounting information are relevance and reliability. The JWG believes that fair value is the most relevant measurement attribute for financial instruments and that sufficiently reliable estimates of their fair value are generally obtainable for use in financial reporting.

Relevance

1.8 The JWG believes that the measurement of financial instruments at fair value has a number of major conceptual advantages. The more important of these are outlined below.[3]

(a) Fair value reflects the market's assessment of the effects on financial instruments of current economic conditions, and changes in fair value reflect the effects of changes

[2] The Draft Standard makes one exception for foreign currency translation gains and losses on financial instruments of certain foreign operations of an enterprise. See Draft Standard paragraph 136.

[3] The following sources provide further information on the underlying issues: IASC Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997; FASB, Preliminary Views, Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value, Appendix A, December 14, 1999; and Accounting Standards Board (U.K.), Derivatives and Other Financial Instruments—A Discussion Paper, July 1996.

in those economic conditions when they take place. This follows from the expectation that the fair value of a financial instrument determined in competitive, open market economies embodies all available information up to the measurement date. Cost-based measures reflect only the effects of conditions that existed when the transactions took place, and the effects of price changes are reflected only when they are realised or settled, even though realisations or settlements are not the events that caused the gains or losses.[4]

(b) Following from (a), fair value provides a better basis for prediction than other measures. The fair value of a financial instrument represents the present value (taking into account all available information) of its expected cash flows discounted at the current market rate of return for commensurate risk. Thus, fair value embodies the market's expectation that the fair value of the instrument will increase over time at that market rate. As a result, if an investor knows the fair value of a financial instrument and has information about its essential terms and risks, he or she has the basics for evaluating the market's expectations. The investor may then make his or her own adjustments for possibly different expectations from those of the market. Cost-based measures only enable extending the effects of past costs to the future by, for example, "predicting" future amortisation and interest coupon payments of a debt-type instrument, assuming no default, restructuring or early repayment effects.

(c) Because it is a market-based notion, fair value is unaffected by:

(i) *the history of the asset or liability*. Fair value does not depend on the date or cost at which an asset or liability was acquired or assumed;

(ii) *the specific enterprise that holds the asset or owes the liability*. Fair value is the same no matter which enterprise has an asset or liability if both enterprises have access to the same markets and, for a liability, if they have the same credit standing; or

(iii) *the future use of the asset or liability*. Fair value does not depend on whether or when it is intended to dispose of an asset or liability.

Thus, fair value represents an unbiased measure that is consistent from year to year within an enterprise and between enterprises. Fair values of financial instruments are comparative and additive at any measurement date, because fair values are current measurements of the present value of expected future cash flows. Cost-based measures, in contrast, impede comparability because they make like instruments look different and different instruments look alike. For example, two enterprises holding

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[4] This is mitigated only to the extent of provisions for impairment of financial assets.

instruments with cash flows of identical timing, amounts and uncertainties probably would report different cost amounts if they were acquired at different times.

(d) Fair value reflects the effects of management's decisions to continue to hold assets or owe liabilities, as well as decisions to acquire or sell assets and to incur or settle liabilities. A historical-cost-based measure ignores the effects of decisions to hold or owe, because it reflects the effects of changes in fair value only when assets are sold or relief from liabilities is obtained, not during the period a financial instrument is held or owed.

(e) Reporting all financial instruments at fair value would reduce the anomalies of the existing mixed cost—fair value accounting for financial instruments. Therefore, it would reduce the need for complex and subjective hedge accounting requirements. If both the hedged item and the hedging instrument are measured at fair value, the degree to which a risk management strategy succeeded in mitigating the risk is readily apparent. (The implications of fair value measurement for hedge accounting are considered in paragraph 7.5.)

1.9 Reporting at fair value does not imply that the fair value will be immediately realised. The relevance of fair value is not affected by the ability to sell an asset immediately or obtain immediate relief from a liability, although marketability may affect the measure of the fair value of a financial instrument.

1.10 It is commonly argued that cost-based accounting is appropriate for financial assets and liabilities that are managed together on the basis of the expected timings and amounts of their net cash flows. Banks, for example, typically manage their "banking book" activities on a cost basis, utilising net cash flow gap analysis and other techniques for managing their financial risk exposures. Many banks strongly advocate cost-based accounting in preference to fair value measurement for financial assets and liabilities managed in their banking books. The JWG considered these arguments and underlying concerns and available evidence. It concluded that accounting for these financial assets and liabilities on a cost basis cannot provide as relevant a measure of their matched and mis-matched cash flow positions as can fair value measurement. In so concluding, the JWG observes that difficult issues arise in assessing the extent to which financial asset and liability positions are matched at any given time, taking into account expectations with respect to credit risk, complex payment options and other uncertainties relating to the timings and amounts of cash flows to result from these positions. It believes that comprehensive fair value measurement of financial assets and liabilities will provide a consistent current market measure of the effects of mis-matched positions, and consequently will provide relevant reporting of the effectiveness of netting strategies.

1.11 Some believe more generally that fair value measurement of financial instruments cannot be considered to be relevant, and should not be required, except when an enterprise manages its financial instruments on that basis. It is obviously desirable that there be consistency between external and internal reporting systems, and it is difficult to see how there could be fundamental and irreconcilable inconsistencies between sound external and internal financial risk management and investment bases. However, the objective of financial reporting is to meet the financial information needs of external stakeholders and, accordingly, the JWG believes that what constitutes appropriate financial accounting standards for financial instruments must be justified primarily from that perspective. The JWG believes that it is important that there be consistent methods for measuring and reporting the results of an enterprise's management strategy. This is not achieved if two enterprises with identical financial instruments and risks present different balance sheet positions and income statement results solely as a result of the way in which they choose to manage those instruments and risks.

1.12 The conceptual case for fair value measurement of financial instruments is supported by a growing body of market-based empirical research. Despite the limitations of fair value disclosures provided to date, the evaluation of a body of academics who have been involved in this research is that:

> The academic literature provides consistent evidence suggesting that fair values of (1) investment securities held by financial institutions, (2) derivatives held by banks for asset-liability management, (3) bank net loans, and (4) bank long term debt, should be recognised on the balance sheet. In addition, empirical results support the inclusion of changes in fair values of these financial instruments in income. Finally, the empirical evidence on comprehensive vs. partial fair value accounting indicates that for fair value accounting disclosures to be most useful, comprehensive, rather than partial, fair value accounting should be adopted.[5]

1.13 Surveys of financial analysts and other users have yielded mixed results. This is consistent with the possibilities that many users are not fully familiar with fair value information and that some analysts prefer cost-based information because it may be less volatile and they believe cost-based income may be more predictable than fair value-based income. A 1997 focus group survey on fair value was conducted by independent consultants on behalf of the Association for Investment Management and Research (AIMR), the FASB and the Canadian Institute of Chartered Accountants. That study found that users who were identified by the independent consultants as being "knowledgeable and informed about fair value accounting for financial instruments" were evenly divided on whether to measure financial instruments at fair value or cost. "The clear and prevailing view" of respondents was that they need more and better information regarding fair values of financial

[5] American Accounting Association's Financial Accounting Standards Committee, Response to a Discussion Paper Issued by the IASC/CICA Steering Committee on Financial Instruments, Accounting for Financial Assets and Financial Liabilities, in Accounting Horizons, March 1998, pages 90-97. This paper overviews empirical and conceptual research on the relevance and information value of fair value measurement of financial instruments, and includes references to specific studies.

instruments.[6] The Financial Accounting Policy Committee of the AIMR has indicated its support for fair value measurement of financial instruments.[7]

Reliability

1.14 The practical concerns most frequently cited by constituents are that observable market prices are not always available and that estimates may be unreliable if they are not based on observable market prices. There have, however, been major advances in valuation techniques that reasonably reflect market pricing methods. Even if a financial instrument does not have an observable market price, its fair value can be estimated using techniques that incorporate capital market pricing principles and information about current market conditions. Such techniques are often used in market price setting processes. Software now commonly available enables many types of computations to be made at reasonable cost.

1.15 However, a number of respondents to the IASC Discussion Paper indicated serious concerns about the ability of enterprises to develop fair value estimates that could be sufficiently reliable for financial accounting in all situations. For the most part, these concerns were expressed only in general terms. The JWG carried out a questionnaire-based survey aimed at more fully understanding the basis for the expressed concerns. The survey covered some of these respondents as well as some others who could be expected to have knowledge that could be helpful in understanding these concerns. There were sixty respondents from ten countries. These included a variety of financial and commercial enterprises as well as three accounting firms. Each respondent was asked to identify specific financial instruments or situations for which it believed it would not be practicable to make fair value estimates that would be sufficiently reliable for financial accounting purposes. Each respondent also was asked to provide details of each identified instrument or situation, and the nature of and reason for the fair value estimation difficulties, as well as information about its experience in addressing these difficulties. The survey and follow-up revealed a number of concerns relating to questions of fair value measurement principles and estimation approaches that the JWG believes are addressed in the Draft Standard and the Application Supplement. The only type of situation raised that the JWG believes might not be practicable of reliable fair value measurement involves certain private equity investments, and the Draft Standard provides an exemption for those investments (see paragraph 122).

1.16 Some believe that the liquidity risk component of fair value often will not be practicable of reliable estimation for financial instruments that are not readily marketable. They believe that the Discussion Paper should require that a liquidity adjustment not be made in estimating the fair value of such financial instruments if an enterprise believes that the

6 Sirota Consulting, Investment Community Interest in Reporting the Fair Values of Financial Instruments in Financial Statements—A Focus Group Summary: Final Report, June 3, 1998.

7 Association for Investment Management and Research, Comment letter of July 24, 1997 on IASC/CICA Discussion Paper, Accounting for Financial Assets and Financial Liabilities.

adjustment cannot be reliably estimated. The JWG believes that fair value measures of financial instruments should reflect reasonable estimates and assumptions for all potentially significant factors that market participants would be expected to consider in estimating a market exit price and that there should be no exception for liquidity risk. However, the Draft Standard provides that certain practical assumptions may be made where little or no market information is available on which to base an estimate of some factors that affect fair value, provided that consistent policies and procedures are applied.

1.17 The JWG believes that the range of acceptable fair value estimation variability for financial instruments should be evaluated in relation to the ranges of estimates accepted in other areas of accounting. The IASC Framework notes, for example, that:

> In many cases cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. (paragraph 86)

1.18 Potentially significant degrees of variability of estimates are accepted in many areas of accounting today. Examples include defined benefit pension obligations, certain liability provisions, provisions for impairment of financial and non-financial assets, and custom-designed derivatives that are presently measured at fair value in "trading" portfolios and are to be measured at fair value under accounting standards in some jurisdictions.

1.19 Some valuation techniques will require internally developed estimates and assumptions as well as judgement about which factors market participants would consider. The JWG believes that an important underpinning for ensuring that these estimates and assumptions are made on a reasonably reliable and consistent basis lies in an enterprise establishing a system of fair value measurement policies and procedures that is appropriate to the nature of its financial activities. The Draft Standard makes this an explicit requirement. Enterprises that are using fair value information about financial instruments for internal management purposes may presently have such systems in place. In some cases, systems developed for different purposes may be adapted for fair value measurement purposes, for example, a credit grading system used by a lender in extending loans and monitoring the credit quality of its loan portfolio.

1.20 Setting accounting standards often requires a trade-off between relevance and reliability. In almost all situations involving financial instruments the JWG believes that relevance should be given more weight. That is, the JWG believes that fair value estimates, even with their limitations, will be a significant improvement over cost-based measures. It notes that the measurement of the amortised or recoverable cost of many of these instruments is also subject to similar estimation difficulties. However, as noted above, the JWG believes that there is one possible exception—certain equity investments for which there is no observable market price.

1.21 Determining the fair value of some non-traded equity investments requires more significant internal information and assumptions than are required for other financial instruments. The JWG believes that an enterprise that invests in private equity investments as a primary business activity should be presumed to be able to make fair value estimates for financial reporting purposes. The JWG accepts, however, that other enterprises with private equity investments may determine that it is not possible, without incurring excessive costs, to regularly make reliable estimates of the fair value of these investments. For example, an enterprise in a development or start-up phase has little or no experience on which to base expectations of future cash flows, and an investor may not have access to some of the internal information of the enterprise.

Fair Value Risk Compared with Cash Flow Risk

1.22 Under the fair value model for financial instruments, financial statements reflect the results of taking <u>fair value risk</u> (that is, the risk of increases or decreases in the fair value of financial instruments). This has particularly important implications for interpreting the balance sheet and income statement effects of changes in basic interest rates on interest-bearing financial instruments.

1.23 Many enterprises focus more on managing <u>cash flow interest rate risk</u> (that is, the risk of increases or decreases in future cash flows resulting from changes in interest rates) than on <u>fair value interest rate risk</u>. In so doing they believe that it is floating rate, rather than fixed rate, interest-bearing assets and liabilities that are risky. The fair value market-based model reflects the opposite premise. If an enterprise has fully floating rate debt, and basic interest rates rise, the fair value of the debt will not be affected, and no gain or loss will be reported. This does not accord with the cash flow risk view, which is concerned that the interest coupon cash flows required under this loan will now increase. This may be seen as an adverse effect because the enterprise will have to pay out more cash, and it may not be able to increase asset cash flows to compensate. Furthermore, it will have to incur higher interest expense in future periods.

1.24 The fair value model, which reflects the basis on which capital markets price interest-bearing financial instruments, is founded on the premise that an enterprise has not gained or lost on its floating rate debt because the debt has maintained its value in terms of the current interest return that can be earned in the market place. When basic interest rates rise, the enterprise has the opportunity to earn a commensurately higher cash flow return on its assets if it has not locked in its investments to receive fixed cash flows. Thus, while an increase in basic interest rates has no effect on the fair value of the floating coupon debt, the value of the enterprise's assets may decrease if they cannot be expected to generate an increase in cash flows commensurate with the increased rate of return currently available on interest-bearing assets in the market place. Of course, on a fair value basis, an enterprise that had issued fixed coupon debt would report a gain due to the increase in the basic interest rate. This enterprise is better off because its debt burden has reduced in terms of the current market cost of capital.

1.25 The historical cost basis does not reflect any gain or loss when basic market rates of interest change. No loss would be recorded on an enterprise's floating rate debt as a result of an increase in interest rates, even if management takes the cash flow risk view that the enterprise is worse off as a result. Neither would the enterprise reflect any gain in the period on fixed coupon debt, unless it decided to realise the gain by settling the debt and refinancing at the new market rate or by acquiring a fixed-floating interest rate swap.

1.26 No measure of a financial instrument of itself conveys information about its particular risk and return attributes. Thus, measurement needs to be supported by disclosures of this information. The Draft Standard would require disclosure of information about the timings, amounts and uncertainties of cash flows related to interest bearing financial instruments, including their floating or fixed nature and the significant contractual conditions that may affect these cash flows (see disclosure requirements in paragraphs 164-169). Thus financial statement users will have information to help them evaluate both cash flow and fair value risks.

Income Recognition Principle

1.27 All changes, after adjustment for receipts and payments, in the fair value of financial instruments and similar items within the scope of this Draft Standard are increases or decreases in the income of a reporting enterprise and should be recognised in its income statement in the periods in which they arise.

1.28 The JWG believes that there are compelling reasons for concluding that all increases and decreases in the fair value of financial instruments, after adjustment for receipts and payments, should be recognised in the income statement of the reporting enterprise. This conclusion is based on consideration of the economic properties of financial instrument income determined on a fair value basis, as well as on practical considerations related to the basis it provides for useful disaggregation and analysis. The JWG believes that fair value income for financial instruments can provide a richer basis for analysis than cost-based or mixed cost—fair value bases and that, in particular, it facilitates the predictive and stewardship purposes of financial statements. The basis for these conclusions is set out in paragraphs 6.2-6.26. This principle also has implications for the treatment of gains and losses arising on financial instruments used to manage risks associated with anticipated future transactions (see paragraphs 7.10-7.20).

Asset and Liability Recognition and Derecognition Principle

1.29 Only items that are assets or liabilities should be recognised and measured as such in financial statements.

1.30 A fundamental purpose of financial reporting is to recognise and measure assets and liabilities of an enterprise on a reporting date. This, in turn, provides the basis for presenting the income and cash flow results that have arisen from assets and liabilities during the reporting period ending on that date. This principle underlies the Draft Standard's definitions of financial assets and financial liabilities and its requirements for their recognition and derecognition. The JWG has concluded that the reasoned application of this principle would require some significant changes to existing standards and practices in accounting for financial instruments in the following areas:

(a) The recognition and derecognition of financial instruments (which are based on determining when financial instruments become assets or liabilities and when they, or parts of them, cease to be assets or liabilities, of the reporting enterprise). Particularly difficult issues arise in applying the basic asset and liability recognition principle to transfers involving financial assets where the transferor has a continuing involvement in the transferred assets. Many and varied forms of often highly complex transactions are now commonly carried out to unbundle, rebundle and transfer components of financial assets comprising certain of their rights and obligations. Traditional concepts have proven to be inadequate to deal with these transactions. Issues of accounting for transfers of financial assets have been subject to intensive study by several leading standard setting bodies in recent years, but there are significant differences in the treatments they prescribe. The JWG has concluded that a components approach best reflects the economics of the market place and the demands for the fair value measurement of financial instruments (see Basis for Conclusions, paragraphs 3.1-3.25).

(b) The prohibition of hedge accounting by deferring gains and losses on financial instruments (see Basis for Conclusions, paragraphs 7.1-7.19).

Disclosure Principle

1.31 Financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies.

1.32 The most convincing demonstration of the benefits of basing accounting for financial instruments on the above recognition, fair value measurement and financial performance reporting principles lies in the usefulness of the resulting information for analysis purposes. The primary objective of investors is to achieve a return on investment that is at least commensurate with the level of risk taken. Conceptual frameworks for accounting generally recognise this in concluding that a primary objective of financial statements is to provide information to help investors, creditors, and other participants in capital markets to evaluate:

(a) the abilities of enterprises to generate a return, that is, to generate net cash or equivalent inflows (and future earnings that are the source of those net cash inflows); and

(b) the timing and uncertainties (risks) of those expected net cash flows.[8]

The Draft Standard disclosure requirements are intended to provide basic information that will help meet these two objectives.

1.33 Different types of financial risk (including basic interest rate, currency, credit, liquidity, commodity price and equity price risks) have different sensitivities to economic events, conditions, and expectations. These risks are commonly managed separately, often by using derivatives or by transactions that isolate and transfer certain of these risks. Thus, investors and other market participants can be expected to seek information about each of the significant financial risks of an enterprise and their financial position, income and cash flow effects.

1.34 The JWG believes that the following disclosures, taken together, provide the fundamentals for analysis of financial risks and returns.

(a) Description of each of the significant financial risks inherent in an enterprise's activities, and the enterprise's objectives and policies for managing these risks.

The JWG believes that this information is necessary to provide the context for understanding and evaluating information about the enterprise's actual financial risks and performance of its financial instruments.

(b) Information about an enterprise's financial risk positions and performance effects during a reporting period for each significant type of financial risk identified in (a).

The Draft Standard would require disclosures that the JWG believes provide basic information to enable informed judgements of (i) an enterprise's future expectations and the potential volatility of those expectations and (ii) management's stewardship in the context of the enterprise's disclosed financial risk objectives and policies.

(c) Information about the methods used to estimate the fair value of financial instruments in order to help users evaluate fair value measurement uncertainties.

1.35 The Draft Standard would require presentations and disclosures directed at meeting the basic informational objectives in each of the above areas. A number of the disclosures required by the Draft Standard are already required by accounting standards in a number of jurisdictions. However, to date, financial instrument disclosure standards have been

8 See, for example, paragraph 15 of the IASC Framework.

piecemeal and incomplete. Income statement disclosures, in particular, have reflected a cost basis perspective or an inconsistent mix of cost and fair value figures (for example, computing interest on a cost basis even for interest-bearing financial instruments that are measured at fair value). The Draft Standard attempts to put in place a coherent framework of presentations and disclosures to enable the analytical benefits of the fair value model to be realised.

1.36 The development of fully effective fair value presentation and disclosure standards requires addressing a number of issues that have not been the subject of accounting study and that require application experience and field testing to enable full evaluation of the practical and conceptual issues in particular circumstances. For example:

(a) While the concepts underlying the term structure of interest rates are well established in finance literature, there has, until very recently, been no consideration of their implications for the determination of interest revenue and expense within a fair value model (see discussion in paragraphs 6.58-6.76).

(b) A number of analysts, securities regulators and others have indicated a need for quantitative information on financial risk sensitivities. Some financial institutions have developed various value-at-risk and other sensitivity measures. However, the JWG believes that these have not yet been sufficiently defined and standardised to be required to be disclosed in financial statements (see discussion in paragraphs 8.30-8.35).

(c) The Draft Standard would require only fairly basic disaggregation of fair value income, because more detailed breakdowns are subject to questions related to methodology and cost-benefit trade-offs. The JWG believes that these questions can only be satisfactorily addressed on the basis of field testing, and after a period of experience with the requirements set out in the Draft Standard.

1.37 The JWG believes that, while further study and testing will probably enable improvements, the presentation and disclosure standards set out in the Draft Standard represent an important base of information that constitutes a significant advance over that provided under existing disclosure standards.

Overall Evaluation and Implementation Considerations

1.38 The JWG recognises that it is a very serious step to put in place accounting standards that fully embrace these four principles and, in particular, to let go of the historical cost basis of accounting for financial instruments. The JWG's conclusion that this step should be taken now reflects its belief that:

(a) Existing mixed cost—fair value accounting for financial instruments is not sustainable in the longer term, and cannot provide a satisfactory basis for financial accounting, because it is based on mixing elements of two incompatible measurement systems for financial instruments. The JWG believes that this is clearly evident from the complexities and inconsistencies of existing mixed cost—fair value standards and practices.

(b) A comprehensive fair value model for financial instruments that is founded on the above four principles is superior in relevance and, therefore, in the usefulness of the information that can be derived from it for economic decision-making purposes, to cost or mixed cost—fair value models.

(c) The Draft Standard is capable of reasonable and reliable implementation. It attempts to balance practical and theoretical considerations on the basis of present knowledge and evidence. It is expected that the requirements will be refined in future periods as experience is gained in applying them and as capital markets and financial risk management practices continue to evolve.

1.39 Some believe that the Draft Standard and Application Supplement should provide specific rules for the estimation of fair value of financial instruments, particularly where valuation techniques must be used. They believe that the Draft Standard cannot be operational unless it specifies when particular techniques should be used (when, for example, particular option pricing models should be used and what adjustments should be made to them in particular circumstances), and unless it provides explicit rules with respect to assumptions that should be made for specific types of instruments in particular circumstances. The JWG does not believe that it is possible or desirable to provide detailed rules covering all situations. Requirements for application are provided where the JWG believes that existing knowledge permits, and where they will not prevent, enterprises from exercising reasonable judgement in applying the principles to new situations and in adopting improved methodologies as markets continue to develop. Furthermore, enterprises would be required to establish policies and procedures to enable reliable and consistent application of the requirements of the Draft Standard.

1.40 There are some unresolved issues, and the Basis for Conclusions outlines those identified by the JWG and the reasons for the approaches the JWG has taken. The JWG believes that they are reasonably accommodated within the Draft Standard, and that their implications are no more serious than many difficult issues that are accommodated within existing standards in other areas of financial accounting. The JWG has concluded that many of these issues cannot be expected to be resolved without field testing and experience in applying the Draft Standard. The JWG understands that enterprises are not prepared to consider detailed application implications for their operations on the basis of only broad principles and objectives.

1.41 Successfully implementing a fair value measurement model for financial instruments requires integrating certain finance and capital markets concepts within financial accounting objectives and concepts. The JWG recognises that understanding and effectively implementing fair value measurement principles require a different "mind set" and expertise from that appropriate to historical-cost accounting for financial instruments. Many financial statement preparers, auditors, analysts and others will likely need some time to develop expertise in fair value measurement objectives and methodologies. The JWG believes that this can be best accomplished by putting the Draft Standard in place, so that everyone will know what is to be required, and then providing a reasonable transition period to enable training and the development of fair value systems and supporting activities.

1.42 The JWG believes that it is of utmost importance to put in place a well planned and internationally co-ordinated implementation process to include education and field testing. It is important that there be a sufficient transition period to enable this. Some considerations in this regard are set out in paragraphs 9.1-9.7.

1.43 The JWG strongly encourages enterprises to work with member accounting standard setting bodies during the exposure period to field test the Draft Standard requirements. The JWG also strongly encourages accounting standard setting bodies to work with representatives of the financial analyst and academic communities to further develop and refine fair-value-based information that would be useful for analysis purposes.

2. Scope

Enterprises Included in Scope

2.1 The JWG has concluded that the proposed accounting principles in this Draft Standard are applicable to all enterprises. A financial instrument has the same economic benefits and risks, and is affected by financial market forces in the same manner, irrespective of who holds it. Accordingly, the JWG believes that accounting should be consistent with the attributes of the particular financial instruments, rather than being based on the industry or type of enterprise that might feature these instruments.

Banks

2.2 A number of banks and banking associations have indicated to the JWG that they strongly believe that, while fair value measurement is relevant to financial instruments held in banks' trading books, it is not relevant to financial instruments that are managed within their banking books. Banks typically manage their banking book activities on a cost basis, using net cash flow analyses and other techniques that do not place a significant emphasis on the fair value of financial instruments. They advocate exempting banks or banking book activities from the Draft Standard.

2.3 The JWG has considered the nature of banking book activities and the concerns raised by banks and their associations. Various members of the JWG have met with bankers and banking regulators and the JWG consulted, and exchanged papers, with The Joint Working Group of Banking Associations on Financial Instruments.[9]

2.4 The JWG believes that the principles of this Draft Standard are fully applicable to banks and that the unique aspects of banking book activities can be reasonably accommodated within the basic requirements of the Draft Standard. It believes that the major issues raised by banking interests about the usefulness of fair value measurement for financial instruments are addressed in this document.

2.5 The JWG recognises that certain issues of application to banking book activities would benefit from additional consideration before the Draft Standard is put in place—for example, the application of fair value measurement principles to bank deposit liabilities and adaptation of the requirements for balance sheet and income statement presentation and supporting disclosures. The JWG expects that a transitional period will be necessary to

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9 See, Financial Instruments Joint Working Group of Standard Setters, Financial Instruments: Issues Relating to Banks, August 31, 1999; The Joint Working Group of Banking Associations on Financial Instruments, Accounting for Financial Instruments for Banks, and Financial Instruments: Issues Relating to Banks, October 4, 1999.

develop systems, or extend existing systems, to implement valuation techniques for estimating the fair value of financial instruments such as loan asset portfolios. The JWG strongly encourages the banking industry and accounting standard setters to work together to conduct field tests of the Draft Standard using the internal data and actual situations of a number of banks in several countries. This would provide a fully informed basis for adapting, refining, and perhaps improving upon the application of the Draft Standard and Application Supplement to banks.

Insurance, Pension and Similar Enterprises

2.6 Paragraph 1 of the Draft Standard excludes from its scope certain insurance contracts and employers' assets and liabilities under employee benefit plans (see paragraphs 2.23-2.30 for further discussion). However, it does not exempt other financial assets and financial liabilities of insurance enterprises, defined benefit pension and other post-employment benefit plans and similar enterprises.

2.7 Some are concerned that this could result in inconsistencies between financial instruments measured at fair value and insurance contracts and employee benefit and similar obligations that are accounted for on other bases. They advocate that the Draft Standard should not apply to these enterprises and that they should be free to adopt methods of accounting for their financial assets and financial liabilities that they believe are consistent with present methods used to measure insurance contracts and employee benefit and similar obligations.

2.8 There is currently great diversity in accounting practice for insurance enterprises internationally and for employee benefit obligations in a number of countries. There is concern that this diversity has made it difficult for users to evaluate financial statements of these enterprises, and to compare them both with each other and with enterprises in other business sectors. Consistent accounting for all financial instruments held by such enterprises, other than those for which special considerations apply, is one step towards alleviating these concerns.

2.9 Implementation of this Draft Standard for all financial instruments other than those for which special considerations apply will result in a period of time during which most financial assets and financial liabilities are measured at fair value, but certain insurance contracts and employee benefit obligations continue to be measured on a different basis. However, the JWG believes that the benefits of measuring financial instruments at fair value exceed any possible benefits that could result from temporarily measuring them on bases that are presently used to measure insurance contracts and employee benefit obligations.

Smaller or Non-public Enterprises

2.10 Some suggest that smaller, non-public or non-listed enterprises should be exempt from the Draft Standard because many may lack the capabilities and resources to implement the proposed recognition and measurement principles. In addition, many such enterprises may have fairly simple capital structures, and less complex financial instruments, so that financial statement users may not have as much need for fair value based accounting in their financial statements. For these enterprises, the cost of implementing this Draft Standard might outweigh the benefits.

2.11 The JWG believes that the accounting principles in the Draft Standard are equally applicable to all enterprises, regardless of whether they are public or private, large or small. To require differential accounting bases is fundamentally inconsistent with the notion that financial instruments have the same economic benefits and risks and are affected by financial market forces in the same manner, irrespective of the enterprise that holds them. Further, smaller or non-public enterprises are in no way insulated from developments in the markets for swaps and other derivatives and may be in just as much need as larger or public enterprises of a standard that fully reflects the fair values of financial instruments in their financial statements.

2.12 On the other hand, the JWG accepts that other issues related to differential reporting might be considered in some jurisdictions. The criteria under which some jurisdictions make accounting distinctions between large or public enterprises and smaller or non-public enterprises differ and involve broader considerations than those relating to financial instruments alone. The JWG believes that it is not the purpose of the its project to consider the broad issues of differential accounting.

What is a "Financial Instrument"?

The Definition of a Financial Instrument

2.13 Definitions of a financial instrument adopted in most jurisdictions are broadly similar, but with a number of differences in the details. For example, IAS 32, in common with similar standards in a number of other jurisdictions, contains the following definitions of a financial instrument, a financial asset, a financial liability and an equity instrument:

> A *financial instrument* is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.
>
> A *financial asset* is any asset that is:
>
> (a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity instrument of another enterprise.

A *financial liability* is any liability that is a contractual obligation:

(a) to deliver cash or another financial asset to another enterprise; or

(b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

An *equity instrument* is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.

2.14 The Draft Standard adopts different definitions of these terms, primarily to clarify aspects of the IAS 32 definitions. These changes to the definitions are based on improvements identified by users of the definitions and are not intended to involve fundamental changes of meaning. These changes include the following:

(a) The IAS 32 definitions require all financial instruments to be contracts. Some question whether cash can be considered to be a contract. Further, the IAS 32 definitions require all financial instruments to give rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise, yet some argue that cash does not do that. These concerns are overcome by amending the definition so that it specifically states that cash is a financial instrument.

(b) The IAS 32 definition of a financial instrument can be interpreted to mean that, whenever a contract gives rise to a financial asset of one party and a financial liability of another party the entire contract is a financial instrument. However, a contract might include financial and non-financial components. In such circumstances, only the financial components constitute a financial instrument. Amending the definition so that it specifies that it is the contractual rights to require delivery or exchange of financial instruments and the contractual obligations to deliver or exchange financial instruments that comprise financial instruments, overcomes this difficulty.

(c) Some believe that the references in the IAS 32 definitions to exchanges on “potentially favourable terms” or “potentially unfavourable terms” preclude an option to put or call a financial instrument at the market price on the exercise date from meeting the definitions. However, it is accepted that such options are financial instruments. These references do not seem to be essential to the definition. By deleting them, the difficulty is overcome.

(d) The IAS 32 definition of a financial instrument refers only to a contractual right to exchange financial instruments, rather than to a contractual right to require such an exchange. It is the right to *require* an exchange of financial instruments that creates a right to an economic resource and, hence, an asset. A reference to the right to require an exchange has, therefore, been added to the definition.

(e) Some believe that a forward contract to purchase or sell non-financial items might meet the IAS 32 definition of a financial instrument. They claim that one party has a contractual right to receive cash or another financial asset from the other party and the second party has a contractual obligation to deliver cash or another financial asset to the first party. However, this interpretation of the definition overlooks the other leg of the transaction, which requires delivery of non-financial items. Adding the words "in exchange for no consideration other than release from the obligation" makes it clear that such an interpretation is not appropriate.

Derivative Financial Instruments

2.15 This Draft Standard does not separately define derivative financial instruments, because the JWG believes that the same accounting principles should apply to all financial instruments and similar items. The complexity of separately defining derivative financial instruments is, therefore, unnecessary.

Financial Instruments Compared to Non-financial Resources

2.16 The Draft Standard contains principles for the recognition and measurement of financial instruments that differ from conventional accounting for non-financial items. Some believe that it is internally inconsistent to measure financial instruments at their fair values while some or all non-financial items continue to be carried on an historical cost basis.

2.17 The JWG believes that there is a real difference between financial instruments and non-financial items and that this difference gives rise to different accounting considerations. Financial instruments represent contractual rights or obligations to receive or pay cash or other financial instruments or residual interests in the net assets of an enterprise. Non-financial items have a more indirect, non-contractual relationship to future cash flows. The non-financial assets of a business (such as most raw materials, plant and equipment, prepaid expenses and intangibles) are all inputs to some productive process. They are expected to contribute, along with other inputs, to the production and sale of goods or services. They must be used in a productive activity, and effectively transformed into goods or services, which must be sold, before there is any right to receive cash.

2.18 The significance of a non-financial asset depends on how effectively it is used in the production or revenue-generating process. Under historical cost, accrual accounting, non-financial assets are carried at cost, or lower of cost and market, until the point at which they are considered to be used up, or until the point of their deemed "realisation" into revenues consisting of cash or claims to cash (i.e., into financial assets). The economic significance of a financial instrument does not depend on a transformation and realisation process; its significance is determined by the value under current conditions of its contractual rights to receive or obligations to pay cash flows.

2.19 This is not to judge the most appropriate accounting for non-financial items, as that is beyond the subject of this Draft Standard. (Some advocate fair value accounting for certain non-financial assets, and some standards permit revaluation of certain non-financial assets as an acceptable alternative treatment.) However, the JWG believes that a distinction can be made between carrying non-financial items on a cost basis, pending their use to generate financial instruments, and recognising and measuring financial instruments on a basis that reflects the fair value of their contractual rights and obligations. In other words, appropriate recognition and measurement of financial instruments should not be limited by cost-based accounting that may be considered to be appropriate for non-financial items.

Financial Instruments Excluded from the Scope

2.20 Certain financial instruments are excluded from the scope of this Draft Standard if, for instance, their characteristics are such that they are better addressed by other accounting standards. The following paragraphs consider these financial instruments.

Equity Interests in Subsidiaries, Associates and Joint Ventures

2.21 Equity interests in subsidiaries, associates and joint ventures are financial instruments. However, any consideration of their treatment as financial instruments would require a reconsideration of existing consolidation and equity accounting principles. Most jurisdictions address accounting for these instruments in separate standards. The JWG thus believes that equity interests in subsidiaries, associates and joint ventures should be excluded from the scope of standards on financial instruments.

2.22 Some have expressed the view that existing accounting for these equity interests is inadequate, particularly the use of the "equity accounting" method for investments in associates and proportionate consolidation for joint ventures. The JWG believes that these matters are beyond the scope of this project on financial instruments.

Employers' Assets and Liabilities under Employee Benefit Plans, Retirement Benefit Obligations of Defined Benefit Plans and Certain Rights and Obligations with Insurance Risk resulting from Insurance Contracts

2.23 Most employers' assets and liabilities under employee benefit plans, retirement benefit obligations of defined benefit plans and rights and obligations with insurance risk resulting from insurance contracts are financial instruments. They are contractual rights or obligations to deliver financial instruments in exchange for no consideration other than release from the obligation. However, these items present unique estimation problems.

2.24 Accounting standards and established practices for accounting for pension and similar post-employment obligations now exist in most jurisdictions.[10] The JWG believes that it is beyond its mandate and expertise to re-examine these standards in the light of the principles in this Draft Standard. Rather, it accepts that enterprises should apply these other standards and that the relevant financial assets and financial liabilities should be excluded from the scope of this Draft Standard. The JWG recommends that these standards be reviewed in due course to determine whether any amendments need to be made to them to ensure that they are fully consistent with the principles in this Draft Standard. However, the JWG also believes that application of the principles in this Draft Standard to other financial instruments is too important to be delayed until such amendments are considered.

2.25 There is currently great diversity in accounting practice for insurance contracts internationally. The insurance industry and the accounting and actuarial professions are working to reach a common understanding about the application of a fair value model to insurance contracts but have not yet reached conclusions in that regard. These efforts are seeking to develop appropriate bases for recognition and measurement of insurance contracts that are consistent with the principles in this Draft Standard.[11] The JWG thus accepts that this Draft Standard should not be applied to such contracts until the application issues have been resolved. However, the JWG also believes that this should not result in delay in adopting the principles in this Draft Standard for financial instruments other than insurance contracts.

2.26 In defining the scope exception for insurance contracts, the JWG has adopted the definition of an insurance contract proposed in the IASC Insurance Steering Committee's Issues Paper: Insurance, November 1999, but believes that certain financial instruments that fall within that definition should not be excluded from the Draft Standard (for reasons described in paragraphs 2.27 and 2.28, below). In the longer term, if insurance contracts were measured on the same basis as financial instruments, a distinction would become unnecessary.

2.27 The JWG believes that financial guarantees, as defined in the Draft Standard, are financial instruments that should be included within the scope of the Draft Standard, even though they may be regarded as a form of insurance. The effect of changes in credit risk is one of the key financial risks addressed by this Draft Standard.

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[10] See, for example, IAS 19, Employee Benefits, and IAS 26, Accounting and Reporting by Retirement Benefit Plans.

[11] See IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999.

2.28 Contracts that require a payment based on climatic, geological or other physical variables are commonly considered to be insurance contracts. In many cases, the payment made is based on an amount of loss suffered by an insured party as a result of an underlying event. Such contracts are insurance contracts and they are excluded from this Draft Standard. However, under some contracts, payments arise that are not based on a loss suffered by a party to the contract as a result of an event. For example, a contract might require a payment based on whether more than a specified amount of rain falls in a certain location during a certain time period, regardless of whether this causes a loss to the contract holder due to flooding. Such contracts are economically no different from financial instruments such as conditional receivables, and the JWG believes that they should be accounted for in accordance with the principles in this Draft Standard.

2.29 Certain items resulting from insurance contracts, such as premium receivables and payables, meet part (c) of the definition of a financial instrument (see Draft Standard, paragraph 7). These items are not subject to insurance risk and are not economically different from other receivables and payables. The JWG, therefore, specifies that only those rights and obligations arising from insurance contracts that are subject to insurance risk qualify for the exemption in paragraph 1(d).

2.30 The JWG also considered whether warranties should be included within the scope of this Draft Standard. If warranty contracts are to be settled by provision of replacement products or services, they do not meet the definition of a financial instrument. However, if such contracts are settled in cash, they do meet the definition of a financial instrument, as well as the definition of an insurance contract. The JWG concluded that both types of contract are akin to insurance contracts, since they are subject to occurrence, severity and development risk. Therefore, all warranty contracts are excluded from the scope of the Draft Standard.

Equity Instruments Issued and Classified as Equity by the Reporting Enterprise

2.31 Equity instruments of the reporting enterprise are subject to different measurement considerations than those relevant for financial assets and financial liabilities as a result of their nature as residual interests in the assets and liabilities of the enterprise. The Draft Standard therefore excludes a financial instrument that is appropriately classified as equity of the enterprise.[12]

Business Combination Contracts involving Contingent Consideration

2.32 An enterprise that accounts for a business combination by the purchase method might issue financial instruments as contingent consideration for the purchase. The accounting for such

[12] IAS 32, Financial Instruments: Disclosure and Presentation, specifies when a financial instrument is appropriately classified as equity of the enterprise.

contracts is addressed by standards on business combinations. Therefore, the JWG has excluded such contracts from this Draft Standard.

Licence Fees, Royalties and Similar Items

2.33 An enterprise might enter into a contract to receive or pay royalties or similar fees based on the future use of, or right to use, non-financial items. For example, an author might enter into a contract with a publisher whereby the author gives the publisher the right to sell books in exchange for a fixed royalty for each book that the publisher sells. Such a contract has value to the author, and a third party might be expected to pay a significant amount to assume that contract from the author. At the reporting date there is clearly a financial instrument related to any amounts payable or receivable relating to past sales of books. The publisher has a contractual obligation to pay royalties to the author, and the author has a contractual right to receive royalties in exchange for no consideration other than to release the publisher from the obligation. Differences of opinion exist, however, about the nature of the contract relating to future sales.

2.34 Some view the right to sell books as an option written by the author and held by the publisher. This option contract gives the publisher the right to demand permission to sell a book (a call option on the rights to sell the books). They view the contract as imposing an obligation on the publisher to pay for the right when the publisher "calls" that option in the future. Viewed in this way, the contract is not a financial instrument—it is an option to acquire a right to sell books (a non-financial right) in exchange for a financial instrument. The promise to pay, when it arises in the future, would be a separate financial instrument.

2.35 Others view the exchange of rights contemplated by the contract as having occurred when the contract was signed. In accordance with this view, the author delivered to the publisher rights to sell books. In exchange, the publisher delivered a promise to make future payments. Viewed in this way a royalty contract is a promise to pay a determinable (but not yet fixed) amount. The payment is for the past exchange of rights, but the amount depends on the number of books sold. In accordance with this view, the royalty is a financial instrument, which is a liability of the publisher and an asset of the author.

2.36 Given the above difference of views as to whether royalties may, or may not, be financial instruments, paragraph 1(g) of this Draft Standard avoids uncertainty by specifically excluding contractual rights and contractual obligations that are contingent on the future use of, or right to use, a non-financial item.

Additional Items Included in Scope

2.37 Some believe that only items that meet the definition of a financial instrument should be included in the scope of this Draft Standard. They believe that this definition is sufficient to define the scope of the Draft Standard and that standard setters should separately consider accounting for non-financial items that do not meet the definition of a financial instrument. Standard setters might determine that certain non-financial items should be accounted for on a similar basis as are financial instruments, but, in their view, such considerations are outside the terms of reference of the JWG. As a result, they would not extend the scope of the Draft Standard to include contracts to buy or sell non-financial items that do not explicitly permit either party to settle net by a financial instrument, servicing assets and liabilities, or hybrid contracts that are not separated into their financial and non-financial elements, because they are not financial instruments.

2.38 The JWG disagrees with this view. The JWG has concluded that, for the Draft Standard to be most relevant, its scope should include certain non-financial items that are so similar to financial instruments in their contractual risk bases, settlement conditions and use that they are usefully accounted for on the same basis as financial instruments. The JWG's evaluation and basis for conclusions about such non-financial items is set out in the balance of this section (paragraphs 2.39-2.70).

Certain Contracts to Buy or Sell a Non-financial Item

2.39 Some contracts to buy or sell a non-financial item (such as a commodity) may be settled net by a financial instrument. That could be because the terms of the contract explicitly permit, or implicitly allow, settlement in that way, or because there is an established market mechanism, or side agreement, outside the contract that facilitates settlement net by a financial instrument, or because the non-financial item that is the subject of the contract has interchangeable (fungible) units that are exactly the same as those for which an active market exists, in which offsetting contracts might be obtained. Although such contracts are not financial instruments, the distinction between such contracts and financial instruments for which the net settlement amount is indexed to an underlying price seems to have little economic significance. For example, in commodity forward markets in which few participants hold commodity contracts to maturity and actively take or make delivery of the physical commodity, the contractual rights and obligations in the commodity contracts are effectively the same as those of a financial instrument. Indeed, such contracts can be used interchangeably with other financial instruments. In addition, if such contracts were not accounted for in the same manner as financial instruments, it would be possible to circumvent the requirements of the Draft Standard by including non-substantive delivery provisions in a contract that otherwise would be considered a financial instrument. The JWG, therefore, believes that it is necessary to extend the scope of the Draft Standard to include such contracts.

2.40 Although many contracts to buy or sell a non-financial item are settled net by a financial instrument, many others are entered into for delivery of the non-financial item. The JWG's objective is not to prescribe accounting principles for inventory or capital expenditures, both of which are outside the scope of the JWG's project. The JWG, therefore, proposes not to include within the scope of the Draft Standard, contracts entered into, and continuing to be, for the purpose of delivery of a non-financial item in accordance with the enterprise's normal purchase and sale activities.

2.41 The JWG is concerned that there be clear criteria for making this determination, so that an enterprise does not have an open choice whether particular commodity contracts that can be settled net by a financial instrument will be accounted for as financial instruments or non-financial items. The JWG believes that, in most cases, contracts that are for the purpose of delivery of a non-financial item under an enterprise's normal purchase and sale activities would be evident from established policies that can be seen to be consistent with the nature of its particular activities under current economic conditions. Paragraph 206 of the Application Supplement would require that an enterprise be able to justify its conclusions in terms of its established policy and operating activities.

2.42 A particular issue arises where a series of sequential contracts that can be settled net are entered into with the purpose of ultimate acquisition or sale of a non-financial item in accordance with the enterprise's normal operating activities. Sub-paragraph 205(a) of the Application Supplement explicitly addresses this issue, concluding that all contracts in the series, except for the final purchase or sales contract for delivery, should be treated as financial instruments. There is no obligation for delivery in the earlier contracts in the series.

2.43 Some argue that all commodity contracts should be included within the scope of the Draft Standard, regardless of whether the enterprise has the ability to settle net with a financial instrument. They believe that contracts to buy or sell commodities have characteristics that are very similar to financial instruments and that, even if the contract does not permit settlement net, offsetting contracts can be entered into to mitigate the risks of changes in commodity prices in the same way that financial risks can be managed. However, to include all commodity contracts within the scope of the Draft Standard would require reconsideration of inventory accounting, which the JWG considers to be beyond the scope of its project.

Servicing Assets and Servicing Liabilities

2.44 Rights to service financial assets (servicing rights) are not financial instruments, since they do not give rise to an obligation to deliver or exchange financial instruments—the servicing enterprise provides a service, not a financial asset or financial liability. Nevertheless, servicing rights and obligations are inherent in many financial instruments and, before their separation from the financial instrument, are accounted for as part of the value of those financial instruments. The Draft Standard would continue to account for servicing rights that have not been separated as part of the value of the financial instrument.

2.45 In the United States and some other countries, markets have developed for the sale or assumption of servicing rights separately from the related financial asset being serviced. As a result, it has become clear that (a) rights to servicing have a value at the time of derecognition of underlying financial instruments and (b) that value can be recognised separately on the sale of the financial assets. As international financial markets develop, this practice is expected to become more widespread.

2.46 The JWG believes that servicing assets and liabilities that are separated from financial instruments should be accounted for at fair value, as they are when included as part of a financial instrument. Recognising such servicing assets or servicing liabilities, whether acquired through purchase transactions or origination activities, is consistent with the notion that servicing assets and servicing liabilities developed through origination activities are no different from those purchased and should be accounted for in the same way. Furthermore, recognising such servicing assets and servicing liabilities and measuring them at fair value avoids misstating net servicing income after the assets being serviced are derecognised. Accordingly, the JWG proposes to include within the scope of the Draft Standard all separated servicing assets and servicing liabilities.

2.47 While the JWG believes that both servicing and the interest-only strip (or other retained interest in the transferred asset) that often accompanies servicing should be accounted for at fair value, it does not believe that the Draft Standard should require that those two items always be presented together. In some instances, there might be valid reasons for presenting those items separately. The two items, while related, are not both dependent on the servicing enterprise remaining as servicer. As a result, the JWG concluded that while both should be measured in the same manner, a servicing asset *need not* be presented together with the interest-only strip.

Hybrid Contracts

2.48 A single contract might contain financial and non-financial rights or obligations, or include some financial instruments that are within the scope of this Draft Standard and some that are not. In these cases, special rules are necessary to determine how such contracts should be accounted for. The JWG considered a number of alternative approaches to this issue.

2.49 One alternative considered was based on identifying the predominant characteristics in a contract and accounting for the entire contract based on those characteristics. However, the JWG believes that such an approach is likely to have a number of drawbacks.

(a) It can be difficult to determine which characteristics predominate, particularly if the balance is relatively even.

(b) Whichever characteristics are determined to predominate, the less dominant characteristics may be accounted for on a basis that is not consistent with their nature, even if they are significant.

(c) The basis for accounting for such a contract could change significantly at the point when the less significant terms and conditions become the dominant ones.

(d) Such an approach can result in different accounting depending upon whether all of the terms and conditions are included in a single contract, with either financial or non-financial characteristics predominant, or whether the financial terms are included in a separate contract from the non-financial terms.

(e) Such accounting is inconsistent with financial risk management approaches under which financial risks and benefits are managed by type, rather than by contracts.

The JWG also notes that measurement and recognition approaches based on predominant characteristics of assets and liabilities have proved problematic in other areas of accounting, such as lease accounting.

2.50 Another alternative considered was to require that a contract for which the sets of rights and obligations are clearly and closely related be accounted for in its entirety as a non-financial contract. This would be similar to the accounting required by IAS 39, Financial Instruments: Recognition and Measurement, and FASB Statement 133, Accounting for Derivative Instruments and Hedging Activities, when a derivative contract is embedded in a non-derivative host contract and is clearly and closely related to that host contract. In such circumstances those standards require that the entire contract be accounted for in accordance with the accounting for the host contract. This approach, however, has the significant drawback that it would result in financial instruments incorporated in such contracts not being measured at fair value, however small or insignificant the set of rights and obligations making up the non-financial items. Furthermore, it is difficult to determine when sets of rights and obligations are considered to be clearly and closely related to one another. The JWG, therefore, rejected this alternative.

2.51 The JWG concluded that a better approach would be to require that sets of rights and obligations that, if they were separated from the contract, would be accounted for as financial instruments in accordance with the Draft Standard be accounted for as such, and that sets of rights and obligations that do not fall within the scope of the Draft Standard be excluded. This approach ensures that a financial instrument falling within the scope of the Draft Standard is accounted for in the same way, regardless of whether it is a stand-alone instrument or is combined with non-financial or excluded items in a single contract. It also overcomes many of the difficulties of the alternative approaches considered in paragraphs 2.49 and 2.50. At the same time, this requirement will limit the circumstances in which non-financial items that are generally measured on another basis are measured at fair value. By focusing on sets of rights and obligations, this approach is consistent with the risk management practices of many financial market participants that focus on managing those sets of rights and obligations within a contract that are subject to a common financial risk.

2.52 In a few instances, a hybrid contract might contain sets of rights and obligations that would be accounted for at fair value in accordance with this Draft Standard as well as sets of rights and obligations that would be accounted for at fair value in accordance with other accounting standards. In such circumstances the JWG believes that an enterprise should not separately account for the sets of rights and obligations in the hybrid contract. If an enterprise were permitted to choose whether to measure these sets of rights and obligations separately, or to measure them as a single contract, possible measurement inconsistencies might arise. Accordingly, the JWG decided that in such circumstances, the entire contract should be accounted for in accordance with the Draft Standard, including requirements for recognition and derecognition, balance sheet and income statement presentation and disclosure. Some believe that the possible measurement inconsistencies that could arise are not likely to be significant. They would not require non-financial rights and obligations arising from a hybrid contract that it is feasible to account for separately from the financial rights and obligations to be included within the Draft Standard.

Other Scope Considerations

2.53 The JWG also considered a number of other questions relating to the scope of this Draft Standard. The main matters considered are addressed in this section.

Leases

2.54 In accordance with the view taken in existing accounting standards for leases, a lease contract is not a financial instrument. It does not meet part (c) of the definition, since the lessor is required to deliver additional consideration other than release from the obligation—the right to continued use of the asset. It does not meet part (d) of the definition, since one party (the lessor) provides the right to use a non-financial asset—not a financial instrument. Neither is it cash or an equity instrument (parts (a) and (b) of the definition). However, a lease contract might contain sets of rights and obligations that if separated from the contract would be a free-standing financial instrument. In order to ensure that financial instruments included within these lease contracts are accounted for in accordance with the Draft Standard, those sets of rights and obligations would be accounted for in accordance with the Draft Standard requirements for hybrid contracts.

2.55 Accounting standards typically distinguish finance (or capital) leases from other leases (operating leases). In finance leases, substantially all the risks and rewards incident to ownership of the leased asset are transferred to the lessee. Finance leases are accounted for by recognising the leased assets and a liability to the lessor in the balance sheet of the lessee. The lessor recognises a receivable and derecognises the leased assets. Commitments under operating leases are not recognised under existing lease accounting standards.

2.56 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 each meet the definition of a financial instrument and, therefore, fall within the scope of this Draft Standard. Because substantially all the risks and rewards incident to ownership of the leased asset have been transferred to the lessee, there is not considered to be any additional consideration to be provided by the lessor other than to release the lessee from the obligation as the lessee makes payments in accordance with the terms of the lease contract.

2.57 This Draft Standard does not reconsider the fundamental bases for recognition and measurement of finance leases. Lease accounting, addressed in separate accounting standards in most jurisdictions, is based on a complex set of rules that has developed over a long period of time. Some advocate that all leases should be accounted for similar to finance leases and some go on to suggest that the lessor's asset and lessee's liability be measured at fair value both on initial recognition and subsequently.[13] However, this is not the practice in accounting today. The JWG believes a fundamental reconsideration of those rules to be beyond the scope of this project.

Commitments to Buy or Sell a Non-financial Item at a Fixed Price in a Foreign Currency

2.58 The JWG considered whether a firm commitment to buy or sell a non-financial item at a fixed price in a foreign currency should be considered to represent a foreign currency risk exposure that should be recognised at current exchange rates, with gains or losses recognised in the income statement when exchange rates change. The JWG understands that many enterprises acquire financial instruments (for example, forward exchange contracts or options) as hedges of the foreign currency risks in such commitments. If financial instruments are measured at fair value, then accounting for these commitments as current foreign exchange risk exposures would result in gains or losses arising from changes in exchange rates on these commitments being recognised in the income statement in the same periods as offsetting losses or gains are recognised on the hedging instruments. This would not be the case if these commitments are treated as non-financial commitments that are not recognised until the non-financial item is actually acquired or sold, unless hedge accounting permits adjustment to the non-financial item.

2.59 The JWG concluded that these commitments taken as a whole do not have the essential characteristics of financial instruments (since they are contracts to exchange financial instruments for non-financial items).[14] Reconsideration of accounting for non-financial items is beyond the scope of a standard on financial instruments, and a requirement to recognise and measure non-financial commitments at fair value would constitute a major change in generally accepted cost-based accounting principles for non-financial items.

[13] See, for example, G4+1 Position Paper: Leases: Implementation of a New Approach, February 2000.

[14] The Draft Standard would require that contracts to buy or sell non-financial items be accounted for as financial instruments only if they meet the conditions for settlement net by financial instruments and are not for the purpose of delivery of the non-financial items in accordance with the enterprise's normal purchase or sale requirements.

2.60 As an alternative, the JWG considered the possibility of separating out the foreign currency risk element of such a commitment and treating it as if it were a separate forward exchange contract. The element of the commitment that would be left would then be treated as a non-financial commitment at a fixed domestic currency price determined by the forward exchange rate at the date the commitment was entered into. In other words, a commitment to buy or sell a non-financial item at a fixed price in a foreign currency would be treated as if it were a hybrid contract with two elements—a forward exchange contract (which would be treated as a financial instrument to be measured at fair value with gains and losses recognised immediately in the income statement), and a fixed price non-financial commitment in the domestic currency (which would be accounted for as such, and therefore would not be within the scope of this Draft Standard).

2.61 Some believe that this accounting would have the following significant benefits. It would result in the same recognition and fair value accounting for the foreign currency forward element of the commitment as for any financial instrument used to hedge the foreign currency risk. It would also remove the possibility that an enterprise could embed a foreign currency exposure in a non-financial commitment, in order to avoid recognising it as a financial instrument, and thus avoid accounting for it on a fair value basis.

2.62 However, the JWG decided that the Draft Standard should not allow enterprises to account separately for the foreign currency risk element in such a commitment for the following reasons:

(a) The foreign currency forward element as defined cannot be relied upon to reflect the foreign currency risk that is inherent in the commitment as a whole if there is the possibility of any correlation between changes in the domestic currency price for the non-financial item and changes in the foreign exchange rate. To the extent that the price in the domestic currency of the non-financial item that is the subject of the commitment changes with changes in the foreign currency exchange rate, the commitment as a whole could have little or no foreign currency risk exposure. The JWG does not believe that a practical basis could be determined at this time to effectively distinguish domestic currency prices of non-financial items that are significantly correlated with particular foreign currency exchange rates, and the extent of such correlation.

(b) A commitment to buy or sell a non-financial item at a price fixed in a foreign currency is not directly analogous to a hybrid contract. A hybrid contract is a contract that has one or more sets of rights or obligations that, if they were separated from the contract, would be accounted for as a financial instrument, and one or more sets of rights or obligations that do not fall within the scope of the Draft Standard. A fixed price foreign currency-denominated commitment to buy or sell a non-financial item consists of only one set of rights and obligations—the right and obligation to exchange a non-financial item for a fixed amount of a foreign currency. The separation of this commitment into a foreign currency forward and domestic currency commitment is artificial.

(c) Some believe that this accounting results in a form of "basis adjustment" of the amount recorded for the non-financial item on its acquisition or sale because the amount to be recorded will not be the actual amount paid or received for it on that date. Indeed, it results in adjusting the recorded amount of the non-financial asset away from fair value.

(d) Some believe that if such accounting were to be required for the foreign currency element of a commitment to buy or sell a non-financial item, then it should also be required for other financial risks in non-financial commitments.

Financial Instruments Held for "Strategic" Purposes

2.63 Sometimes, an enterprise makes what it views as a "strategic" investment in either traded or non-traded equity instruments issued by another enterprise, with the predominant intention of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made. For example, an investment of this kind might be necessary to obtain expected operating benefits in excess of the benefits resulting from holding an equity instrument, either directly from the other enterprise or as a result of the operating relationship. Such relationships include mutual shareholdings or "keiretsu" (historically prevalent in Japan) and co-operative agreements whereby enterprises benefit from synergies such as joint marketing or bulk purchasing arrangements.

2.64 Some suggest that such investments are of a different nature from other financial instruments and that, therefore, a different measurement basis should apply or that changes in fair value should be presented in a different manner. They argue that the purpose of such investments is broader than the generation of economic benefits from rights to residual interests in the net assets of an enterprise, because other non-financial benefits are also associated with the investment. For example, there might be additional economic benefits arising from purchasing, manufacturing, selling, or research and development activities of the investee.

2.65 The JWG believes that an equity instrument that contains no other rights should be accounted for as an equity instrument in accordance with the Draft Standard, regardless of the intent. An equity instrument is a financial instrument with the same rights and financial risk exposures regardless of the purpose for which it is held. Equity instruments that convey significant influence, control, or a joint venture interest are excluded from the scope of this Draft Standard.

2.66 Some believe that a contract that contains some non-financial rights in addition to being an equity instrument should be subject to different accounting. However, such contracts are hybrid contracts. Therefore, the portion that is a financial instrument falling within the scope of this Draft Standard would be recognised and measured in accordance with the principles in this Draft Standard (for example, a traded equity investment would be measured at its market value). However, any non-financial portion, or portion falling outside the scope of this Draft Standard (for example, a premium paid for access to additional non-contractual benefits, such as those arising from research and development or marketing synergies) would be separated, if material, and accounted for in accordance with principles for such items. The objective is to achieve the same accounting result whether contractual rights to benefit from "strategic" synergies are embedded in a financial instrument or are contracted for separately.

Indirect Investment in Non-financial Assets

2.67 The Draft Standard would require all equity investments in other enterprises that are not interests in subsidiaries, associates or joint ventures to be accounted for in accordance with the Draft Standard. Some believe that this can result in an inconsistency in accounting for equity investments in research and development activities. Generally, research costs are charged as an expense of the period in which they are incurred. However, by measuring an equity investment in an enterprise that undertakes such research at fair value it might appear that such costs are effectively being capitalised. The JWG believes that fair value accounting for such investments is appropriate unless they represent a position of control or significant influence (in which case they are accounted for in accordance with other standards). When the investing enterprise has no direct ability to benefit from the research other than by selling or holding the investment, its asset is no different from any other equity instrument.

Taxes, Legal Fees, Fines, etc.

2.68 Some believe there to be little if any difference in substance between a liability to pay cash that is required as a result of a contractual obligation and one that is required by broader legislated requirements (i.e., by the macro "contracts" between government authorities and society). Such liabilities or assets may expose an enterprise to one or more financial risks (for example, interest rate or foreign currency risks) in some circumstances. However, the JWG believes that accounting for such items requires consideration of recognition and measurement issues that are dealt with in separate standards[15] and should not be dealt with in this Draft Standard.

2.69 Payments that have been reduced to a fixed payment schedule continue to involve a government authority as one party to the agreement. There is no exchange of consideration to establish a contract at any time and, therefore, the JWG believes that such payments also fall outside the scope of this Draft Standard.

[15] The IASC requires income taxes to be accounted for in accordance with IAS 12, Income Taxes.

Related Party Transactions/Inter-company Balances

2.70 Some argue that financial instruments issued and held by related parties, and inter-company balances, should be excluded from the scope of the Draft Standard because:

(a) they are not subject to arm's-length valuation and the related parties could change the terms at any time; and

(b) the contractual rights and obligations of inter-company balances and loans might not be fully specified and, in some cases, might be more in the nature of equity instruments or capital than receivables or payables.

However, the JWG believes that, despite the valuation difficulties that might arise, a financial instrument, not appropriately classified as equity of the reporting enterprise, arising from a related party transaction should be valued on the basis of its contractual rights and obligations like any other financial instrument.

3. Recognition and Derecognition

Approaches to Recognition and Derecognition That Could be Adopted

Implications of the Framework for Recognition and Derecognition

3.1 Conceptual frameworks for financial accounting generally require that, to be recognised as an asset (or liability), an item needs to meet three criteria[16]:

(a) it should be probable that any future economic benefit associated with the item will flow to (or from) the enterprise;

(b) the item should have a cost or value that can be measured with reliability; and

(c) the item should meet the definition of an asset (or liability).

Probable that Any Future Economic Benefit Associated with the Item Will Flow to (or from) the Enterprise

3.2 In accounting, the probability that an economic benefit will flow to (or from) the reporting enterprise has traditionally been considered to be a factor in determining whether an asset (or a liability) should be recognised. The recognition process seems to use the notion in two rather different ways.

(a) Sometimes probability has been used to establish a recognition hurdle based on the likelihood of there being a future flow of economic benefits. The belief seems to have been that an asset or liability should not be recognised if there is only a low probability that conditions will occur that will result in a future inflow or outflow of economic benefits. However, the Draft Standard is reasoned from a premise that is well recognised and accepted in finance theory and in capital markets pricing practices. This premise is that the likelihood of there being a future flow of economic benefits arising from the financial instrument, and the probable amount of those future inflows or outflows, is a matter entering into the measurement of its fair value, not a matter affecting whether it should be recognised.

(b) Sometimes probability has been used to determine whether, if there is to be a future flow of economic benefits associated with an item, it is likely that those benefits will flow to or from the enterprise. However, that is not an issue in the case of financial instruments because the contract establishing a financial instrument determines that any economic benefits that result from the instrument will flow to or from the enterprise.

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16 See, for example, paragraphs 83, 80 and 91 of the IASC Framework.

The Item Should have a Cost or Value that Can be Measured with Reliability

3.3 Issues that relate to the reliability of the measures that the Draft Standard would require be used for financial instruments are discussed in detail in paragraphs 1.14-1.21 and 4.64-4.67. However to summarise, the JWG believes that it will be possible to measure all financial assets and all financial liabilities with sufficient reliability for them to be recognised.[17]

The Item Should Meet the Definition of an Asset (or Liability)

3.4 Therefore the factor that determines whether, and when, a financial asset or financial liability should be recognised is whether the item involved has the essential conditions of an asset or liability. For that reason, the recognition and derecognition principles proposed by the JWG focus on the definitions of assets and liabilities.

3.5 The IASC Framework defines "assets" and "liabilities" in the following terms:

> <u>An asset</u> is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
>
> <u>A liability</u> is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

In the case of a financial asset, it is the contractual right that gives rise to the resource (i.e., the expected future inflow of economic benefits) and an enterprise's control over that resource is usually[18] specified by the contract. When control is specified by the contract, the past event will be when the enterprise becomes a party to the underlying contract, because it is that event that establishes the rights that make up the asset. Similarly, in the case of a financial liability, the expected outflow is defined by the contract, and the past event is becoming a party to a contract that allows the enterprise little, if any, discretion to avoid the outflow of resources it specifies.

3.6 An enterprise therefore usually controls the rights to economic benefits or is obligated to deliver benefits to another party from the time that it becomes a party to the contractual rights or subject to the contractual obligations that make up the instrument. That is the point at which it *has* the contractual rights or contractual obligations, and that is the time at which the essential conditions of being an "asset" or a "liability" are met.

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[17] Although the JWG believes it is possible to reliably measure all financial instruments, it accepts that it might not always be practicable to make a reliable estimate of the fair value of certain private equity investments (as explained more fully in paragraphs 1.14-1.21 and 4.64-4.67).

[18] Paragraphs 3.51-3.63 explain that a transferor's continuing involvement in contractual rights it has transferred to another enterprise could mean that it continues to have the benefits of those rights even though it is no longer a party to the contract that gives rise to the rights.

3.7 Thus, where relatively simple financial instruments are involved and the potential recognition or derecognition event is a relatively straightforward transaction, an enterprise wishing to determine whether to recognise a financial instrument need only ask whether it has an asset (or liability). Similarly, when considering whether to cease recognising (i.e., derecognise) a financial asset (or liability), all it needs to ask is whether it still has that asset (or liability).

3.8 However, many financial assets comprise components—i.e., bundles of contractual rights (and sometimes also contractual obligations) that are financial assets (and perhaps also financial liabilities) in their own right. Also, many potential recognition/derecognition events involve unbundling financial assets into their components, transferring some of the components to one or more other parties, and rebundling the other components either with themselves or with other contractual rights and obligations. In such circumstances, some rather more difficult recognition and derecognition issues arise. It is not only in the context of financial assets that complex recognition and derecognition issues can arise. For example, practices such as in-substance defeasance have raised issues about when a liability should be derecognised.

FRS 5, FASB Statement 140 and IAS 39

3.9 The complex recognition and derecognition issues that arise in the context of financial instruments have been studied by a number of standard setters over the years, and a number of accounting standards and other authoritative statements have been issued on the subject. The two main accounting standards on the subject are the United Kingdom's FRS 5, Reporting the Substance of Transactions, (effective 1994), and the United States' FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement 125, which was effective from 1997). Important new standards on the subject have more recently been issued by the IASC and by Japan's Business Accounting Deliberation Council (BADC).[19]

3.10 The approaches adopted in these standards and other pronouncements are not the same and, as a result, there are significant differences in the accounting treatment they prescribe. In developing its proposals on recognition and derecognition, the JWG has, therefore, sought to develop an approach that can be adopted in all jurisdictions.

3.11 The JWG's first thought was to try to develop a common approach by either reconciling the approaches adopted in the two standards that were at that time in issue (FRS 5 and FASB Statement 125) or extracting common principles from those standards that could

[19] IAS 39, Financial Instruments: Recognition and Measurement, (effective from January 2001) and, BADC, Accounting Standards for Financial Instruments, (effective from April 2000). Other authoritative statements that have been issued include CICA Emerging Issues Committee, EIC-9, Transfers of Receivables, November 1989.

form the basis of a harmonised approach. However, the JWG found this impossible and eventually had to conclude that the two approaches are mutually incompatible.

3.12 The JWG also considered adopting either the FRS 5 approach or the FASB Statement 125 approach in its entirety. However, although both clearly have many strengths and are well-established in their own jurisdictions, the JWG does not believe that either approach would always provide the best framework through which to analyse accounting issues arising on current transactions in all jurisdictions. It also has doubts as to both approaches' ability to address appropriately the transactions that may develop in the future. Finally, the JWG believes that its fair value measurement proposals make demands of the recognition and derecognition criteria that neither approach can meet.

3.13 IAS 39 was issued during the early stages of the JWG's work, giving the JWG the opportunity to consider basing its proposals on the approach adopted in that standard. However, the JWG has a number of concerns about that approach and is not convinced that it is sufficiently coherent to provide the basis for a common approach to the subject.[20]

3.14 The JWG therefore concluded that its best hope of achieving convergence was to develop a new approach rather than simply to adopt one of the existing approaches or to try to refine those approaches in some way.

An All-or-nothing Approach or a Components Approach?

3.15 All approaches to the recognition and derecognition of financial instruments fall into one of two broad categories: all-or-nothing approaches and components approaches.

(a) All-or-nothing approaches look at potential derecognition events and ask whether circumstances are such that the whole of the previously recognised asset should be derecognised or the whole of the asset should continue to be recognised. Different all-or-nothing approaches assess the circumstances involved in different ways. For example, some ask which enterprise has all, or substantially all, the risks and rewards arising from the asset, while others try to determine which enterprise has overall control of the asset. However, the principle is the same: each financial instrument is treated as an indivisible unit.[21]

[20] The JWG's attempt to extract common principles from FRS 5 and FASB Statement 125 provided some of the source material for IAS 39's principles on recognition and derecognition material.

[21] FRS 5 mostly adopts an all-or-nothing approach, although it modifies that approach for certain "special cases" for which it requires accounting that is similar in many respects to a components approach.

(b) Components approaches treat financial instruments as divisible units (or components) and ask, in respect of each component, whether circumstances are such that that component should be derecognised or whether it should continue to be recognised.[22]

3.16 The JWG has chosen to adopt a components approach to the recognition and derecognition of financial instruments. It has adopted this approach because it believes that, for financial instruments, components approaches best reflect the economics of the market place and best meet the demands of the fair value measurement system—both of which are, in the JWG's view, prerequisites of any framework that is to be successful in analysing the recognition and derecognition issues that arise on current transactions and that could arise on transactions that may develop in the future around the world. The JWG also believes that, contrary to the views that some have expressed about components approaches, such approaches *are* capable of being implemented and they *do* result in accounting information that can be understood by users.

Reflecting the Economics of the Market Place

3.17 As already mentioned, most financial instruments comprise bundles of contractual rights and/or contractual obligations, and transactions are taking place all the time that unbundle those rights and obligations and rebundle them in different ways. The JWG believes that if financial statements are to give a faithful representation of transactions and events, the recognition and derecognition approach adopted needs to reflect this unbundling and rebundling fully.

3.18 That seems to suggest that the approach should focus on component contractual rights and obligations, rather than on the entire assets and liabilities in which they were originally contained, and that the approach should be that if an enterprise ceases to have a contractual right that was previously part of an asset it was recognising, it should derecognise that right and continue to recognise the rest of the asset. Such an approach would be consistent with the way participants in financial markets look at financial assets and manage risk components.

3.19 Assessed against this benchmark, all-or-nothing approaches, by treating the financial instrument as an indivisible unit, seem to provide a rather simplistic and incomplete representation of many modern-day transactions. Components approaches, on the other hand, measure up well.

[22] FASB Statement 140 mostly adopts a components approach, although some aspects of its approach can be characterised as nearer to an "all-or-nothing" approach. A components approach was also proposed by the IASC/CICA Steering Committee on Financial Instruments, in its Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997.

The Demands of the Fair Value Measurement System

3.20 The Draft Standard would require that financial instruments should be measured in the financial statements at fair value. The fair value of a financial instrument reflects the value of the contracted cash flows embodied in the instrument so, to measure the fair value of an instrument properly, it is necessary that all the contractual rights and contractual obligations that the reporting enterprise has are taken into account and that contractual rights and obligations that the reporting enterprise no longer has are ignored. Components approaches clearly do that. All-or-nothing approaches, on the other hand, seem to do it rather less well. For example, under an all-or-nothing approach an enterprise will sometimes continue to recognise and measure, as part of a "larger" asset, some contractual rights that it no longer has. This is because it continues to have overall control of the larger asset or still has substantially all the risks and rewards arising from that larger asset. Unbundling and rebundling of financial assets is often designed to unlock value and enhance value. In such cases, it is wrong to measure the original asset or liability at fair value as if nothing has happened.

Capable of Implementation

3.21 The implementation issue most often raised by critics of components approaches concerns measurement—if the approach results in the recognition of new and unusual assets and liabilities, will they not present new and unusual measurement issues that will not necessarily be capable of being resolved? The JWG does not believe that the measurement difficulties created by components approaches are as significant as is sometimes made out. First, there will not be many "new and unusual" assets and liabilities recognised. The vast majority of the unbundled components recognised will be similar in nature to assets and liabilities that are already being recognised. Second, as components approaches reflect the economics of the market, those involved in carrying out the transactions will usually have had to determine the fair value of all the components in order to ensure that the transaction is correctly priced and all its implications fully understood. That means that the valuation methodology and sources of information needed will generally have been established at the outset, thereby significantly reducing the likelihood of later measurement difficulties. As a result, the JWG has concluded that there is no reason why such items will be any more difficult to measure at fair value than other financial instruments.

3.22 The main implementation issue concerning all-or-nothing approaches relates to the "risks and rewards" tests on which such approaches are usually based, particularly the notion of "substantially all the risks and rewards" that is at the heart of some approaches. This notion has been criticised by some as being difficult to apply. The issues that are seen as operationally difficult include:

(a) determining whether each identified risk and reward should be substantially surrendered to allow derecognition;

(b) determining whether all risks should be aggregated separately from all rewards or whether risks and rewards should be offset and then combined for evaluation; and

(c) interpreting what *substantially all* means in the evaluation of those risks and rewards.

Some standard setters have reached the conclusion that such difficulties introduce an unacceptable degree of uncertainty into the recognition process.

3.23 In consequence, although accepting that the "substantially all the risks and rewards" approach may have a role to play in the analysis of complex or linked transactions, the JWG prefers to take a components approach as its starting point for the recognition and derecognition of financial instruments.

Result in Accounting Information that Can Be Understood by Users

3.24 Regardless of the conceptual merits of components approaches, it is also important that they provide information that users can understand. Some think that components approaches do not provide understandable information. They argue that components approaches have the effect of decreasing the number of familiar, traditional assets and liabilities that are recognised in the balance sheet and increasing the number of unfamiliar rights and obligations recognised. As a result, balance sheets would become unfamiliar and more difficult for users to understand. The JWG considers such criticism to be misconceived: it is the financial markets, and the financial engineers, that are unbundling traditional assets and liabilities through complex transactions; components approaches are simply trying to faithfully represent such transactions in the financial statements. Complex transactions that have non-traditional effects can result in recognition of complex and non-traditional assets and liabilities.

3.25 Similarly, critics of components approaches claim that, although users understand the benefits and risks inherent in "traditional" financial assets and liabilities, they would not know what to make of the "new" financial assets and liabilities that would result from the adoption of a components approach. The JWG does not accept this argument for two main reasons. First, although it might once have been possible for users to make assumptions about the benefits and risks inherent in assets and liabilities shown under the various balance sheet captions, that has not been the case for some time now because of the increased complexity of transactions over the last few decades. For example, balance sheets already show assets that have a "density" of risk far greater than "traditional" assets. That is one of the reasons why there has been an increased demand for comprehensive risk disclosures and more precise balance sheet descriptions; such disclosures serve to alert users to the unusual benefits and/or risks inherent in particular balance sheet items. Second, as already mentioned, the JWG believes that the extent to which the unbundled components will be novel forms of asset and liability is exaggerated. Most of the components recognised will be similar in nature to assets and liabilities that enterprises are already recognising.

Derecognition

3.26 As already explained, the essence of the components approach is that it treats each financial asset and each financial liability as a divisible unit (or component) comprising "smaller" financial assets and financial liabilities. It asks, in respect of each component, whether that component should be derecognised or should continue to be recognised. Therefore, because the factor that determines whether a component should be derecognised is whether it ceases to be an asset (or liability) of the reporting enterprise, paragraph 37 of the Draft Standard asks, in respect of each component, whether the essential conditions of being an asset or a liability continue to be met—i.e., does the enterprise still have the contractual rights (or contractual obligations)?

3.27 There are three types of event that result in an enterprise no longer being entitled to the contractual rights, or no longer being subject to the contractual obligations, that make up a financial instrument or component thereof:

(a) the expiry of the contractual right or contractual obligation involved;

(b) the fulfilment of the contractual right or obligation; or

(c) the transfer and relinquishment to another party of a contractual right.

3.28 Most of these events are quite straightforward and non-controversial. Few would question that a financial instrument should be derecognised when it is extinguished, in the normal course, by payment of the entire amount due, thereby discharging the debtor from any further obligation under the contract. Similarly, few issues arise when a right or obligation from a financial option is extinguished as a result of the contractual term expiring without the holder requiring the writer to deliver or purchase the underlying financial instrument.

3.29 There has been some debate in the past about the circumstances in which an enterprise should be considered to have fulfilled an obligation. The JWG believes that the only circumstance in which an enterprise has fulfilled a contractual obligation is when it has been released from primary responsibility for that obligation. That might be achieved through settlement, by accommodation with the creditor or by process of law. It will not, however, be achieved by the practice known as "in-substance defeasance" of debt[23] because, in those circumstances, the debtor is not released from the primary obligation under the debt agreement. If the assets in the trust prove to be insufficient, for example,

[23] Under this practice, the debtor transfers essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets, which are used to meet obligations to the creditor, closely approximate the scheduled interest and principal payments of the liability.

because default by the debtor accelerates its debt repayment, the debtor must make up the difference. The rights of the creditor, who may not know of the defeasance arrangements, are not limited to the cash flows from the assets in the trust.

3.30 Some transfers involving financial assets can give rise both to derecognition issues and consolidation issues. For example, it may be that an enterprise transfers a financial asset in a transfer that has substance to an enterprise that may be part of the transferor's group for financial reporting purposes. In such circumstances, it is necessary first to decide whether the transferor should derecognise the transferred asset and then to decide whether the transferee forms part of the transferor's group. Some believe that the criteria that should be used to address both these issues are the same and that the two issues can therefore be combined. Others believe that, although they are not the same issue (and, as a result, different criteria may be involved), a derecognition framework that addresses the derecognition of financial assets in an individual enterprise's financial statements without also addressing consolidation issues is incomplete. However, the JWG has taken the view that consolidation issues are outside the scope of its project. It has not carried out the analysis necessary to determine whether the same criteria can be used to address both the derecognition issue and the consolidation issue. It has, therefore, made proposals only about the first issue.

Transfers involving Financial Assets

3.31 The most difficult recognition/derecognition issues arise in the context of transfers involving financial assets, particularly where either:

(a) an enterprise has entered into an arrangement that results in cash flows passing from one enterprise to another and it is not clear whether the arrangement has had the effect of transferring a financial asset; or

(b) an enterprise has a continuing involvement in a financial asset it has transferred and, as a result, it is not clear whether it has retained control of that asset.

Arrangements to Pass Cash Flows Through One Enterprise to Another

3.32 As discussed in paragraph 3.5, in essence an asset of an enterprise is a resource that the enterprise controls from which future economic benefits are expected to flow to the enterprise. An item that was an enterprise's asset would therefore cease to be its asset if the future economic benefits that are expected to flow from the item will no longer flow to the enterprise. Paragraphs 41-48 of the Draft Standard focus on this issue.

3.33 The IASC Framework explains:

> The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. (paragraph 53)

The proposals in paragraphs 41-48 are based on the JWG's view that a right to receive a cash flow will not represent a future economic benefit to the holder of that right in certain circumstances in which the holder of that right also has an obligation to pay exactly the amount received to a third party. Instead, the effect of assuming the obligation will be to transfer the flow of future economic benefits from the resource, leaving the enterprise with neither an asset nor a liability. The JWG decided that the "certain circumstances" in question will be when the effect of the contractual right and contractual obligation is that the cash flows required to be passed on to a third party fully reflect all (and only) the cash received.

3.34 The JWG believes that a significant advantage of the proposed approach is that the expectations of future cash in-flows that are controlled by the transferor, and the risks that arise from those expectations, will be correctly stated on the balance sheet and in the note disclosures analysing the balance sheet amounts.

3.35 Some believe that this proposal is wrong and that, despite the back-to-back arrangements, no transfer has taken place. They believe that this view is supported by the fact that, if the original lender became bankrupt, its receiver would treat the transaction as involving two separate transactions. However, as explained in paragraphs 3.78-3.80, the JWG has concluded that it is not necessary for a transfer to be bankruptcy remote for it to have an accounting effect. Others believe the proposal is wrong because there has been no transfer of legal title. However, as explained in paragraphs 3.46 and 3.47, the JWG does not believe that the notion of legal title should be used to determine who has which asset.

3.36 Some have also expressed the view that the proposals in this area are not consistent with the offset rules set out in IAS 32 (paragraph 33)[24]. However, the JWG believes that its proposal and IAS 32's offset rules deal with fundamentally different issues.

(a) IAS 32's offset rules relate to the *presentation* of financial assets and financial liabilities that should be recognised in the financial statements.

(b) The JWG's proposals address a *recognition/derecognition* issue relating to whether the effect of the obligations taken on as a result of a transaction has been that a holder of a contractual right to future cash flows has transferred its right to future economic benefits.

As such, the JWG believes that the notion that there are inconsistencies between its proposals and IAS 32's offset rules has no validity.

[24] IAS 32's offset rules state that a financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

3.37 Having said that, the JWG's proposals in this area have an implication for an aspect of IAS 32's offset rules. Paragraph 36 of IAS 32 deals with three party offsetting arrangements, explaining that:

> In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off.

Some commentators are of the view that three party offsetting arrangements, despite being treated in IAS 32 as a presentation issue, raise issues about which assets and liabilities the enterprise has and should, therefore, not be dealt with in the offset rules. Implementation of the JWG's proposals in this area would enable the three party offset provisions of IAS 32 to be deleted from its offset rules and put into what some would consider to be a more appropriate recognition and derecognition context.

The Difficulties and Issues That Can Arise in Determining Whether to Derecognise a Transferred Asset

3.38 As mentioned in paragraph 3.31, one source of difficult recognition and derecognition issues is transfers that result in the transferor having a continuing involvement in the asset that is the subject of the transfer. The main principles involved are those that underlie all recognition and derecognition decisions. Each party to the transfer should recognise the contractual rights and contractual obligations it has acquired as a result of the transaction and should derecognise those that it no longer has. However, in a transfer that leaves the transferor with a continuing involvement in the asset, it can be difficult to determine precisely which contractual rights and obligations the transferor still has and which have been relinquished.

3.39 A transfer might, for example, involve an enterprise transferring a contractual right to another party while retaining an involvement in the performance of that right. Residual interests (such as retained subordinated interests) and recourse and guarantee obligations are examples of a continuing involvement. Such involvement can mean that:

(a) the transferor has an obligation that could result in it repaying all the consideration received under the transfer. Some argue that, if that is the case, the transfer transaction sounds very similar to a traditional financing transaction; and

(b) the transferee will receive a fixed return from the asset and the transferor will receive the benefit of any surplus over that return and will suffer any shortfall. If that is the case, the effect of the continuing involvement is that the transferor's exposure to the performance of the asset has been unaffected by the transaction. Some argue that such transactions also sound much more like a financing transaction than a traditional sale transaction.

3.40 On the other hand, a transfer may leave the transferor with a continuing involvement that involves it either having the right or being obliged (or both) to take the asset back. Such arrangements are typically achieved through the use of call options, put options or forward contracts. Some argue that a transaction in which, say, an enterprise transfers an asset to another enterprise while at the same time agreeing to take that same asset back at some future date is also more in the nature of a loan (either of the asset or of the transfer consideration) than a sale. This is the case, particularly, if the terms of the transaction effectively give the transferee the equivalent of an interest return on its money for the period it holds the assets.

3.41 If the transferee has been set up specifically to hold the transferred financial assets and, perhaps, is limited in the activities and actions it can undertake, further complications may be created because it might not be clear whether the transaction has any substance. Similar concerns can arise if the transaction can be reversed by one or both parties if one or the other becomes bankrupt. Resolving that issue involves determining whether a transaction that will not be confirmed as a true sale at law for bankruptcy purposes should ever be treated as a sale for accounting purposes.

3.42 In all such cases, although the transferor may appear to have transferred a contractual right, it is not clear that it no longer *has* the right.

Control Is the Key Determining Factor

3.43 Assets are defined in the IASC Framework as resources "*controlled* by the enterprise as a result of past events…" (paragraph 49, emphasis added). The concept of control is, therefore, fundamental to the determination of whether an enterprise has an asset (or component thereof) or whether it no longer has an asset (or component thereof). The JWG believes that it is also at the heart of the derecognition issues raised above and that paragraph 3.42 is, in effect, asking whether the transferor has relinquished or surrendered control of the contractual right that it has transferred. If control has been relinquished, the contractual right involved has been sold and should be derecognised. If control has not been relinquished, the contractual right has been transferred but not sold, so it should continue to be recognised.

3.44 "Control" in this context means, in general terms, the ability to obtain the future economic benefits that arise and the ability to restrict the access of others to those benefits, i.e., the ability to deploy the economic resources involved and the ability to benefit from that deployment.

3.45 In transfers that leave the transferor with no continuing involvement in the transferred contractual right, it is clear that control over the resource that the contractual right represents has been relinquished. However, the existence of a continuing involvement in the transferred right could mean that the transferee's ability to deploy the economic resources involved and to benefit from that deployment is constrained so much that control of the right has not passed.

Determining whether Control Has Been Relinquished

Legal Ownership and Legal Title

3.46 It is sometimes suggested that it ought to be possible to determine whether an enterprise has relinquished control of a resource solely by reference to the notions of legal ownership and legal title. The IASC Framework, however, takes a different view:

> Many assets … are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the enterprise controls the benefits which are expected to flow from the property. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. (paragraph 57)

3.47 The JWG believes the Framework's comments are equally valid for financial assets, even though they are based on *contractual* rights. Although the contractual rights are the resource that represents the asset, and the contract is the source of that resource, the contract itself will not necessarily be the means by which the resource is controlled. Furthermore, with financial assets and financial liabilities it is easy to separate legal title from access to future economic benefits. These points can be illustrated by considering the position of an enterprise that registers its securities investments in a nominee name. In such a situation, legal title and legal ownership of the securities rest with the nominee company, even though the enterprise has beneficial ownership through its contractual relationship with the nominee company or, in some jurisdictions, because trust law applies. As a result, the nominee company has the contractual rights embodied in the financial instrument, but the beneficial owners have the right to direct how those contractual rights are employed, i.e., they control the contractual rights.

A Lack of Detailed Concepts

3.48 Although the JWG has concluded that it is not possible to determine whether an enterprise has relinquished control of an asset by focusing on legal ownership and legal title, it has not been able to identify any other existing concepts and principles that *are* sufficiently developed to represent an overarching derecognition framework that can be used to determine where to draw the distinction between transfers where control has passed and transfers where control has not passed. Most of the conceptual framework documents that have been issued around the world do not make any specific reference to derecognition and those that do refer to it do not deal with the subject in any detail. Furthermore, although much has been written in various documents issued by standard setters about the notion of control, little agreement seems to have been reached on the most difficult issues that arise when there has been a complex transfer involving a financial instrument. Finally, even the accounting standards that are based on a components approach (and those consultative documents that have proposed or recommended the use of a components approach) do not contain an overarching framework that can be used to determine where control lies in any particular case.

3.49 Yet, the JWG knows that it needs to draw a distinction between transfers where control has been passed and transfers where control has been retained if it is to propose the adoption of a components approach. In particular, the distinction is needed in order to differentiate between transfers that involve the sale of a financial asset and transfers that involve a loan secured by the transferred asset. If no distinction is drawn and every transfer of a component of a financial asset is treated as involving a loss of control over that component, a loan secured by a financial asset would be represented in the financial statements by derecognising the asset used as security. However, it is generally accepted that the faithful representation of a loan secured by a financial asset requires that the borrower continue to recognise the asset used as security while also recognising the assets loaned and a liability to return them.

Application of the JWG's Recognition and Derecognition Principles to Transfers involving Financial Assets

3.50 As existing concepts and principles that can be used to distinguish between transfers where control has passed and transfers where control has not passed are incomplete, the JWG has developed some criteria. The following principles, which deal with the simpler transfers, are, the JWG believes, reasonably uncontentious.

(a) Transfers that lack substance should have no accounting effect. If a transaction or other event is to be treated as having the effect of passing control of a resource from one enterprise to another, that event needs to be something more than a nominal bookkeeping entry. It needs to have substance. (The characteristics that give a transfer substance are discussed in paragraphs 3.72-3.80 below.)

(b) If, following a transfer, the transferor has no continuing involvement of any kind in the transferred asset, it no longer controls the asset. It is easy to forget that, amongst all the complex transactions involving financial instruments, most are very straightforward, every-day transactions where one enterprise transfers all its rights and obligations relating to a financial asset to another enterprise and acquires no new rights and obligations relating to that asset. In such transfers there is no doubt that control passes from the transferor to the transferee.

(c) If the transferee is free and able to transfer the whole of the asset that the transferor had to a third party, the transferee has control of that asset. The JWG believes that an enterprise is only able to give control of an asset to a third party if it, itself, has that control. That will, furthermore, be the case even if the transferor has a continuing involvement in some (and maybe all) of the rights transferred. (The Draft Standard expresses the notion of the transferee being "free and able" to transfer an asset by focusing on whether the transferee has the practical ability to transfer the financial asset in its entirety to a third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. This is discussed further in paragraphs 3.81-3.92 below.)

3.51 That leaves the most complex transfers, where the transfer results both in the transferor continuing to have an involvement in the "larger" asset of which the transferred contractual rights were previously part and in the transferee not being free and able to dispose of that larger asset. For the reasons explained above, the JWG believes that at least some of these transfers are loans secured by the transferred asset. In the absence of any existing concepts that help it to identify which of the transfers are loans, the JWG decided that the best approach was to devise a set of principles based on the essential characteristics of loans and other financing transactions.

Obligations to Repay the Transfer Consideration

3.52 An essential characteristic of a loan is that the borrower receives something now that it is obliged to return at a later date. The JWG therefore believes that a key factor in determining whether a transfer involving a financial asset is in the nature of a loan is whether the transfer results in the transferor having an obligation to repay the transfer consideration it received. A transfer that is part loan, part sale would therefore involve an obligation to repay some, but not all, of the transfer consideration. If it is determined that a transfer is a loan, control of the transferred asset will not have passed to the transferee. This means that the transferor will continue to recognise the transferred asset. If it is determined that a transfer is part loan, part sale, control of part only of the transferred asset will have been retained and control of the remainder of the asset will have passed to the transferee. In this latter circumstance, the transferred asset will be partially derecognised. Paragraphs 3.93-3.98 discuss in greater detail the determination of the amount of the loan.

3.53 In the case of most traditional forms of loan, the obligation that the borrower has to repay the loan is unconditional. However, some transfers involve the transferor receiving cash that the transferee will receive back either from the cash flows arising on the transferred asset or, if those cash flows are exhausted, from the transferor itself. In such a transfer, the transferor has an obligation, but whether that obligation will result in the transferor having to pay cash to the transferee will be conditional on the transferred asset's performance. For example, assume an enterprise (the transferor) transfers a portfolio of receivables to a factor in exchange for a cash payment, and the transferor undertakes to make good any and all losses incurred by the transferee in collecting the amounts due on the receivables. The transferor will therefore have a conditional obligation that could, depending on the performance of the transferred receivables, involve it repaying all the consideration it received.

3.54 The JWG has considered whether such a transfer has the essential characteristic of a loan. Although the transaction could be described as the transferor taking on a conditional obligation, the JWG believes that an alternative description would be to say that it has taken on an obligation that it has agreed will be met initially out of the proceeds of its receivables and, if that source of funds becomes exhausted, then from its general assets. When the transfer is viewed in this way, it can be seen that, although it may not at this stage be any clearer who controls the receivables, it is clear that the transferor has an obligation that could involve it repaying all the transfer consideration. The JWG believes that, if an enterprise enters into a transaction that involves it receiving cash and accepting an obligation that may involve it paying that cash back, the transaction is more in the nature of a loan than a sale.

3.55 The discussion in the last few paragraphs has been about identifying whether a transfer has the essential characteristics of a loan. If, and to the extent that, it does have such characteristics, control of the transferred asset will have been retained by the transferor. For example, in the preceding paragraph we described the transaction as involving the transferor taking on a loan that will be repaid initially out of the proceeds of the receivables and, if that source of funds becomes exhausted, from the general assets of the transferor. As a result, control of the receivables involved will be deemed to have been retained by the transferor. The JWG accepts that there will sometimes not be many outward signs of the transferor exerting control over the transferred assets: control has been so obscured that its existence is apparent only by analysing the rest of the transaction.

3.56 Such obligations arise from a variety of sources, including guarantees, forward contracts, put options written, and recourse arrangements. In developing its derecognition framework, the JWG has not seen any reason to differentiate between obligations depending on their source. As a result, all obligations to repay consideration that result from a transfer involving a financial instrument are treated in exactly the same way.

The Transferee Cannot Transfer the Contractual Right and the Transferor Has the Right to Get it Back

3.57 One implication of the JWG's conclusions about obligations to repay consideration is that an enterprise that transfers a financial asset in a transfer that meets all the following criteria will be deemed to have retained control of the transferred asset:

(a) the transfer has substance;

(b) the transferor has a continuing involvement in the asset the transferor had;

(c) the transferee is not free and able to transfer the asset the transferor had to a third party; and

(d) the transferee has a put option enabling it to insist that the transferor accept the transferred asset back and return the transfer proceeds.

3.58 The JWG believes that, if a put option held by the transferee will ensure that the transferor still has control of a transferred asset in the circumstances described in sub-paragraphs 3.57(a)-(c), a call option should usually have the same effect. Indeed, if the transferee is not free and able to dispose of the transferred asset, a call option held by the transferor will give the transferor the ability to choose what to do with the assets. It can leave them with the transferee, or recall them and then retain or dispose of them itself, i.e., it has the abilities that paragraph 3.44 explained were the essence of control—the ability to deploy the economic resources involved and the ability to benefit from that deployment.

3.59 On the other hand, if the transferee is free and able to transfer the transferred contractual right, whatever the nature of the transferor's continuing involvement in the asset, it must have passed control of the resource represented by the contractual right to the transferee.

3.60 The JWG has therefore concluded that, in the circumstances described in sub-paragraphs 3.57(a)-(c), a call option held by the transferor over a transferred component will ensure that control has been retained, as long as the transferee is not free and able to dispose of the transferred asset.

3.61 Some argue that, in all cases in which an enterprise transfers a contractual right but retains a call option requiring the transferee to return that right, the transferor has retained control of the contractual right. The JWG does not accept that argument. Holding a call option over an asset is not always the same as holding the asset itself. For example, if the transferee is free and able to transfer the asset to a third party, any influence that the transferor might be able to exert through the call option will be minimal. Furthermore, if a call option over an asset always enables the option holder to control the underlying asset, it would seem to follow that the enterprise should also recognise an asset it has never held when it acquires a call option over such an asset.

Other Types of Transfer

3.62 The types of transfer described in paragraphs 3.52-3.61 are, in the JWG's view, the only transfers that involve a component being transferred but control of that component being retained. It follows that, in all other cases, an enterprise that has transferred a component of a financial asset will also have passed control of that component to the transferee. Therefore, for such transfers the transferor can determine what to recognise and what to derecognise by determining which components have been transferred and should be derecognised and which have been retained and should continue to be recognised.

The JWG's Principles for Transfers involving Financial Assets

3.63 To summarise the discussion in paragraphs 3.50-3.62, the JWG has decided that its recognition and derecognition principles for transfers involving financial assets should be applied by transferors as follows.

(a) Transfers that lack substance should have no accounting effect.

(b) If, following a transfer, the transferor has no continuing involvement of any kind in the asset involved, it no longer controls the asset.

(c) If the transferee has the practical ability to transfer to a third party, unilaterally and without imposing additional restrictions on the transfer, the whole of the asset previously recognised by the transferor that is the subject of the transfer, the transferee has control of that asset.

(d) If a transfer that is not described in sub-paragraphs (a)-(c) results in the transferor having an obligation that could or will involve it repaying transfer consideration, the transfer is a loan to the extent of that obligation.

(e) If a transfer that is not described in sub-paragraphs (a)-(c) results in the transferor having a call option over a transferred component, such component being one that the transferee is not free and able to dispose of, the transfer is a loan to the extent of that call option.

(f) If the transfer is not as described in sub-paragraphs (a)-(e), the transferor has not retained control of any of the transferred components, although it will have retained control of any components that have not been transferred.

Mirror-image accounting, symmetry and history not mattering

3.64 In determining the principles that should underlie its derecognition requirements, the JWG would ideally liked to have identified principles that met the following, somewhat overlapping, objectives.

(a) The principles could be applied by both transferors and transferees, resulting in *mirror image accounting*.

(b) The principles would make *derecognition symmetrical with recognition,* rather than making it more difficult to derecognise an asset than to recognise it.

(c) The principles would require two enterprises that arrive at the same financial position by two different routes to recognise identical assets and liabilities, so that *history does not matter*. Put another way, if two enterprises are in the same financial position, it should not matter for accounting purposes what transactions they went through to get there.

3.65 However, although that was the JWG's aim, it has been only partially achieved: the principles set out in sub-paragraphs 3.63(a)-(c) meet the objectives, but the principles set out in sub-paragraphs 3.63(d) and 3.63(e) do not. That is because the JWG has not found it possible to agree on a set of principles that meets the objectives while at the same time drawing a clear distinction between transfers that are sales and transfers that are loans that results in transferor accounting that seems appropriate in all circumstances.

3.66 In developing its principles the JWG was faced with a choice: either adopt an approach that results in some accounting treatments that do not appear to reflect appropriately the transactions, or allow an element of asymmetry between recognition and derecognition and allow some of the influence of history to remain. The JWG has chosen the latter option, primarily because the approach seems to result in accounting which, taken as a whole, produces more appropriate results. Therefore, just like other aspects of existing accounting practice, some aspects of the Draft Standard's principles involve asymmetry and are influenced by history.

3.67 It is usual for the accounting by two parties to a contract to be the mirror image of each other. That is, if the transferor is required to derecognise an asset, the transferee is required to recognise it and, if the transferor is required to continue to recognise an asset, the transferee is required not to recognise the asset. Notwithstanding this, the JWG is proposing to require the transferee to adopt accounting that will *not* be the mirror-image of the transferor's accounting in certain circumstances in which the transferor's accounting is affected by history. Although the JWG reluctantly concluded that the accounting it should require transferors to adopt should be affected by history, it does not see why that should result in transferee accounting that depends on the transferor's history. In its view, it is more important to keep the incidence of asymmetry and historical dependence to a minimum than it is to achieve mirror image accounting for transferees and transferors. It also notes that in many cases the only implication for the transferor's financial statements of adopting non-mirror image accounting will be that some of the transferee's balance sheet classifications will be different from what they would otherwise have been.

3.68 Some believe that this approach is wrong, and that having reached the conclusions summarised in paragraph 3.63, the JWG should have applied them to the accounting of both transferors and transferees; not just transferors. Such people generally accept that it can be difficult to draw a distinction between transfers in which control of the transferred asset has been passed and transfers in which control has been retained, but see little difficulty (and much merit) in drawing the same distinction for both parties to the transaction. The JWG does not accept this view for the reasons set out in paragraph 3.67.

Is the components approach being consistently applied?

3.69 Some believe the adoption of the principles summarised in sub-paragraphs 3.63(d) and (e) is not consistent with the components approach. In their view:

(a) if the transferee is not free and able to dispose of the transferor's previously recognised asset and the transferor has an obligation in the form, say, of a forward purchase agreement that will involve repaying some or all of the transfer consideration received (i.e., the type of transaction that falls within sub-paragraph 3.63(d)), a "pure" components approach would require the transfer to be accounted for by the transferor as a sale of the asset together with the purchase of a forward purchase agreement. The transferee would treat it as a purchase of the asset together with entering into a forward sale agreement; and

(b) if the transferee is not free and able to dispose of the transferor's previously recognised asset and the transferor has a call option over a transferred component that the transferee is not free and able to dispose of (i.e., the type of transaction that falls within sub-paragraph 3.63(e)), a "pure" components approach would require the transfer to be accounted for by the transferor as a sale of the asset together with the acquisition of a call option. The transferee would treat it as a purchase of the asset and the writing of a call option.

That view leads them to conclude that the approach being proposed is an exception to the components approach. In their view, the underlying reasons for adopting a components approach for financial instruments, particularly under a fair value model, is so compelling that any exception to the approach will be unjustified. They are concerned that, by "modifying" the components approach in this way, there is a danger that the advantages that components approaches are perceived to have over other approaches will all be lost. They also argue that, as with any inconsistent application of a concept, modifying the components approach is likely to address only one issue while raising a number of others. The mirror-image accounting issue is, they argue, an example of this.

3.70 Others believe that, although the principle *does* represent an exception to the basic recognition framework, and should be presented as such in the Draft Standard, it *is* justified because, without it, few transactions would be accounted for as loans secured by transferred assets.

3.71 The JWG does not accept that the principles described in sub-paragraphs 3.63(d) and 3.63(e) are necessarily inconsistent with the adoption of a "pure" components approach. The components approach, just like the definition of an asset itself, depends on the existence of control. The principles in sub-paragraphs 3.63(d) and 3.63(e) have been developed *because* transfers of the type described in sub-paragraphs 3.69(a) and 3.69(b) make it so difficult to determine where control lies.

Transfers That Lack Substance Should Have No Accounting Effect

3.72 Although there can be little argument that a transfer has to have substance if it is to have an accounting effect, it is less clear what the characteristics are that give a transfer substance. Some argue that a transfer involving a financial asset will have substance only if it has a significant effect on the transferor's exposure to that asset. Others argue that a transfer has substance only if it results in the transferor being completely isolated in all circumstances from the transferred asset. The JWG is proposing that a transfer has substance only if the counter-party (the transferee) carries out substantial non-transferee business with parties other than the transferor or, if that is not the case, if the transferred components have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Substantial Non-transferee Business with Parties Other Than the Transferor

3.73 Essentially what the JWG is proposing is that, in order for a transfer to be more than a mere nominal bookkeeping entry, the transferee cannot be an enterprise that is the transferor's nominee. To ensure that that is the case, the JWG would require the enterprise to have a separate existence from the transferor and not to be dependent on it (i.e., it carries out substantial business with enterprises other than the transferor).

3.74 Some argue that the JWG has adopted too narrow a meaning of "dependence on the transferor" and, as a result, enterprises that are financed by the transferor will be treated as having substance when that might not be appropriate. They point out that subsidiaries, for example, are by definition at the beck-and-call of their parent, yet will be treated as having substance if they carry out substantial business with enterprises other than their parent. Such arguments raise complex consolidation issues and issues relating to accounting for related party transactions that the JWG believes are more appropriately covered in other accounting standards.

3.75 The Draft Standard also would require that, in considering whether the transferee carries out substantial business with enterprises other than the transferor, business that involves the transferee acting as a transferee of financial assets should not be taken into account. That is because the JWG does not believe that a transfer involving a financial asset can have substance simply because the transferee carries out many such transfers, some with other parties.

3.76 The JWG recognises, however, that it would be equally inappropriate to say that, just because the transferee only carries out transfers involving financial assets, those transfers lack substance. The JWG has therefore proposed that, if the transferee's main activity is to carry out transfers involving financial assets, one should look to the transfer itself to determine if it has substance. The JWG's proposal is that the test in these circumstances should be whether the transfer results in the transferred asset being isolated from the transferor in all circumstances (including bankruptcy). This notion is often referred to as "achieving legal isolation" and the test as a "bankruptcy remoteness test".

3.77 The type of transactions that will probably be affected most by the inclusion of this will be securitisations, because the transferee in a securitisation is often a special purpose enterprise that has been set up solely for the purpose of this, and perhaps other similar, transactions. Under the Draft Standard's proposals, if the transferee in a securitisation is such an enterprise, the securitisation will generally have no accounting effect unless the arrangements legally isolate the transferor from the securitised assets.

Isolation in Bankruptcy

3.78 An implication of paragraphs 35 and 36 of the Draft Standard is that a non-bankruptcy remote transfer (i.e., a transfer that does not achieve legal isolation) can still have an accounting effect (i.e., still result in derecognition of the transferred asset) if the transferee carries out substantial non-transferee business with enterprises other than the transferor.

3.79 Some believe that a transfer must be bankruptcy remote if it is to cause derecognition of an asset or component of an asset. They point out that this is a central plank of the approach adopted in FASB Statement 140. In their view it is misleading for a transferee to recognise a transferred financial asset on its balance sheet if, were the transferor to go into receivership, that asset would have to be returned and replaced with an unsecured claim on the financially weak transferor. Whether or not a transfer achieves bankruptcy remoteness is considered by the markets to be a not insignificant matter and it will affect the pricing of the transfer. In their view a derecognition framework that ignores the notion is not fully reflecting the economics of the market place.

3.80 The JWG has not accepted these arguments. It accepts that bankruptcy remoteness plays a role in the pricing of a transfer and that information about transfers that are not bankruptcy remote is important to a transferee if there is more than a remote possibility of the transferor going into receivership. It also accepts that the notion has a role to play in certain circumstances in determining whether a transfer should have an accounting effect, and it believes that some of the Draft Standard's proposals implicitly give effect to the notion for some transactions in some jurisdictions. However, it has not been able to agree that the notion should be given a greater significance in its proposals. To some extent that is because bankruptcy remoteness is an unfamiliar and largely untested notion in some jurisdictions, but it is also because of concerns in some jurisdictions as to the accounting that would result from its application.

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

3.81 As explained in sub-paragraph 3.50(c), the JWG has concluded that, if a transfer involving some or all of a financial asset takes place and, as a result of that transfer, the transferee is free and able to transfer the whole of that asset to a third party, it follows that the transferee must now have control of the whole of that asset. The Draft Standard expresses the notion of the transferee being "free and able" to transfer an asset by focusing on whether the transferee has the *practical ability* to transfer the financial asset in its entirety to a third party and is able to exercise that ability *unilaterally* and *without needing to impose additional restrictions* on the transfer. The key issue is therefore what the transferee is able to do in practice; not on what contractual rights the transferee has concerning what it can do with the asset or what contractual prohibitions exist. In particular:

(a) a contractual prohibition on disposing of an asset (or the absence of a contractual right to dispose of it) may have no effect on the transferee's practical ability to dispose of the asset if it is easy to obtain replacement assets (see paragraph 3.82-3.84);

(b) a contractual right to dispose of the asset is of little practical use if there is no market for the asset (see paragraph 3.85 and 3.86); and

(c) an ability to dispose of an asset is of little practical use if it cannot be exercised freely. For that reason:

   (i) the transferee's ability to dispose of the asset must be capable of being exercised independently of the actions of others (i.e., it must be a unilateral ability); and

   (ii) the transferee must be 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 giving the transferee the right to repurchase the asset) (see paragraphs 3.87-3.91).

A Contractual Prohibition on Disposing of an Asset may have No Effect if it is Easy to Obtain Replacement Assets

3.82 It is quite common for an enterprise (the transferor) to transfer a security to another enterprise (the transferee) on terms that stipulate that the transferor will repurchase the security at some specified date and that, in the meantime, do not permit the transferee to dispose of the security. Yet, if the security is one in which an active market exists, the transferee will often sell the security to a third party, knowing that it will be easy to obtain a replacement asset prior to the repurchase date to fulfil its obligations under the repurchase arrangement. As the concern here is with what the transferee is able to do in practice, it is important that such market practice is taken into account. The JWG is therefore proposing that a contractual prohibition on disposing of an asset may have no effect on the transferee's practical ability to dispose of that asset if it is easy for the transferee to obtain replacement assets.

3.83 As most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one easily replaceable security in exchange for another easily replaceable security[25], an implication of the proposal explained in the preceding paragraph is that most repo transactions will, under the Draft Standard, be treated as involving the sale of both securities. That means that each party to the transaction will derecognise the security it had been recognising prior to the transaction and each will recognise the security received in return. In most jurisdictions around the world this will represent a fundamental change in accounting treatment because, to date, sale and repurchase agreements have generally been treated as secured borrowings, and stock lending transactions have generally not affected the assets and liabilities recognised in the balance sheet at all.

3.84 The JWG recognises that is a change that will have a major impact on the reported financial position of many enterprises. The JWG is also aware that FASB concluded, in FASB Statement 125, that the nature of the transactions was ambiguous and that a change in practice could not be justified. Nevertheless, for the reasons set out in paragraph 3.81 the JWG believes its proposal to be appropriate.

A Contractual Right to Dispose of an Asset is of Little Practical Use if there is No Market

3.85 As the objective is to establish whether a transferee is genuinely free and able to give control of the asset to another party, some argue that the existence or otherwise of a market is irrelevant.

(a) The purpose of the assessment is to establish where control lies. If an enterprise would be able to transfer the asset (i.e., would have control of the asset) had a market existed, it does not cease to have control merely because a market does not exist.

(b) The proposal, if taken to its logical conclusion, means that the creation of a market for an instrument that did not previously have one would be a recognition/derecognition event.

(c) A buyer can be found for most, if not all, financial assets if the price is right. The absence of a market for a financial instrument does not therefore mean that an enterprise is unable to sell the instrument. It merely means that, if it wants to sell the instrument, it might have to accept a price that is lower than its intrinsic value. The discount involved reflects the lack of liquidity and, perhaps, other uncertainties, but is not the cost of withholding control of the asset.

3.86 The JWG does not accept that argument. It believes that, unless an accessible market exists, whether or not the transferee has the ability to transfer the asset to a third party is of

[25] The same is true of most stock and securities lending transactions.

little practical significance, and things that are of little practical significance are not generally allowed to influence accounting treatments.

The Need to Impose Additional Restrictions on the Transfer

3.87 The JWG believes that a transferee is not genuinely free and able to transfer to a third party the *whole* of the asset that was previously recognised by the transferor if it risks being in default of its obligations to the transferor if it undertakes a transfer without attaching restrictions to protect its position. For example, a call option held by the transferor will constrain the transferee's ability to dispose of the asset unless either replacement assets are readily available or if it is virtually certain that the call option will not be exercised. Similarly, the JWG believes that, if a transferee has to attach additional restrictions on a transfer of a transferred asset to a third party in order to protect itself from losses that it would otherwise incur on the transfer, it is economically impeded from, and therefore not genuinely free and able to, transfer to a third party the *whole* of the asset that was previously recognised by the transferor. For example, a put option held by the transferee that is virtually certain to be exercised will constrain the transferee's ability to dispose of the asset unless replacement assets are readily available. The JWG has reached these conclusions for the following reasons.

(a) While a call option that is virtually certain not to be exercised will not have a significant effect on a transferee's actions (and is therefore unlikely to prevent it from transferring the asset to a third party should it wish to do so), all other call options are likely to constrain the transferee to some extent because it will be concerned about the possibility of defaulting on the option.

(b) Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option that is virtually certain to be exercised will convey benefits to the transferee that it is unlikely to be prepared to give up lightly, so its existence is likely to constrain the transferee.

3.88 The Draft Standard would require that the assessment by the transferor as to whether an option constrains a transferee should be made once only, at the date of transfer. That requirement reflects the JWG's view that, regardless of the merits that any alternative approach might have, it would be impractical to require the transferor to re-evaluate the option and, if necessary, change the accounting treatment of the transfer, on an ongoing basis throughout the life of the option. However, the Draft Standard treats the expiry unexercised of an option previously considered to be constraining as a recognition/derecognition event.

3.89 Some do not agree with these proposals, believing that by requiring enterprises to determine whether it is virtually certain that a put option will be exercised or whether it is virtually certain that a call option will not be exercised:

(a) the approach being proposed contradicts the comments made in paragraph 3.2 about probability having no role to play in the recognition and derecognition of financial instruments;

(b) the approach is placing unrealistic demands on preparers, who cannot be expected to predict the future. In their view, there is no clear way in knowing whether an option will be exercised at exercise date and, as a result, an option, no matter how much it is in the money at the date of issue, is not a forward contract and should not be treated as such. Circumstances may change which could result in the option being out-of-the money at exercise date. Conversely, an option that is out of the money at issue date can be deep in the money at exercise date; and

(c) the approach implicitly accepts that the transferor and transferee may not be adopting mirror image accounting in a wider range of circumstances that that envisaged by paragraph 3.67. This is because the transferor and the transferee may have different views as to whether the option will be exercised which will again lead to asymmetrical accounting.

Those who hold this view believe that the Draft Standard should adopt an approach to options that will ensure that transferors and transferees treat them consistently. They suggest that one way to achieve this might be to require that call options held by a transferor will always ensure that control is retained unless the transferred asset is easily replaceable.

3.90 The JWG accepts that an implication of its proposals in this area is that, because transferors and transferees may reach different conclusions about whether an option constrains the transferee's ability to dispose of a transferred asset, the decision the transferor takes about the recognition or derecognition of the transferred asset may not be consistent with the decision taken by the transferee. The JWG does not, furthermore, believe that the proposals in this area contradict its early comments on the role of probability in the recognition process or that they place unreasonable demands on preparers. The objective of the "virtually certain" test is to ensure that options that have no economic relevance are not treated as relevant for accounting purposes. If it is possible that a put option that is in the money at the date of issue might be out-of-the money at exercise date then it is not virtually certain that it will be exercised.

3.91 Paragraph 3.87 states in effect that, where a transferee has a put option over a transferred asset that it is virtually certain to exercise, it is economically impeded from transferring the asset without imposing additional restrictions on that second transfer. Some believe that this is not correct because the transferee would generally be able to sell the asset and put option together to another party and, in that circumstance, the put option would not represent an additional restriction imposed on the transfer. The JWG believes that there will be many circumstances in which the put option is not transferable in that way (a put option held by a factor to give effect to the recourse arrangements underlying a transfer of receivables with recourse is an example of a non-transferable put) and is not aware of any satisfactory way of differentiating the two types of option.

Clean-up call options

3.92 Sub-paragraph 50(b) explains that clean-up call options should be ignored when determining which contractual rights and contractual obligations to recognise and which to derecognise. That is because such options do not affect the control of the transferred assets—they are simply a means of bringing to an end a securitisation that has ceased to be economic to operate because almost all the securitised assets have matured and been paid out.

Transfers Where the Transferor has an Obligation To Repay Consideration Received

Determining the Amount of the Loan

3.93 As explained in sub-paragraph 3.63(d), the proposal is that, if following a transfer, the transferee is not free and able to transfer to a third party the whole of the asset previously recognised by the transferor, and the transferor has an obligation that could or will involve it repaying transfer consideration, the transfer is a loan to the extent of that obligation. That means that, where the transferor's obligation is conditional or for an uncertain amount, the amount of the transfer consideration that should be treated as a liability will be based on the maximum amount that the transferor might be required to repay under its obligation or, if lower, the amount of the transfer consideration received.

3.94 Some oppose basing the amount of the loan on the maximum amount that the transferor might be required to repay. They argue that an implication of the approach will be that the amount recognised as a loan will not reflect the amount likely to be repaid. In their view, the amount of liability recognised should be based on the amount likely to be paid to meet the obligation.

3.95 Under the approach proposed, a full recourse factoring, in which the transferor has guaranteed even the catastrophic losses that might be incurred on the factored receivables, is treated as involving no sale of a receivable. On the other hand, if the amount of the loan were to be calculated by reference to the amount that is likely to be repaid, a significant portion of the receivables would be treated as sold. In the JWG's view, "no sale" treatment is the appropriate treatment of such transactions, so it considers its approach preferable to the alternative suggested. Having said that, it is true that the difference between guaranteeing all losses including those arising from catastrophic risks and guaranteeing an amount of losses that comfortably exceeds the amount of losses that will be incurred in almost all circumstances is also not a major change in the transferor's economic position. However, the difference will have a substantial effect on the transferor's balance sheet. The

JWG believes that it is inevitable that, when one draws a "bright line" between fundamentally different types of accounting, small changes to situations close to the bright line can have a major accounting effect.

3.96 The JWG also notes that, if the amount of the loan was to be calculated by reference to the amount that is likely to be repaid, the effect would be to allow the transferor's assessment of its likely exposure under some transfers to determine the extent to which it derecognises those assets. The JWG sees that as a disadvantage that can be avoided by adopting its approach.

3.97 Others suggest that recognising a liability for an amount derived from the transferor's maximum exposure is not consistent with the JWG's overall conclusion that all financial instruments should be measured at fair value. A similar issue arises, they argue, with the asset that is recognised in such circumstances. For example, assume that a portfolio of receivables (fair value 100) has been factored with full recourse in exchange for a cash payment of 85. The recourse arrangements are achieved through a simple guarantee given by the transferor, who also retains a residual interest in the portfolio. Those who believe that recognising a liability of 85 conflicts with the fair value principle would argue that it cannot be right to recognise a liability of 85 when the fair value of the payments that are expected to be made under the guarantee is virtually nothing—because the fair value of the receivables to which the factor first looks for payment is 100.

3.98 The JWG believes that such a suggestion confuses the recognition process with the measurement process. In its view, the correct way to look at the position is to first of all apply the recognition and derecognition provisions, resulting in the conclusion that the transferor has a liability to repay 85 to the factor. This liability will be met initially from the cash collected on the receivables and then, if those monies are insufficient, from the transferor's other assets. The JWG believes that, although the principles summarised in sub-paragraph 3.63(d) have the effect of recognising greater amounts of assets and liabilities on the transferor's balance sheet than would the recognition of only a guarantee at its fair value, that better reflects the assets still under the transferors' control and the obligations that are to be satisfied from those assets.

Transfers Where the Transferor Has a Call Option over a Transferred Component

Removal of Accounts Provisions and Call Options over Assets

3.99 As explained in paragraph 3.63(e), the Draft Standard is proposing that control of a contractual right has not passed to the transferee if both the following criteria are met:

(a) the transferee does not have the practical ability to transfer to a third party, unilaterally and without imposing additional restrictions on the transfer, the whole of the asset previously recognised by the transferor that is the subject of the transfer; and

(b) the transferor has a call option over that specified transferred contractual right.

3.100 In some transfers of groups of contractual rights, the transferor will acquire a call option in respect of each and every transferred contractual right and is free to exercise as many or as few of those options as it wishes. In such circumstances, it is consistent with the analysis underlying paragraph 3.63(e) to conclude that control has been retained in respect of each and every transferred contractual right. However, the position is not as clear if the call option relates to a group of assets and the terms are such that only some, not all, of those assets can be reacquired through exercising the option.

3.101 Securitisations are sometimes carried out on terms that contain a provision that enables the transferor to call back some of the assets securitised at a subsequent date. Some of these "removal-of-accounts" provisions (or ROAPs) allow the transferor to determine the identity of the assets called back; others specify that the assets will be identified by other means (such as randomly or by the transferee). Such provisions are included for good business reasons. For example, credit card balance securitisations commonly have a ROAP that permits the transferor to specify the assets to be called back. The transferor may wish or need to transfer to another credit card issuer some of its credit card accounts, perhaps those for customers with a particular attribute or characteristic. In such a circumstance, the originator may prefer to be able to reclaim, from amongst the securitised assets, any uncollected balances relating to those credit card holders. A ROAP that permits the transferor to specify the assets to be called back would enable it to do that.

3.102 In deciding how to deal with such provisions, the JWG considered which, if any, ROAPs mean that the transferor has retained control over some or all of the transferred assets. The JWG decided the following.

(a) If the transferee does not have the practical ability to transfer the assets transferred to it to a third party (which is usually the case with securitisations), a ROAP that enables the transferor to choose which assets to reacquire from amongst a group of assets will mean that the transferor can reacquire, and thus has not relinquished control over, *any* of the transferred assets. This is the case even if the terms of the ROAP mean that it cannot reacquire that whole group of assets. The transferee's inability to dispose of the transferred assets means that all it can do with them is hold onto them until either all the cash flows due on them have been collected or the transferor calls them back, and it is the transferor that decides which it shall be. In such circumstances, the assets effectively remain at the transferor's command.

(b) Other types of ROAP do not maintain the transferor's control over any part of the group of assets. Even though the transferee is not able to dispose of any of the assets involved, the transferor's inability to specify the transferred assets to be reclaimed means, in the JWG's view, that the transferor has not retained control of the assets. That means that ROAPs that allow the transferor to remove randomly selected, transferred assets at its discretion will not fall within the scope of paragraph 60(b). Neither will ROAPs that involve the transferee selecting the transferred assets to be returned fall within the scope of paragraph 60(b), as long as such provisions do not have the practical effect of allowing the transferor to remove *specific* transferred assets.

Implications of the JWG's Recognition and Derecognition Proposals for Non-financial Items

3.103 The JWG's proposals on recognition and derecognition have been developed for application to assets and liabilities arising from instruments and other contracts falling within the scope of the Draft Standard. They have not been developed with non-financial items in mind. Financial instruments and non-financial items have significantly different characteristics, which means that what is appropriate for financial instruments may not be appropriate for non-financial items. Therefore, although the JWG's proposals may shed some light on the recognition and derecognition frameworks for non-financial items, they do not have any direct implications for those frameworks.

4. Fair Value Measurement

Defining Fair Value—the Exit Price Objective

4.1 Fair value has traditionally been defined in most jurisdictions as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's-length transaction. In practice there has been uncertainty as to whether fair value should be interpreted to be the current entry price (the amount that would be paid for an asset or the amount that would be received from the issuance of a liability at a measurement date) or the current exit price (the amount that would be received for an asset held or that would be paid to be relieved of a liability owed at a measurement date). In many cases, the two are the same or near enough to the same that there is no practical difference for accounting purposes. However, for instruments that are not frequently traded or that are usually traded as a part of portfolios, the entry price differs significantly from the exit price. One example involves financial institutions that make loans to individual customers, sell those loans in portfolios, and realise immediate gains or losses.

4.2 The JWG decided that exit price is the more relevant measure of the fair value of a financial instrument. The market exit price of an asset or liability that an enterprise currently holds or owes reflects the market's expectations of the amount that would be realised on the measurement date. In contrast, an entry price reflects what would be paid to acquire an asset, or received to assume a liability, which amount may be more or less than what would be realised at that date. An "asset" is defined in terms of the economic benefits that are expected to flow from it. The exit price of a financial asset is consistent with that definition because it is the market's estimate of the value of the benefits that are expected to flow to the enterprise from that asset on that date. Similarly, a "liability" is defined as a present obligation that is expected to require future outflows of enterprise resources. The exit price of a financial liability is the market's estimate of the current value of the future resources that the enterprise will have to sacrifice to be relieved of that liability.

4.3 The JWG's conclusion that the fair value measurement objective should be exit price only applies to financial instruments. The JWG has not addressed, and makes no judgement as to, the possible relevance of market entry price for non-financial assets and liabilities. As observed in paragraphs 2.16-2.19, non-financial assets and liabilities have distinctly different characteristics and functions from financial instruments, which may make different accounting appropriate.

Value-in-use, Recoverable Amount and Deprival Value

4.4 Some have advocated that, for the purposes of measuring financial instruments in financial statements, "fair value" should be taken to mean "value-in-use" or "recoverable amount" or "deprival value"[26].

4.5 An asset's value-in-use[27] to an enterprise should be management's best estimate of the net present value of the future cash flows expected to be obtained from the asset's use, and ultimate disposal, by the enterprise. Value-in-use is therefore an enterprise-specific measure that would take into account management's assessment of any ability an enterprise had to extract above-average net cash flows from a financial asset or any inability it had to extract even average net cash flows. In other words, it would reflect management's perception of the enterprise's private skills. It would also reflect any private information that the enterprise had about the likely performance of the asset.

4.6 A financial asset's value-in-use will tend to be either above or below its market exit price. Logically, if all other things are equal, an enterprise will hold on to a financial asset if its estimate of the asset's value-in-use is higher than its market exit price, but will sell the asset if its value-in-use is lower than its market exit price. That causes some to argue that the true reflection of the value of a financial asset is the higher of its value-in-use and net realisable value.[28] This is known as the asset's recoverable amount.

4.7 Others suggest that the true worth of a financial asset to an enterprise is the loss that the enterprise would suffer were it to be deprived of the asset; a notion known as deprival value. An asset's deprival value will depend on the circumstances involved.

(a) If an enterprise is putting the asset to profitable use, the asset's value in its most profitable use (i.e., its recoverable amount) will exceed the cost of replacing it (i.e., its current replacement cost, which is its market entry price inclusive of transaction costs). In such circumstances, the enterprise will, if deprived of the asset, replace it, so its deprival value will be its current replacement cost.

(b) However, a financial asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, if the enterprise is deprived of the asset its loss will be limited to its recoverable amount.

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26 Deprival value is sometimes also referred to as "the value to the business". In some jurisdictions, the terms "current value" and "deprival value" are treated as synonymous.

27 Although the discussion here is framed largely in terms of financial assets, the notions discussed and the arguments involved are the same for financial liabilities.

28 The net realisable value of a financial asset is its market exit price adjusted for selling costs.

In other words, in simple terms, a financial asset's deprival value may be considered to be the lower of its current replacement cost and its recoverable amount; its recoverable amount being the higher of its net realisable value and value-in-use.

4.8 When people advocate the use of value-in-use, recoverable amount or deprival value, they are arguing that market entry prices (in the case of deprival value) and value-in-use can, in appropriate circumstances, be satisfactory measures of financial assets for external financial reporting purposes.

4.9 It has been explained in paragraphs 4.1-4.3 why the JWG does not accept that entry value is a satisfactory measure for financial assets except where it approximates exit value. The JWG does not accept value-in-use for measuring financial instruments because it is dependent upon internal estimates and assumptions even when market prices are available, and because it will not be comparable from enterprise to enterprise. Management may be forced to use its own assumptions in estimating the market exit price of a financial instrument if there are no observable market prices for identical or similar instruments. However, the objective is to replicate the assumptions that market participants would use. In contrast, the objective of value-in-use is to apply present value or other valuation techniques based on management's expectations about cash flows, market conditions, and other uncertainties. The JWG believes that the benchmark for measuring performance of financial instruments should be market expectations, not management's expectations.

4.10 The JWG does not make any judgements about the appropriateness or otherwise of these measures for non-financial items, because this is a subject that is outside its scope.

Direct Costs to Sell or Obtain Relief (Exit Costs)

4.11 Direct costs to sell an asset or obtain relief from a liability affect the net cash flows from a financial instrument, and consideration of those costs in determining fair value could be considered to be consistent with an exit price objective. The JWG decided against that treatment for a variety of reasons. Some believe that such costs should not be recognised until a transaction takes place because they are not, in their view, a liability of the enterprise until that time. Others believe that in concept such costs should be provided for under an exit value objective, but would not require that treatment for reasons of practical expediency. Exit costs will not be significant in many cases, and would be difficult to measure in other situations because they can vary significantly depending on the type of transaction. In addition, such costs have generally been considered costs of the period in which they occur, that is, as the cost of the decision to sell or obtain relief.

Hybrid Contracts

4.12 A financial instrument that is part of a hybrid contract is to be measured as if it were a free-standing instrument even though its value as a part of a hybrid contract may not be the same as if it were free-standing. The non-financial portion of the hybrid contract is not measured separately; its value is simply the difference between the total fair value of the hybrid contract and fair value of the financial instrument portion determined as if it were free-standing. In similar situations involving separate measurement of two or more portions of a single contract, international accounting standards and some national standards permit or require allocation of the entire fair value (or cost) of the whole instrument to its parts based on their relative fair values. The JWG acknowledges that there is no conceptual basis for measuring the financial instrument component as if it were free-standing and attributing any value arising from combining the components in the hybrid contract to the non-financial portion. Some believe that an allocation of such value should be made between the financial and non-financial components. However, any allocation basis will be arbitrary, and the Draft Standard approach is simpler.

4.13 An alternative view would be to measure both the financial and non-financial components at their respective fair values on initial recognition, with any difference between the sum of their fair values and the fair value of the hybrid instrument as a whole recognised as an immediate gain or loss in the income statement. It would seem, however, difficult to justify the recognition of a gain or loss on initial recognition solely as a result of the apparent effect of combining components into a hybrid contract.

4.14 The JWG believes that the requirements of paragraphs 4, 5 and 74-76 of this Draft Standard will ensure that items included in a hybrid contract that are economically equivalent to those measured at fair value in accordance with the Draft Standard will be accounted for in the same manner. At the same time the requirements will limit the circumstances in which non-financial items that are generally measured on another basis are measured at fair value. This approach is consistent with the risk management practices of many financial market participants that focus on individual financial risks within contracts.

4.15 The JWG acknowledges that, in some circumstances, an enterprise may not be able to reliably identify and measure the separate sets of rights and obligations in a hybrid contract that would fall within the scope of the Draft Standard. In these circumstances, the JWG believes that the entire contract should be accounted for as if it were a single financial instrument, primarily to preclude any possibility that the Draft Standard requirements could be avoided for a financial instrument by embedding it in a hybrid contract. Some may be concerned that this requirement could result in a contract with only a minor financial instrument element being accounted for on a fair value basis. The JWG believes that it would rarely be the case that the financial instrument element will not be capable of reliable identification and measurement, and that it is not practicable to develop criteria for determining when a financial instrument element is minor.

4.16 If an enterprise determines that it can no longer reliably identify and measure the separate components of a hybrid contract, then the JWG believes that the enterprise should measure the entire contract at its fair value throughout its remaining period. It does not believe that an enterprise should be permitted to determine in one period that it could not reliably identify and measure the separate sets of rights and obligations and in a later period revert to separately accounting for those sets of rights and obligations. The JWG considered whether to require an enterprise to make this assessment only at the inception of the contract. However, it decided that it is conceivable that an enterprise would determine part way through the life of a contract that, as a result of a change in circumstances, it could no longer reliably identify and measure the separate sets of rights and obligations if circumstances were to change.

Differences Between Bid and Asked Prices (Bid-asked Spreads)

4.17 Some have advocated that the mid-point price should always be used for financial instruments for which there are quoted bid and asked prices. They argue that the difference between bid and asked prices in an active dealer market represents an exit cost that is included in the quoted price. If so, the requirement to exclude exit costs could be extended to require that the dealer's profit is estimated and the bid or asked price adjusted accordingly. However, because removing exit costs presumed to be included in bid or asked prices could be difficult if not impossible, the JWG decided to permit the use of the mid-point between quoted bid and asked prices for instruments traded in active markets where the differences between the bid and asked prices are small. The JWG can see no justification for using a mid-point price in other situations—that is, where the difference between the quoted bid and asked prices is large enough to make a significant difference in the fair value of a financial instrument—because the mid-point price cannot be relied upon to represent the price at which a market transaction would occur. In these cases, enterprises should estimate the price they would expect to receive for assets or pay to be relieved of liabilities whether it is the bid price, the asked price, or another price within the range.

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

4.18 The Draft Standard adopts the principle that the fair value of a financial instrument should be derived directly from its contractual rights and obligations, even if the only observable prices regarding a particular financial instrument take into account cash flows that do not result directly from those rights and obligations. The JWG believes that any expected benefits, or sacrifices, that are not directly attributable to the rights or obligations under the financial instrument contract should not enter into the estimation of its fair value (see Draft Standard paragraphs 92 to 94).

4.19 Some assert that in certain circumstances this principle is in conflict with the principle that fair value should be based on observed market exit prices whenever they are available. They believe that this conflict exists particularly in respect of financial instruments that are traded only in combination with closely related non-contractual benefits. Two examples are credit card contracts and demand deposit liabilities. Observable prices may exist for the entire credit card and demand deposit relationships. For example, a portion of the observable market exit price for a portfolio of demand deposit liabilities is attributable to expected future benefits from the relationship with the depositors apart from their existing balances. It is not likely to be possible to determine by reference to observable market evidence the portion of the total observed market price that is attributable to the existing balances. Some believe that the observable price of the total relationship should be used in these situations—that the principle of using observable market prices whenever available should be given priority over the principle of estimating the fair value of only the financial instrument contract.

4.20 The primary principle, in the view of the JWG, is to estimate the fair value of the financial instrument. The JWG believes that a market exit price that includes the value of expected customer relationships that are traded with the financial instrument does not fairly represent the fair value of the financial instrument. The fair value of the customer relationships represents the value of an intangible asset to the enterprise that should be treated as such, not as part of the value of the financial instrument. For example, an observed market exit price for a portfolio of credit cards would include the fair value of expected future benefits to result from future business with those cardholders, as well as the fair value of the existing receivable balances and lines of credit extended to those cardholders. The acquisition of such a portfolio may be regarded as equivalent to the acquisition of a credit card business, requiring allocation of the purchase consideration between the identifiable assets acquired and liabilities assumed (that is, allocation on the basis of the fair values of the financial asset receivables, financial liabilities for the lines of credit, and the intangible assets representing customer lists and/or “goodwill”).

4.21 Those who advocate using the observed market exit price for the package in these situations because it is a reliable market price point out that the estimation of the fair value of the financial instrument elements is likely to require certain assumptions for which there may be no available market information because there are no transactions involving the financial instruments alone. The JWG does not believe it is appropriate to use the observed market exit price without adjustment simply because it is available, if it represents an asset or liability that is different from the one being measured. The JWG agrees that it probably will be necessary to use internal valuation techniques for credit card receivables and borrowing options, and for demand deposit liabilities. However, it believes that reasonable techniques and assumptions can be developed in respect of these financial instruments, and the Application Supplement provides some implementation guidance (see paragraphs 332-339) with respect to the nature of such techniques. Further, the JWG expects that the alternative approach of pricing the packages would also have to make use of internal valuation techniques in many situations because transactions in these packages are likely to be infrequent in many jurisdictions.

4.22 Some have expressed the view that the expected benefits to result from credit card and demand deposit relationships that are evidenced by prices of observed market transactions should be recognised as intangible assets. This Draft Standard does not address questions relating to the possible recognition of intangible assets because they involve issues that go well beyond those that are relevant to financial instruments.

Written Options That Are Not Embedded in Other Financial Instruments

4.23 Some difficult issues arise in determining the projected cash flows that should be considered to be directly attributable to certain written options that give rise to expectations of future benefits to the writers of such options.

4.24 Generally an option is priced on the expectation that it will be exercised when it is “in the money”, that is, when the value of the option to the holder exceeds its strike price. However, some types of options are issued with the expectation—supported by historical evidence and current market exit prices—that holders will be influenced by factors other than the values of the options in relation to their strike prices in deciding to exercise or not exercise them. That is, a proportion of holders probably will exercise these options when they are “out of the money”, or not exercise them when they are “in the money”, as assessed in terms of the strike prices. The result is that such options can give rise to expected positive value to the writer. A prominent example is credit card borrowing options.

4.25 Some believe that the writer should estimate the market exit price of these options on the basis of including the expected benefits. This would result in the writer reporting these options as assets. The JWG believes that a written option can only be a liability of the writer. It cannot have an asset value. The JWG believes that any expected future asset value associated with a written option relates to expected future business with the option holders, which is an intangible asset and not directly attributable to the option contract.

4.26 It would be inappropriate, in the JWG’s view, for an enterprise to record as an existing financial asset an option that enables customers to borrow money in future periods at or above existing market interest rates for equivalent risk. It may be assumed that the enterprise will extend loans on these terms to all qualified customers whether or not they hold this option. In both cases there may be considerable expected future benefits to result from future loans to customers. To ascribe financial asset value to such an option would open up the opportunity for enterprises to create financial income and financial assets simply by writing at-the-money options.

4.27 In other words, the expectation of a future benefit is a necessary, but not a sufficient, condition for the recognition of a financial asset. To be recognised as a financial asset requires that there be an existing contractual right as a result of a past transaction. In the JWG’s view a written option carries with it no contractual rights to future benefits because the writer cannot compel the holder to exercise the option when it is out of the money or to not exercise it when it is in the money. An option to lend money at or above current market rate of interest may have a small fair value as an obligation. However, it would be expected to have some value to the extent that it could move to be in the money before it expires (for example, if interest rates were to rise or an option holder's credit worthiness were to deteriorate).

Financial Instruments That Contain Options

4.28 In contrast, the JWG believes that the fair value of an existing financial instrument that contains a written option, such as a prepayment option contained within a loan contract, should be estimated taking into account market expectations of the probability of the exercise of the option.[29] The JWG recognises that this position can be considered to be inconsistent with that in respect of free-standing written options discussed in the immediately preceding paragraphs. The fair value of the expectations for out-of-the money behaviour by holders of prepayment options embedded in loans can be considered to be just as much an intangible, rather than a financial, asset to the issuer as the value of expected benefits to result from a free-standing option. However, the JWG believes that there are important differences that warrant the options contained within another financial instrument being treated differently.

(a) A financial option that is contained in another financial instrument enters into defining the contractual rights or obligations of that financial instrument. For example, the prepayment option in a mortgage is an integral and inseparable part of the mortgage contract, which, along with the other provisions of the contract, defines the obligation and rights of the borrower and the lender. The lender (who is the writer of the option) has a contractual right to specified interest and principal amounts that is constrained by the expected effects of the prepayment option. The probability of prepayment will enter into the determination of the interest rate and cash flow expectations that market participants will build into the estimation of the fair value of the mortgage (which is the present value of its expected cash flows at a market rate of return adjusted for prepayment expectations and risk, along with other risks).

(b) The fair value of an option embedded within a loan contract reflecting the market expectations of the probability of prepayment is not conditional on anticipating benefits from expected future loans or other future relationships with customers. It relates only to estimating the future cash flows to be received from the particular existing loan contract. It is therefore not as open to being used to create financial income and financial assets as a free-standing option.

[29] This is subject to the condition set out in paragraph 100 of the Draft Standard.

Application to Demand Deposit Liabilities

4.29 In accordance with the principles explained in the preceding paragraphs, the fair value of demand deposit liabilities will reflect the market's expectations of the timing of withdrawals of existing deposit balances, the level of interest rates on borrowings of equivalent term and risk, and the costs of servicing those deposits. Benefits expected to result from future deposits from existing or new depositors, or from other relationships with depositors, will not enter into the determination of their fair value.

4.30 It is recognised that deposit-taking institutions manage existing financial assets and liabilities in relation to cash flows and risks expected to result from future deposits. Such institutions base the maturities and risks of their investments in loans and other financial assets on the expected timings and amounts of future deposits. The JWG does not believe that there is any conflict between this management objective and the Draft Standard requirements for the fair value measurement of existing deposit liability balances. The objective is to fairly reflect the financial assets and financial liabilities of an enterprise that exist on the reporting date. This, in turn, is based on the premise that a clear picture of existing financial assets and financial liabilities is the essential reference point for evaluating future plans and expectations. The exclusion of expected benefits to result from future deposits in measuring the fair value of existing demand deposit liabilities is consistent with this objective.

4.31 The JWG believes that the link between financial assets and financial liabilities existing at the end of a reporting period and their use in managing expectations with respect to future transactions is appropriately provided by supporting disclosures about an enterprise's financial risk management objectives and policies. Accordingly, the Draft Standard would require the disclosures set out in paragraphs 156-163.

4.32 The JWG understands that most deposit-taking institutions have not addressed the fair value measurement of demand deposit liabilities within a context that is consistent with the principles of the Draft Standard—so that a transition period will be necessary to enable the development of valuation techniques and supporting systems, and the testing of these systems. The Application Supplement, paragraphs 336-339, sets out some basic considerations related to estimating the fair value of demand deposit liabilities. The process of developing fair valuation techniques for demand deposit liabilities may enable more in-depth guidance to be provided.

Prices from More than One Market for the Same Instrument

4.33 The Draft Standard (paragraph 96) would require that, if an enterprise has access to more than one exit market for a financial instrument, the determination of the most advantageous market exit price would take into account any significant difference in the costs that would have to be incurred to realise that price. The JWG believes that this requirement is necessary, even though these costs would not be recognised in measuring the fair value of the financial instrument. Otherwise, it is possible that the observed, most advantageous, market exit price would not be the most advantageous net amount that would be realised on the measurement date. The JWG is concerned that this might lead to efforts to create different markets for the same financial instruments with the only difference being whether certain costs are included in or excluded from the quoted market exit price.

Large Blocks of Instruments and Control Premiums

4.34 It may be contended that the requirement in Draft Standard paragraph 102 for holdings of large blocks of financial instruments will not accurately reflect the expected exit price of an enterprise that holds so many units of a financial instrument that the market could not be expected to absorb them immediately at the prevailing price. One might expect that some adjustment should be made for the expected effects, if information necessary to estimate them is available. The primary reason for the Draft Standard requirement is that market information necessary to estimate the adjustment is not likely to be available. In fact, it is not even clear from market evidence whether or when the adjustment for some equity securities would be positive or negative. The result depends on what weighting might be given to possible positive effects of having a "control premium" versus possible negative effects of the supply exceeding demand at the current market price. Thus the JWG concludes that the most useful representation of exit price is the observable market exit price for smaller quantities if an observable market exit price for a large block is not available. Enterprises are required to disclose the existence of large blocks and the fact that they may not be capable of liquidation immediately at their quoted market prices.

4.35 However, the JWG acknowledges that, if agreed-upon methods were developed for reliably estimating the fair value of large blocks, there would be merit in requiring an adjustment to the price of the security sold individually or in small blocks. In this eventuality, the JWG believes that the requirement of paragraph 102 should be reconsidered.

Estimating Fair Value without Observable Market Exit Prices

Loan Assets and Credit Risk

4.36 Few observable market transactions occur for some types of loan assets in some jurisdictions. In that situation, an enterprise will have to estimate fair value using a valuation technique. The credit quality of loan assets is a key price-determining variable in such a valuation technique. The estimation of the fair value effects of credit quality and changes in credit quality depend on two basic factors: (a) a reliable on-going loan asset credit grading system which is used in extending loans and in continuously evaluating the credit quality of loan assets and (b) a reliable basis for translating the credit grades assigned to loan assets into their estimated fair values at measurement dates. The Application

Supplement to the Draft Standard (paragraphs 359-363) indicates how these factors could be generally incorporated into a loan asset valuation technique.

4.37 The JWG understands that credit risk grading systems with the basic attributes outlined in the Application Supplement are in place in many major lending institutions. It notes that the Basel Committee on Banking Supervision has been urging banks to develop internal risk rating systems that include policies and procedures for identifying, measuring, monitoring and controlling credit risk exposures that are appropriate to the nature, size and complexity of an enterprise's lending activities.[30] An effective credit grading system enables an enterprise to identify and monitor changes in the credit standing of its loan portfolio as changes occur. This in turn facilitates the institution of timely controls over the enterprise's exposure to credit risk. Traditional accounting is based on carrying loans at cost without adjustment for credit deterioration until there is evidence that specific loans are impaired. Some consider that accounting to be deficient in presenting relevant information about lending activities because credit deterioration is not recognised in the periods in which the value of the loan is affected.

4.38 A valuation technique based on an enterprise's internal credit grading system may not be entirely consistent with the exit price objective of fair value measurement because it estimates the current market entry prices between the lender enterprise and borrowers. These entry prices may differ from the prices that the lender would realise if it sold its loan assets on the measurement date in arm's-length transactions in the market place. However, such an internal model would, if based on sound lending practices and consistent policies and procedures, result in an estimate of the fair value of loan assets that consistently reflects the effects of changes in lending market prices for credit standing. The JWG believes that, in the absence of observable market exit prices, such credit grading-based models will provide an acceptable approximation of fair value.

4.39 Some have advocated that accounting standards should specify detailed policies and procedures for estimating the fair value of loan assets. The JWG believes that the determination of appropriate implementation policies and procedures are best left to the enterprise. The enterprise then has the ability to develop a system that is appropriate to its circumstances and the nature, size, and complexity of its lending activities. To help compensate for potential differences in estimation techniques from enterprise to enterprise, the Draft Standard would require certain disclosures of an enterprise's fair value estimation policies, key assumptions and measurement uncertainties (see paragraph 183).

4.40 Some are concerned that the fair values of loans that are estimated on the basis of internal credit grading models may not be comparable between enterprises. The JWG expects some degree of measurement variability between enterprises that have different credit granting

[30] See, Basel Committee on Banking Supervision, Principles for the Management of Credit Risk, Consultative Paper, Basel, July 1999.

policies and grading systems. This could result in loans of similar credit quality being made at somewhat different interest rates by different lenders, with resulting differences in subsequent credit grading and fair value estimates of these loans. Similar differences would occur within cost-based accounting in circumstances where initial amounts loaned on the same contractual repayment terms with the same credit risk differ as a result of different credit grading policies. The JWG expects that differences in estimated fair values between enterprises will be contained within limits that are reasonable for financial accounting purposes because lending enterprises should normally be expected to be pricing contracted cash flows at interest rates that are consistent with competitive lending rates in open and competitive lending markets.

4.41 In some countries government closely regulates loan rates and terms. Such regulations may include requirements for loans to certain classes of individuals or enterprises that may be linked to the amounts of deposit balances and the interest rates to be paid on the deposits of these individuals and enterprises. Government imposed lending and deposit terms could become uneconomic if economic conditions change, and there may be questions about whether or when changes in government regulation could be anticipated to adapt the regulations to current conditions. Some are concerned that it may be difficult in these situations to determine the fair value of these instruments, that is, how the market may be expected to value them (evaluate future expectations) when there are no observable market prices for these instruments. The JWG expects that the implications of government regulation of the terms of loans and deposits for the estimation of fair value will need to be addressed on the basis of the particular situations in specific countries—within the context of the requirements of this Draft Standard. The JWG believes that guidance on the application of the Draft Standard to these situations is best developed by the accounting standard setting bodies in consultation with the appropriate government bodies and the affected enterprises in these countries.

Impaired Loan Assets

4.42 All loan assets, whether fully performing or in default, would be measured on the basis of the same principles for estimating current market expectations of future cash flows and the interest return that market participants will charge.

4.43 Some believe that there is no need to distinguish loans that may be considered to be impaired. They note that the fair values of all loans reflect some expected incidence of default, and that what may be considered to be an impaired loan is open to a wide range of possible definition. Traditional accounting practices based on identifying impaired loans have been the subject of significant criticism and concern.

4.44 On the other hand, the JWG understands that many users want to know what portion of an enterprise’s portfolio is considered to be impaired and what the income statement effect has been in the period, in part as an indication of management performance. The JWG believes that the separate identification and disclosure of impaired loans on the basis provided for in the Draft Standard can provide useful information within the context of the fair value measurement of loan assets.

Identification of Impaired Loans

4.45 The first issue is how to distinguish impaired from unimpaired or performing loans. Traditional definitions that focus on loans for which there is no longer "reasonable assurance" of timely collection of contracted cash flows beg the question: What level of probability should be considered to be "reasonable assurance"? In practice this has been open to a wide range of interpretations. The definition of "impaired loans" might be left to individual enterprise judgement, in which case it is open to a high degree of variability. Alternatively, a rigid definition (such as any breach of loan covenants or repayment terms, or where contracted payments are more than 60 or 90 days overdue) would be artificial and arbitrary in some degree.

4.46 The Draft Standard defines impaired loan assets as individually identifiable loan assets whose credit quality has deteriorated to the extent that it is more likely than not that the lender will fail to receive the full amounts owed in accordance with the terms of the loan contracts. The JWG believes that the "more likely than not" criterion should result in a more consistent identification of impaired loans than under traditional practice. This criterion is already used in accounting standards for the recognition of provisions and deferred tax assets in a number of jurisdictions.

Fair Value Measurement of Impaired Loans

4.47 An enterprise may not be able to apply its normal credit grading system to estimate values of loans with credit quality that has declined below levels at which it would be prepared to grant new loans. But the difficulties of estimating future cash flows are no greater under a fair value system than under traditional approaches. Further, the basic present value methodology for valuing impaired loans is well established and in place in some jurisdictions.[31]

Financial Liabilities

4.48 The benefits of measuring financial instruments at fair value, outlined in paragraphs 1.6-1.13, apply to both financial assets and financial liabilities. Fair value represents the estimated market exit price of the current economic benefits of a financial asset and of the current economic burden of a financial liability. However, some believe additional considerations warrant exceptions to full fair value measurement for certain liabilities. These considerations are addressed in the following paragraphs.

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[31] These jurisdictions include Canada and the U.S. See also paragraph 115 of IAS 39.

Non-financial Assets Financed by Debt

4.49 Some hold the view that it is inconsistent to measure fixed coupon debt at fair value while carrying non-financial assets that are financed by that debt at amortised cost because the result yields non-comparable figures for the debt and non-financial assets. They advocate cost-based accounting for this debt, to achieve consistency and comparability with the accounting for the non-financial assets. The JWG believes that requiring cost-based accounting for debt would not enhance comparability or consistency with non-financial assets financed by that debt. It would only result in a less relevant measure of debt. Fixed coupon debt has a direct and immediate exposure to changes in interest rates, the effects of which are measured by the debt's fair value. On the other hand, any effect of changes in interest rates on the value of non-financial assets generally is indirect and uncertain. Thus the JWG believes that the measure of financial liabilities should not depend on whether they could be considered to be financing non-financial assets carried on a cost basis. In addition, any effort to make that link would necessitate requirements for designation and create other problems similar to those created by hedge accounting.

The Implications of an Enterprise's Credit Risk

4.50 The fair value of debt is its estimated market exit price, which reflects the credit risk inherent in the liability. It would take into account the credit standing of the enterprise that is obligated to pay and any collateral or other security provided. Many question whether an enterprise's credit risk, or changes in its credit risk, should enter into the measurement of its financial liabilities.

Measurement on initial recognition

4.51 When an enterprise incurs an unsecured liability in exchange for cash, the effect of its credit risk is clearly observable. An enterprise with a strong credit standing will receive more cash in return for a promise to pay a fixed amount than an enterprise with a weak credit standing. For example, suppose two enterprises both promise to pay 500 in five years. One enterprise with a strong credit standing can borrow at 6 percent. It would receive about 374. The other enterprise with a weak credit standing must pay 12 percent. It would receive about 284. Each initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates each enterprise's credit standing.

4.52 Few dispute this fair value determination on initial recognition of financial liabilities exchanged for cash. However, liabilities issued in exchange for other consideration, such as non-financial assets or services, have often been measured without recognising any effect for the credit risk of the enterprise obligated to pay. The JWG sees no convincing case for excluding the effects of credit risk from measurement of these financial liabilities. It concludes that the same principles should apply to all financial liabilities without regard to how they arose or the nature of consideration that was received in exchange.

Separation of the liability default option

4.53 The risk that an enterprise will fail to pay its liability has been described as an implicit option on the part of the debtor to "put" its assets to the creditor instead of settling the liability according to its contractual terms. An enterprise would be motivated, or forced, to exercise this option if its future cash generating prospects are poor and the enterprise cannot meet its obligations from its own resources. Theoretically, it would be possible to separate from a liability the value of that implicit "put" option. Separation would result in the liability being valued at the present value of its contracted cash flows discounted at the current basic (risk-free) interest rate. The option could presumably be separately accounted for as an asset of the enterprise, although some might argue for it to be treated as a charge against the equity of the enterprise. Some support separation of the option from the liability on the grounds that it results in measuring the liability at the amount that the enterprise is obligated to pay without any reduction for the market's evaluation of the statistical probability that the enterprise will not meet its obligation.

4.54 The JWG concluded that, while the approach may have some theoretical merit, it would be difficult for users to understand and would introduce complexity and practical computational issues that the JWG believes would outweigh its possible benefits.

Measurement subsequent to initial recognition

4.55 The fair value of a financial liability changes as the market's assessment of the risk it will not be paid changes. This is clearly evident from market prices for traded corporate debt. If a borrower's credit risk improves (deteriorates), the observable market exit price of its traded debt will increase (decrease). Some believe that the change in fair value of liabilities caused by changes in credit risk is not relevant to users of the debtor's financial statements. In their view the results are confusing and counterintuitive. In particular, if an enterprise's credit risk worsens, the fair value of its liabilities declines and the enterprise records a gain. They do not believe that a decline in credit worthiness could be considered to create a gain for an enterprise. Although this is an unfamiliar result, the JWG has concluded that the effect has a sound, explainable economic basis. It reflects the consequences of an important source of changes in economic conditions that affect the financial liabilities. The following considerations support this conclusion.

(a) The recognition of the effect of changes in credit risk on the fair value of an enterprise's liabilities is necessary to reflect the current economic burden of those liabilities. The enterprise's financial position changes as a result of changes in its credit risk if its contracted debt payments are not affected by its credit risk. It is better off if it has outstanding debt that bears a contractual rate of interest that is less than what the market would currently demand. Conversely, it is worse off if it has locked itself into long-term debt at a higher cost than it would now have to pay because its credit rating has improved. The effect on the enterprise is the same whether a change in the interest rates the market would demand is due to a change in the basic interest rate or a change in the enterprise's credit rating.

(b) A change in credit standing results in a change in the relative status of shareholders' and creditors' claims to an enterprise's assets. If the enterprise's credit risk worsens, the fair value of the creditors' claims diminishes. The amount of the shareholders' residual claim may appear to increase as a result, but in most cases an apparent gain from a decline in credit standing will be offset by the effects of losses and asset write-downs that have caused the decline in credit standing (although see paragraph 4.57). Because shareholders usually cannot be called upon to pay an enterprise's liabilities, the amount of their residual claim approaches, and is limited to, zero.

(c) A failure to include the effects of changes in enterprise credit risk in the measurement of its liabilities ignores economic differences between liabilities. Consider the case of an enterprise that has borrowed at two different times. The first borrowing occurred when the enterprise had a strong credit standing and a correspondingly low interest rate. The second occurred later when the enterprise had a lower credit standing. Failure to include credit changes in the enterprise's credit risk makes the two borrowings seem to be different, even though the market place evaluates the quality of their respective cash flows as similar to one another.

4.56 Some have suggested that the effects on the fair value of liabilities of changes in credit risk should not be included in the measures of those liabilities because they reflect changes in the internal conditions of the enterprise, rather than changes in external conditions. The JWG believes that, while the effect may seem unfamiliar, it validly reflects how market participants evaluate the interest rate to be charged on a loan. A debt issuer's credit worthiness is affected by its own operating results, but the effect on the fair value of the debt is externally imposed. It reflects the estimate of the market's evaluation of the enterprise's ability to pay.

4.57 Changes in the credit standing of an enterprise may reflect, in part, changes in its internally generated intangible assets, which are generally not recorded under existing accounting standards. Some believe that there is a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's liabilities, while not reporting potential offsetting effects of changes in unrecognised intangible assets. It is beyond the scope of the JWG project to examine accounting for intangibles. However, the JWG does not believe that what some might regard as a shortcoming in accounting for intangibles should be used to compromise appropriate accounting for financial liabilities.

4.58 If an enterprise is in serious financial difficulties, the fair value of the enterprise's debt may reflect the market's expectation that the enterprise probably will not continue as a going concern. (In other words, the market may evaluate the enterprise on the basis of its expected break up value.) That may create a discontinuity in accounting if the enterprise continues to account for its assets on a going concern assumption while the fair value of liabilities is determined on the expectation that it will not continue as a going concern. The JWG concluded that it was not appropriate to try to adjust the fair value measurement of financial liabilities, or require any special income statement adjustments, in such situations. It reached this conclusion in large part because of practical problems in assessing when these situations should be considered to exist and how to determine appropriate adjustments. However, the JWG believes that disclosures required by the Draft Standard (in particular of contractual terms of financial liabilities and any net gain due to the increase in the credit risk of an enterprise's liabilities) will be useful to users in evaluating the extent of potential going concern uncertainty.

4.59 The JWG considered whether the conceptual merits of including changes in credit risk in measuring financial liabilities could be outweighed by practical difficulties of users understanding the effects. The IASC Discussion Paper[32] suggested that making an exception for fair valuing debt for changes in credit worthiness might not undermine the essential elements of the fair value objective, if it is not a financial risk that can be expected to be actively managed by an enterprise, and if excluding it would not give rise to any measurement mis-matching problems with other financial instruments, or require hedge accounting adjustments. However, the JWG concluded that there would be complexities in removing the effects of changes in credit risk from the observable price of publicly traded debt and in explaining the resulting figures (which would represent neither fair value nor cost). Furthermore, some enterprises manage the credit risk of their debt by utilising derivatives, so that failure to measure the effects on fair value of changes in the credit risk of such debt would result in measurement mis-matches with the fair value of these derivatives.

4.60 In summary, the JWG concluded that a change in the credit risk of an enterprise's financial liabilities constitutes a vital element of their fair value, reflecting significant and relevant economic consequences. It believes that the fair value measurement and disclosure of these effects should have significant information value for users once they become familiar with its measurement basis and implications.

4.61 The Draft Standard would require disclosure of the net gain or loss resulting from changes in the credit risk of an enterprise's interest-bearing liabilities, both in the reporting period and cumulatively, so that users will have the basic information necessary to judge its significance for themselves.

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[32] See sub-paragraph 6.8(d) of IASC, Accounting for Financial Assets and Financial Liabilities, Discussion Paper, March 1997, chapter 5.

4.62 The JWG considered how the estimation of the current credit risk element of financial liabilities might be simplified where there is no observable market exit price for identical instruments. It decided to permit an enterprise to presume that there has been no significant change in the credit risk related to its non-traded financial liabilities unless available information indicates that one or more specified events that are likely to have affected credit risk have occurred (see Application Supplement paragraphs 370-372).

Financial Guarantees of an Enterprise's Financial Liabilities

4.63 Application Supplement paragraphs 373-375 set out and explain the JWG's position on government insurance of deposit liabilities of regulated financial institutions, and how that may be considered to differ from commercial guarantees. The JWG considered whether insurance provided by government, or possibly in some situations by industry sponsored funds, might effectively provide a blanket guarantee of repayment of some other types of liabilities and that, as a result, such insurance should enter into the measurement of the fair value of these liabilities. It concluded, however, that an informed position on this possibility would require study of the facts and circumstances of particular situations, and accordingly the Application Supplement does not address it.

Exception for Certain Private Equity Investments

4.64 The JWG believes that certain private equity investments may not be practicable of reliable fair value estimation, and accordingly the Draft Standard, paragraph 122, provides for an exception. The basis for concluding on the need for this exception is discussed in the context of the JWG's overall evaluation of the reliability of fair value measurement of financial instruments (see in particular paragraphs 1.20-1.21). The Draft Standard would require that certain information be given about these investments so that readers will be in a position to evaluate their overall significance to the enterprise's financial position and results of operations.

4.65 Such an investment is to be reported at its carrying amount at the time that its fair value was determined to be not practicable of reliable estimation or at a lower amount if there is evidence that the full carrying amount cannot be recovered. The Draft Standard does not provide any guidance on how to determine whether such an investment's carrying amount cannot be fully recovered and its lower recoverable amount if this is this case. The JWG believes that such determinations would be made on the basis of existing standards and practice for identifying and accounting for impaired assets carried on a cost basis.[33]

4.66 Some believe that, if there is evidence that the carrying amount of an equity investment to which paragraph 122 applies cannot be fully recovered, it should be required to be written down to zero. They reason that, since fair value is not practicable of reliable estimate, its

[33] See, for example, IAS 36, Impairment of Assets.

recoverable amount on impairment cannot be expected to be reliably measured. However, the JWG concluded that the Draft Standard should not rule out the possibility that an enterprise might be able to ascertain that, for example, the minimum liquidation value of such an investment is an amount that is greater than zero.

4.67 The Draft Standard would require that such recoverable amount not be subsequently adjusted upward, even if there is compelling evidence that a higher amount up to its original carrying amount could be recovered, unless it is determined that it is now practicable to measure the investment at fair value on an ongoing basis. The JWG believes that this requirement is necessary to avoid the possibility of potentially unreliable adjustments.

Establishing Fair Value Estimation Policies and Procedures

4.68 Draft Standard paragraphs 129 and 130 require that an enterprise establish appropriate policies and procedures for estimating the fair value of its financial instruments. Application Supplement paragraph 376 stresses the need for appropriate supervision and control over the fair valuation process. The critical importance of establishing and maintaining a fair value estimation process based on clearly defined policies and procedures is well recognised for investment enterprises (such as mutual funds) that regularly measure their investments on a fair value basis, and regulators have set out some requirements in some jurisdictions.

4.69 Some believe that it is inappropriate and unnecessary for an accounting standard to set out any requirements for the procedures an enterprise should put in place to implement the standard. They point out that an enterprise must, of course, adopt appropriate procedures to be able to properly implement any accounting standard, and that other accounting standards do not contain requirements for such procedures. The JWG believes that it is important to make the requirement for establishing appropriate policies and procedures explicit in the Draft Standard because fair value estimation represents, for many enterprises, a very significant extension beyond policies and procedures generally necessary to support traditional historical cost-based accounting systems. Furthermore, the reliability of fair value measurements of financial instruments will depend significantly in many situations upon the application by enterprises of rigorous fair value estimation processes. The requirement for enterprises to have appropriate policies and procedures in place enables the fair value estimation requirements of the Draft Standard to be based for the most part on principles, rather than detailed rules, and it enables enterprises to have some degree of flexibility in developing and improving their estimation processes. The JWG believes that, ultimately, the cost to establish and maintain appropriate policies and procedures for financial instrument fair value estimation will be exceeded by the benefits because reliable fair value measurement of financial instruments is fundamental to effectively monitoring and managing fair value financial risks within an enterprise.

5. Balance Sheet Presentation

5.1 The JWG's approach to balance sheet presentation has been to specify primary groupings of financial assets and financial liabilities to provide an overall indication of the nature and significance of an enterprise's financial instruments by type.

5.2 Separate presentation of cash and cash equivalents and equity instruments held by an enterprise is commonly required in current best practice. This presentation has been retained.

5.3 The JWG believes that a distinction between straightforward unconditional financial instruments, and conditional and other more complex instruments, is helpful to an understanding of the basic nature of an enterprise's financial instrument positions. Such a distinction provides an initial indication of the certainty of the cash flows from financial instruments, as well as separately presenting those financial instruments whose fair value is dependent upon more highly leveraged risk positions.

5.4 The JWG considered a classification dependent upon whether a financial instrument is a delivery or exchange contract, in accordance with parts (c) and (d), respectively, of the definition of a financial instrument in Draft Standard, paragraph 7. However, the JWG believes that, while this distinction is useful to explain the definition of a financial instrument, it does not provide a clear, useful distinction for balance sheet presentation purposes. Indeed, some financial instruments, such as a swap contract, might fall partly within one classification and partly within another (for example, the next payment on an interest rate swap is an unconditional right of one party and an unconditional obligation of the other party to deliver, but the interest rate swap contract itself is an exchange contract). The JWG decided that it is more useful to distinguish the most straightforward unconditional delivery contracts in one classification, and to group other more complex financial assets or financial liabilities with conditional financial assets and financial liabilities in another classification.

5.5 The JWG considered whether an enterprise should disaggregate the fair value of financial instruments and hybrid contracts that contain more than one type of instrument for balance sheet presentation. Except in a few cases when disaggregation might be necessary to determine fair values, or might be done to manage individual risks in an instrument, enterprises would have no other need to disaggregate such financial instruments. Therefore, the JWG concluded that a requirement to disaggregate would be unduly burdensome and complicated. The Draft Standard instead focuses on requiring disclosures of key information about the significant terms and conditions and risk positions of an enterprise's financial instruments (see paragraphs 164-182).

6. Income Statement Presentation

6.1 The income statement presentation requirements are reasoned from two fundamental conclusions of the JWG.

(a) Changes in the fair value of financial instruments, after adjustment for receipts and payments, represent income that should be recognised in the income statement in the reporting periods in which they arise.[34]

(b) Fair value income from financial instruments should be disaggregated on a basis that facilitates analysis of the income statement effects of the significant financial risks assumed by an enterprise during a reporting period. The JWG believes that this income statement information complements disclosures about the enterprise's financial risk positions (required by Draft Standard paragraphs 170-180) and its financial risk management objectives and policies (required by Draft Standard paragraphs 156-163).

The bases for these conclusions are set out in the following paragraphs.

Fair Value Changes as Income

6.2 There are several dimensions to the assessment of the usefulness of income determined on a fair value basis for financial instruments.

(a) First, there are conceptual and practical considerations relating to (i) the economic (capital maintenance) properties of fair value income and (ii) the cause and effect relationships (of recognising income in the period that the events that gave rise to income took place).

(b) Second, there are practical considerations relating to whether fair value income (i) can help users in predicting the ability of the enterprise to generate cash and cash equivalents in the future, and (ii) can facilitate the stewardship or accountability of management for the resources entrusted to it.[35]

Each of these areas of consideration is addressed under separate headings in the immediately following paragraphs.

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[34] The Draft Standard makes one exception, for foreign currency exchange gains and losses arising in translating financial instruments from functional currencies to the reporting currency. The reasons for this exception are discussed in paragraphs 6.27-6.29.

[35] These are the fundamental purposes commonly cited in accounting conceptual frameworks (see, for example, IASC Framework, paragraphs 14-16).

The Concept of Fair Value Income

6.3 The economic concept of income is founded on the maintenance of an enterprise's capital. Specifically, income is defined as the amount that can be distributed to equity owners of an enterprise while maintaining its capital, after adjustment for owners' contributions and withdrawals. Accounting conceptual frameworks generally accept that this should be the objective for income determination. For example, the IASC Framework states that:

> ... only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. (paragraph 105)

6.4 From a capital market perspective, an increase in the fair value of a financial asset is income in the important sense that it represents the amount that can be distributed to owners while maintaining the value of the capital invested in the financial asset to earn the current market rate of return.[36] In other words, on a fair value basis capital is maintained in terms of the present value of the market's expectation of future cash flows to be generated by the asset discounted at the current available market rate of return adjusted for commensurate risk.

6.5 For example, suppose Company A bought a zero coupon bond of 10,000 due in three years, for which it pays its fair value of 7,938 (which is its present value at an effective annual yield of eight per cent). At the end of one year, this bond would have increased in value to 8,573 if future rates of return for a two-year bond were expected to be eight percent. Suppose the market rate of interest for bonds of this risk changed at the end of year one to ten percent. If Company A recognised a profit of 635 (i.e., 8,573 minus 7,938), it would not have maintained its capital in terms of its ability to earn the current market rate of return because, at 8,573, its investment can expect to earn only eight percent. Rational investors would not accept an eight percent rate of return at the end of year one when ten percent is available in the market place. To maintain its capital in terms of its capacity to earn the rate of return currently available in the market place, Company A would have to write down its investment to the present value of the expected future cash flows at ten percent (which is 8,264)—i.e., to its fair value. Its income for the period could be represented as interest income of 635 (at eight percent, which was the market rate prevailing during the year) less a loss of 309 (8,573 minus 8,264) due to the increase in the market rate of interest at the end of the year.

6.6 Historical cost income for financial instruments does not have this capital maintenance property, because income on a historical cost basis is recognised when it is realised, rather than when economic events change market prices. Thus the cost of a financial asset may be

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[36] It is important to distinguish the measurement of income (as the amount that can be distributed while maintaining the <u>wealth</u> of an enterprise) from considerations relating to whether the additional resources represented by that income should be distributed to shareholders or retained as additional capital of the enterprise. See further discussion of this point in paragraph 6.23.

relied upon to represent the present value of expected cash flows at the rate of return for commensurate risk demanded in the capital market place *only* at the moment when it was acquired or issued.

Reflecting the Effects of Events in the Periods they Occur

6.7 The practical result of recognising income on the basis of fair value rather than cost is that the fair value consequences of events are reflected when those events take place. Recognising the income statement effects of changes in economic conditions when they occur, rather than when they happen to be realised, enables analysis of economic causes (changes in market rates of interest, for example) and their income statement effects.

Basis for Prediction

6.8 A fundamental purpose of financial accounting information is to aid in evaluating the ability of an enterprise to earn income and generate cash flows in the future. For example, the IASC Framework states:

> The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. (paragraph 15).

6.9 Sub-paragraph 1.8(b) of this Basis for Conclusions notes the usefulness of fair value measures of financial instruments for predictive purposes. Some contend that, while fair value balance sheet figures have predictive value, income on a fair value basis has little or no usefulness for predictive purposes. They believe that gains and losses resulting from changes in the fair value of financial instruments are likely to be volatile and non-recurring results of unexpected, and often temporary, fluctuations in market conditions. They conclude that such gains and losses can provide no basis for predictions of future income and cash flows. Some express the concern that such gains and losses may actually serve to inhibit the ability of users to evaluate the sustainable earnings of an enterprise, which is considered to be a primary objective of financial analysis.

6.10 This concern would seem to presume that the objective of reporting income should be to facilitate forecasts of future income and cash flow streams based on simple projections of past periods' reported income. The JWG does not accept this objective as being either desirable or feasible. Certainly, reliable forecasts of the future income statement effects of a financial instrument are unlikely to be possible from simple extrapolations of past gains and losses. The potential implications of past gains and losses for the future are likely to be less direct. Investors and analysts can be expected to want to evaluate past gains and losses in assessing the potential variability of future returns, as well as in assessing future income expectations. As an example, past gain and loss experience on loans is an important input in evaluating future expected cash flows to result from loan assets and the variability (risk) of those cash flows.

6.11 More specifically, the market's expectations for future income to result from an enterprise's investment in a fixed-coupon loan portfolio may be deduced from its fair value and the current market rate of return for loan assets of commensurate risk. This return is subject to significant variability, depending on the potential for changes in the general level of interest rates and in the range of potential default experience. Estimation of this variability would be based in significant part on past experience with interest rates and loan defaults, taking into account current conditions. Models have been developed to utilise statistical data on past experience to aid in this analysis.

6.12 Some have claimed that income determined on a fair value basis is inferior to that determined on the cost basis for predicting future income and cash flows of, in particular, fixed-coupon, loan-type financial instruments. Certainly, the amortised cost basis can enable a reliable prediction of future historical cost interest to result from such instruments, if they are held to maturity and do not default. This predictability results because interest on the amortised cost basis is calculated as the average annual rate inherent in the difference between the acquisition cost and the future contracted cash flows. It is simply "predicting" an accounting allocation that is determined solely by a past transaction. One can easily project future income if it is simply the result of amortising a past cost. Fair value-based income provides a richer basis for prediction, because it reflects the effects of changes in conditions and events occurring during the reporting period. Recognising income effects of changes in economic conditions and events when they occur is essential to analyses of causes and effects that are at the basis of informed predictions.

Accountability for Income Performance

6.13 Recognising gains and losses as income when they occur also facilitates accountability and assessment of management performance because it attributes gains and losses to management in place when such gains and losses occur rather than possibly to a different management team who may realise them later. Fair value income effectively holds management accountable for the income statement effects of its decisions to hold and owe financial assets and liabilities.

Concerns with Respect to Recognising All Fair Value Gains and Losses Immediately in the Income Statement

6.14 The JWG considered the following areas of concern that have been raised with respect to recognising all gains and losses arising from measuring financial assets and liabilities at fair value in the income statement in the periods in which they arise.

Relationship to Accounting for Non-financial Operating Activities

6.15 Some believe that recognising unrealised gains and losses resulting from changes in the fair value of financial instruments in the income statement is inconsistent with the well accepted income recognition principles for accounting for non-financial operating activities. Revenues of a manufacturing activity, for example, are generally not recognised until they are realised as a result of sales transactions. They argue that, until such time, if any, that the accounting standards for manufacturing and other revenue-generating activities are changed to recognise unrealised gains and losses, unrealised gains and losses arising on financial instruments should not be recognised within the income statement. Rather, unrealised gains and losses resulting from changes in the fair value of financial instruments should be presented outside the income statement, to be recognised in the income statement when they are realised.

6.16 The JWG does not accept this view for the following reasons.

(a) Non-financial assets held for use in productive revenue-generating activities give rise to different accounting considerations than those appropriate to financial assets and liabilities (see discussion in paragraphs 2.16-2.19). Further, the JWG does not believe that standards that improve the presentation of income from financial instruments should be precluded until such time, if any, that it might be determined that similar accounting should be adopted for productive revenue-generating activities.

(b) The recognition of unrealised gains and losses on financial instruments is well accepted when the financial instruments are intended for trading purposes. The JWG believes that it *is* inconsistent to recognise unrealised gains and losses on potentially identical financial instruments within or outside the income statement depending on management's intentions to hold or trade those instruments.

Presenting some or all Financial Instrument Gains and Losses outside the Income Statement

6.17 Some believe that certain gains and losses arising upon the fair valuation of financial instruments are of such a different quality or significance that they should be presented outside the income statement (that is, be presented in a separate section of the statement of equity, or in another performance statement). Furthermore, some have expressed concern about the consequences of abruptly changing long established income recognition conventions. They advocate presenting gains and losses that are not consistent with conventional income reporting outside the income statement, with full disclosure so that users can decide for themselves on their relevance to the income of an enterprise in a reporting period.

6.18 The JWG has two general reservations with respect to this recommendation.

(a) It is concerned that presenting some financial instrument gains and losses outside the income statement would obscure the economic significance of fair value income, and thereby diminish its usefulness as a basis for prediction and accountability.

(b) It is far from clear what the "conventional" cost or mixed income model for financial instruments is, and what it represents. The objective of transparency could be met by highlighting particular gains and losses on financial instruments <u>within</u> a single income statement without the complexity, and the potential for confusion, of placing some gains and losses in a separate equity section or performance statement.

6.19 Despite these general reservations, the JWG agrees that it is important to consider practical issues relating to certain types of gains and losses. It considered the following possibilities for the presentation of gains and losses outside the income statement.

(a) All unrealised gains and losses.

(b) Certain unrealised gains and losses.

(c) Gains and losses on financial instruments designated as hedges of existing unrecognised and expected future risk positions.

All Unrealised Gains and Losses

6.20 The conventional cost-realisation model generally does not recognise income until it has been confirmed by realisation as a result of sale or settlement. Some advocate that it would be helpful for users familiar with this model if all unrealised gains and losses on financial instruments were presented outside the income statement. The difficulty with the resulting presentation of income is that realisation is not an event that results in any increase or decrease in the economic value of a financial instrument to the enterprise. The JWG is concerned that recognition of only realised gains and losses in the income statement would perpetuate the shortcomings of the cost basis of accounting for financial instruments. Gains and losses would not be recognised in the income statement in the period that the underlying causal events occurred.

6.21 The JWG recognises that there could be information value in distinguishing realised and unrealised gains and losses, particularly if they trigger tax consequences or indicate something of management's investment strategies. However, these would not seem to be sufficient reasons for excluding unrealised gains and losses from the income statement. Consideration of disclosing the amounts of realised and unrealised gains and losses recognised in the income statement is discussed in paragraph 6.44.

6.22 Presentation of unrealised gains and losses outside the income statement has also been advocated on the grounds of alleviating the potential for unrepresentative volatility in reported income. The JWG believes that the volatility of changes in the fair value of financial instruments is unrepresentative only if fair value estimates are not reliable, that is, do not reasonably reflect market-equivalent value at a measurement date. (Considerations relating to presenting unrealised gains and losses resulting from subjective fair value estimates are addressed in paragraph 6.25.) Otherwise, where reliability is not a consideration, how is one to judge whether a change in fair value is unrepresentative, for example, whether a change in a quoted market price is not representative of the real economics of the situation? What decision basis can be used for second guessing the market and judging which gains and losses are real and will be sustained, and which are not? The JWG believes that recognition on the basis of realisation of gains and losses is a less appropriate basis, because it replaces the market's unbiased measure of the effects of economic events with management's timing of realisation, which timing has no necessary relationship to any income earning activity or events.

6.23 The JWG understands that the concerns of many about the potential volatility of fair value income are concerns about risk—concerns that unrealised gains recognised in the income statement in one period may reverse to become losses in future periods. A possible response to this concern may be for an enterprise to set aside an amount to be held as capital as a buffer against risk, rather than modifying the recognition of income for financial instruments. Various models for quantifying the market risk of financial instruments now exist, and a number of regulators of financial institutions are actively considering whether certain of these models may be helpful in determining minimum capital requirements for these institutions.

Certain Unrealised Gains and Losses

6.24 Few now believe that *all* unrealised gains and losses on financial instruments should be excluded from the income statement. Most enterprises would recognise unrealised gains and losses on trading activities in the income statement, but they would exclude unrealised gains and losses on financial instruments that are intended to be held for the long-term. The JWG accepts that it may be useful to distinguish the income statement results of trading and non-trading financial activities, especially where the two activities are managed with different strategies by different managers in separate segments. It does not believe, however, that this warrants different measurement bases or presenting unrealised gains and losses of non-trading activities outside the income statement.

Distinguish Gains and Losses Where Fair Value Estimates Are Highly Subjective

6.25 Some advocate that unrealised gains and losses on financial instruments should be separately presented outside the income statement where fair value is subject to significant estimation variability, until they are realised or until the estimation uncertainty has been resolved. Some believe that unrealised gains and losses that are subject to significant measurement uncertainty should be amortised to the income statement over some period of time, as are, generally, "experience gains and losses" arising on estimates of defined benefit employee benefit plan obligations in employer financial statements. The JWG believes that issues of reliability are appropriately addressed in relation to measurement on the balance sheet, and that there need be no additional tests for the income statement recognition of gains and losses.

Gains and Losses on Financial Instruments Held for Hedging Purposes

6.26 Many believe that gains and losses on financial instruments held as hedges of items that are not recognised or measured at fair value on the balance sheet, or as hedges of future transactions, should be deferred on the balance sheet or separately presented outside the income statement, possibly to be transferred to the income statement as the hedged items are presented in the income statement. The JWG has given separate, extended consideration to these issues (see paragraphs 7.17-7.20 of this Basis for Conclusions).

Exemption of Certain Foreign Currency Translation Gains and Losses

6.27 The Draft Standard, paragraph 136, makes one exception to the requirement for the recognition of all gains and losses on financial instruments in the income statement when they arise. Accounting standards and accepted practices in most of the world require that gains and losses arising on translating assets and liabilities of certain foreign operations from their functional currencies to the reporting currency be presented outside the income statement. The exclusion of these gains and losses from the income statement is premised on the assumption that an enterprise is exposed to foreign currency risk in respect of changes in exchange rates with the functional currencies of the foreign operations, rather than with the reporting currency of the enterprise.

6.28 Despite certain reservations on this point, the JWG has concluded that an exemption is necessary pending a comprehensive reconsideration of accounting for the translation of the assets and liabilities of foreign operations. The JWG's conclusion is based on its understanding that an amendment to foreign currency translation standards to require all translation gains and losses on financial instruments to be recognised in the income statement would necessitate a fundamental revision of these standards, and that this, in turn, would require reconsideration of underlying principles for foreign currency translation that go beyond accounting for financial instruments.

6.29 The Draft Standard would require enterprises to disclose the amount of any net exchange gain or loss on financial instruments that has been presented outside the income statement, so that the effect of this exception will be transparent.

Disaggregation of Fair Value Income

The Need for Fair Value Income Disaggregation

6.30 The first question is whether there is any need for disaggregating changes in the fair value of financial instruments at all. The JWG believes that a one-line presentation of changes in fair value of financial instruments is not sufficient—and that the information value of the reported fair value income of an enterprise can be much enhanced by reporting the significant types of revenue, expense, gains and losses that make up that income.

6.31 Having arrived at this conclusion, the JWG then considered whether particular income presentation information should be required by the Draft Standard, or whether this might be left to the discretion of reporting enterprises. The JWG concluded that the Draft Standard should specify certain items to be presented and, in some cases, the methods for their determination, so as to improve the relevance and comparability of fair value income information.

JWG Approach

6.32 There are many possibilities for presenting items within an income statement. These include reporting by activity centres or functions, by types of financial instruments, by types of financial risks, by realised and unrealised income, by distinguishing expected from unexpected income, unusual from non-recurring income, and sustainable from non-sustainable income. The classification possibilities overlap in some respects, and a number of them present difficulties because their bases for distinction are necessarily highly subjective.

6.33 In order to identify and assess possibilities, the JWG:

(a) looked to existing financial income presentation standards, and how they have been evolving to meet perceived user needs and expectations in light of developments in capital markets, and in financial risk management and investment practices;

(b) examined the implications of the fair value model itself and the extent to which the income statement presentation standards can be reasoned from fair value concepts and principles that can be discerned from the rational information needs of financial capital markets; and

(c) considered practical issues of computation involved in determining fair value income breakdowns.

Existing Standards

6.34 Accounting standards typically require the disclosure of certain revenue and expense items, and the distinction of income or loss from unusual, “extraordinary”, and discontinued operations. However, beyond this, income statement presentation standards have generally avoided being narrowly prescriptive and have permitted considerable flexibility of presentation.

6.35 Most accounting standards require disclosure of interest revenue and interest expense (determined on an historical cost “effective interest” basis) and other income from investments, and some disclosures about losses from loan assets that are considered to be impaired. In addition, several standards require some information on the income statement effects of financial instruments used in designated hedging relationships.

6.36 In recent years, some standards have been developed for disclosure of certain of an enterprise's financial risk exposures at the reporting date, and its financial risk management purposes, policies and strategies, including policies for hedging major types of anticipated future transactions. These disclosures have resulted from concerns of users to better understand an enterprise's exposure to financial risks, how they are managed, and the performance of an enterprise in managing these financial risks. Today's standards for disclosure of financial risks and the income statement effects provide an incomplete picture, however. For example, IAS 32 and IAS 39 require information related to interest and credit risk exposures, but nothing on foreign currency, commodity and other market risks.

Implications of the Fair Value Model and Financial Markets

6.37 One of the major advantages of fair value income for financial instruments is that it directly reflects gains and losses from assuming particular financial risks (including interest rate risk, credit risk, risks of changes in commodity and equity instrument prices, and currency exchange risks) when the underlying market conditions change. The JWG believes that it follows from this that a primary objective of the income statement presentation for financial instruments should be to provide information about the gains and losses for each of the significant financial risks that is inherent in an enterprise's financial activities.

Computational Issues

6.38 The disaggregation of fair value income on a basis that facilitates analysis of each significant financial risk inherent in an enterprise's financial activities gives rise to a number of issues that have not previously been addressed in accounting literature. These issues arise because the fair value model for financial instruments is reasoned in part from concepts outside conventional accounting—in particular, from finance and capital markets pricing theories and practices. Furthermore, there are questions relating to whether it is possible to reasonably allocate fair value income effects by types of risk where these effects are the joint result of changes in underlying conditions. For example, calculations of gains and losses resulting from changes in basic interest rates and credit risk are affected by the order in which the calculations are performed when changes in underlying conditions are interdependent or occur more or less simultaneously during a reporting period.

6.39 Based on its work, the JWG does not believe that these problems are insurmountable. It observes, for example, that enterprises commonly manage basic interest, credit, foreign exchange, and specific commodity and equity price risks separately, and may, therefore, be expected to have reasonable bases for assessing the income statement results of assuming these risks. However, the JWG believes it is important not to place too great a burden on enterprises by requiring detailed breakdowns of gains and losses by specific types of risk at this time, pending further study of alternatives, and a period to enable field testing and experience with the application of less detailed requirements.

6.40 The Draft Standard tries to strike a reasonable balance in prescribing items of income and bases of calculation where they can be derived from accepted accounting or finance concepts or capital market practices, and allowing an enterprise some flexibility to choose approaches that are consistent with the ways in which it is managing risks where no one approach is demonstrably superior.

6.41 The Draft Standard also provides for approximations and simplifying assumptions with respect to certain calculations (notably in respect of interest and foreign exchange calculations). At the same time it encourages enterprises to develop more sophisticated methodologies and presentations that are consistent with the required standards.

Other Possible Bases of Income Statement Presentation

6.42 The JWG considered a number of other possible bases of income statement presentation, and reached the general conclusions in paragraphs 6.43-6.45, below.

Trading and Non-trading Classification

6.43 The JWG considered whether enterprises should be required to distinguish between financial income (and financial assets and liabilities) of its trading and long-term financial investment and financing activities. It concluded not to put in place any specific requirements in this regard. However, it notes that such activities could require separate disclosure under segment disclosure standards in some jurisdictions if they are managed as separate business segments. It may also be necessary to provide some separate information on trading and long-term investment portfolios if they are subject to different management objectives and policies (see Draft Standard, paragraphs 156-159).

Unrealised Gains and Losses

6.44 The JWG accepts that the disclosure of unrealised gains and losses on financial instruments may be useful supplementary information. It concluded that this disclosure should not be required, but left optional, because it is not fundamental to the analysis of fair value income.

Operating, Financing, Investing Classification

6.45 The JWG considered whether the Draft Standard should set out requirements or guidance for the presentation of items of financial income under "operating", "financing", "investing" or other headings within the income statement. Some believe, for example, that all revenue, expense, gains and losses from financial instruments should be presented outside the “operating income” section of the income statement, at least for an organisation that is not a financial institution. The JWG believes it is not appropriate at this time for it to dictate how an enterprise should present items of financial instrument income within the income statement.[37]

Interest Revenue and Expense

6.46 Accounting standards in most jurisdictions require disclosure of interest income or revenue and interest expense. Interest is considered to represent a distinct source of revenue and expense. The JWG agrees that interest revenue and expense should be separately disclosed.

6.47 While the general concept of interest is well recognised, the term is not precisely defined in accounting standards or supporting literature. In order to determine "interest" on a consistent and relevant basis a clear definition is needed. The development of the definition provided in the Draft Standard required that two fundamental issues be addressed: (i) What are the appropriate elements to be included in an interest rate? (ii) What should be considered to be interest-bearing financial instruments on which interest should be determined?

Elements of an Interest Rate

6.48 Paragraphs 347-354 of the Application Supplement discuss the relationship between discount rates and projected cash flows in present value determinations. They compare the discount rate adjustment and cash flow adjustment approaches. The Draft Standard does not prescribe whether or when either basis (or a basis that has elements of both) should be used in a present value model for estimating fair value. Properly applied, they will arrive at the same estimate of fair value. The two approaches, however, will result in very different determinations of interest revenue and interest expense.

6.49 The JWG believes that one concept of interest revenue and expense should be specified in the Draft Standard to facilitate comparability. The Draft Standard specifies a definition of interest revenue and expense that is generally consistent with the discount rate adjustment approach. This approach is also consistent with how interest is defined in practice, and in the market place, where interest rates are usually quoted in terms of rates that equate contracted cash flows with fair values.

What Are "Interest-bearing Financial Instruments”?

6.50 Traditionally, interest revenue and expense have been determined and disclosed with respect to all forms of loans, and bond and mortgage securities, that is, where cash has been loaned in return for a contractual promise to pay. However, there is no clear definition of interest-bearing financial instruments in authoritative accounting literature. There are some

[37] A number of accounting standard setters have been considering issues of reporting financial performance. See, G4+1 Position Paper: Reporting Financial Performance, August 1999. The IASC has established a Steering Committee to consider the issues.

significant questions with respect, for example, to whether some or all forms of derivative financial instruments should be considered to be interest bearing. These questions have not been given significant consideration in accounting literature to date.

Derivative financial instruments

6.51 On the one hand, derivative financial instruments may be considered to be interest bearing, because they comprise contractual rights and obligations to deliver or exchange financial instruments in future periods, and their fair values can be expected to be affected by the time value of money. It may be claimed, then, that an interest revenue or expense figure will be incomplete if it does not include the time-value-of-money income effect on the fair value balances of derivatives during a reporting period.

6.52 On the other hand, "interest" (time value of money) effects in respect of certain types of derivatives would seem to have a rather indirect and complex relationship to their fair values. For example, the time value of money effects on the fair value of an option that can be exercised at any time during its life will depend in some part on the value of its volatility and the ability of the holder to delay payment of the exercise price, rather than being a direct function of the market interest rate accruing on its fair value. It may also be questioned whether a derivative should be considered to be interest bearing if its underlying variable is not based on interest rates, particularly if it is based on a variable that is tied to some measure of an equity or similar return.

6.53 The JWG has not been able to resolve these questions to its satisfaction. The JWG considered whether interest should be required to be determined on the fair value balances of all derivatives, except those based on equity instruments, without specifying the basis for determination—or whether enterprises might be allowed to determine for themselves whether derivatives should be included and, if so, on what basis. It was concerned that these alternatives could be too burdensome and lead to inconsistencies between enterprises. It concluded that, pending further study of defensible conceptual and practical bases for inclusion of some or all derivatives as interest-bearing financial instruments, all derivatives should be excluded from the definition of interest-bearing financial instruments. The JWG believes that, while the resulting definition of interest-bearing financial instruments is not complete, (a) it will capture the large proportion of the interest generating base for the large majority of enterprises, and (b) it avoids the additional complexities and potential for differences in calculating interest.

6.54 The fair value of certain derivative financial instruments, such as interest rate swaps and forward contracts, is a direct function of changes in interest rates. For the reasons noted above, no interest is to be accrued on these fair value balances under the Draft Standard definition of interest-bearing financial instruments. Rather, the full income effect of changes in the fair value of such derivative financial instruments (that is, derivative financial instruments with underlying variables that are based on interest rates or credit risk) is to be presented together with the amount of the net gain or loss arising from interest-bearing financial instruments (see sub-paragraph 137(e)).

Income statement information on impaired loans

6.55 Some believe that impaired loan assets are not interest-bearing financial instruments, and that the discount accrual effect should be considered to be part of the net gain or loss on impaired loans in a reporting period. The JWG believes that whether a financial instrument is interest-bearing should be determined by the nature of the financial instrument contract, not by its performing or impaired status. Further, the JWG believes that useful information is provided in determining gains and losses on impaired loans after the determination of interest accruing on those loans. The Draft Standard would require separate disclosure of interest revenue on impaired loans, as well as the net gain or loss on impaired loans after interest, so as to enable users to determine the net income statement effect of impaired loans in the reporting period.

Trading portfolios

6.56 Some believe that interest-bearing financial instruments that are held in a trading portfolio should be excluded in determining interest. They note that many enterprises have separate trading and long-term portfolios of financial assets, which are typically managed by different departments on different bases with different objectives. Some believe that the distinction of interest revenue and interest expense is not relevant to the management of a trading portfolio, and that its distinction would require complex computations and costly record keeping for little benefit. Others believe that an enterprise should be accountable for the income statement effects of changes in basic interest rates whether or not an interest-bearing asset or liability is designated by management for trading purposes. They also note that an enterprise must determine interest on an interest-bearing instrument on an appropriate basis in order to be able to compute gains and losses that have resulted from changes in interest rates, that is, to be able to evaluate the income statement results of taking basic interest rate risks. The JWG agrees with this latter view—that interest revenue and expense should be defined to include interest on all interest-bearing instruments including those designated as trading.

6.57 The JWG recognises concerns that the bookkeeping costs to calculate interest on interest-bearing financial instruments that are turning over on a short-term basis could be onerous. Accordingly, the Application Supplement provides for approximate calculations based, for example, on average fair value quarterly balances. The JWG believes that such calculations should generally be practicable and enable determinations that will be sufficiently reliable for financial reporting purposes (see paragraphs 386-389).

Determining Interest Revenue and Interest Expense within a Fair Value Model

The historical cost method

6.58 Some believe that interest on interest-bearing financial instruments measured at fair value should continue to be determined on the historical cost "effective interest" basis. They point out that this basis is familiar to users. It may also be claimed that this method has important information value because it reflects the contracted interest rate inherent in an interest-bearing financial instrument. Further, some express concern that requiring a "fair value" determination of interest would be confusing.

6.59 While the historical cost "effective interest" basis is well accepted, it is within the context of the historical cost rather than fair value measurement model. It is not an appropriate basis for determining interest revenue and interest expense within the fair value model. Using the historical cost "effective interest" method to determine interest when the interest-bearing assets and liabilities are measured at fair value would result in misrepresenting the current economic interest return/cost and is not compatible with fair value measurement. The effect would be to distort the reported amounts of gains and losses resulting from changes in market interest rates. This, in turn, would seriously detract from the information value of fair value income figures for prediction and accountability purposes. The basis for the JWG's conclusion may be illustrated by a simple example:

Suppose an enterprise pays 1,000 for a three-year bond with fixed coupon payments to yield an average annual 10 percent rate of return. Its contracted cash flows would therefore be as follows:

	Year ends			
	0	1	2	3
Contracted future cash flows		100	100	1,100
Fair value (present value at 10%)	1,000			

6.60 Suppose that at the end of year 1, the interest rate on two-year money changes to 8%, so that the bond now has a fair value (present value of contracted cash flows discounted at 8 percent) of 1,035.67. Thus there would be a reported gain of 35.67. For simplicity, assume that the yield curve is flat, and that the market rate of interest at the end of year 2 is still 8 percent. The disaggregation of income on this loan using the historical cost effective interest method would be as follows:

	Years 1	2	3
Historical cost interest income (at 10%)	100.00	100.00	100.00
Gains (losses)	35.67	(17.15)	(18.52)
Aggregate income return	135.67	82.85	81.48

6.61 The above calculation makes it appear as though the enterprise has incurred losses on a fair value basis in years 2 and 3, offsetting the gain in year 1. If these losses were expected at the end of year 1, should there not have been an impairment write down offsetting the gain? This strange looking result is the product of continuing to show historical cost interest income at 10 percent of historical cost balances in years 2 and 3, when the current economic interest rate determined on a fair value basis is 8 percent. If there has been no change in the 8 percent rate through years 2 and 3, there should be no gain or loss reported on a fair value basis in those years.

6.62 The disaggregation of income with interest measured on a fair value basis in this situation would be as follows:

	Years 1	2	3
Fair value interest income	100.00 (10%)	82.85 (8%)	81.48 (8%)
Gain	35.67	0	0
Aggregate income return	135.67	82.85	81.48

6.63 Some are also critical of the historical cost effective interest method because it is based on the assumption that there is no yield curve, or that the yield curve is flat—because the method reflects the average rate for each period. Thus, it may be said that the historical cost effective interest method misstates even historical cost interest on a period by period basis over the term of a loan.

6.64 Some may wish to provide supplementary information on the historical cost effective interest rates (which some refer to as the “contracted rates”), and perhaps the amortised cost of interest-bearing instruments at the end of the reporting period. Some may also wish to disclose historical cost interest revenue and expense, particularly where such historical cost determinations comprise the basis for determining interest rate coverage or compliance with provisions of bond indentures, etc. The JWG accepts that such disclosures may be useful in some situations. However, the above example demonstrates that historical cost based calculations should <u>not</u> be used in disaggregating fair value change figures.

The computation of fair value interest

6.65 At any point in time market interest rates are represented by a term structure, or "yield curve", that indicates the current spot rates of interest for increasing terms. The interest rates along the yield curve change as economic conditions, government policies and market expectations as to future conditions (in particular inflation) change. Usually, but not always, the yield curve will be upward sloping, that is, rates increase as term is lengthened so that the market demands a higher rate of interest the longer the term of a loan. There are fundamental questions with respect to whether or how the yield curve should be factored into the determination of interest revenue and expense. These questions have not been addressed by accounting standard setters to date, and there is little accounting literature on the subject. The JWG has given consideration to finance theories of interest in identifying and assessing alternatives for the determination of fair value interest.

6.66 Some may favour the "liquidity preference" interpretation. It presumes that the yield curve represents the greater risk of longer term loans, and that the market generally requires a higher rate of interest to commit money for a long term than it does for a short term. Under the liquidity preference assumption the interest revenue and expense for a period would be based on the prevailing rate for the final year of an interest-bearing financial asset or liability, and the rate would be expected to reduce (assuming a rising yield curve) as the remaining term to its maturity reduces. This method might be favoured because it may be reasoned that it factually represents the effects of changes in rates along the yield curve. If rates along the yield curve do not change during a period, no gain or loss will be reported. A criticism of this method is that the market prices financial instruments on the expectation that interest rates will change, which is the "market expectations" assumption.

6.67 Some may favour the "market expectations" interpretation, which presumes that the yield curve reflects expected future period interest rates. To illustrate, it would be assumed that the existing two-year and three-year rates at the beginning of year one will be the one-year and two-year rates at the end of year one. A primary reason for a rising yield curve within the market expectations assumption may be that the market expects that the rate of inflation will increase over future periods. The effect of using this assumption is that interest revenue and expense for a period would be based on the short-term rate prevailing during the reporting period, regardless of whether the remaining term of an interest-bearing financial asset or liability is one or twenty years. Some may not believe that this result is a reasonable reflection of the effect of the term of a loan on its interest rate. However, forward interest contracts and interest swaps are priced and traded in the market place on the basis of the market expectations assumption.

6.68 Alternatively, it might be expected that, at different times, the yield curve reflects different mixes of these two effects, or some other effects. Thus some may believe that fair value interest should be determined on a basis that yields results between those resulting from the liquidity preference and market expectations assumptions.

6.69 The Draft Standard would require that fair value interest be determined on the current yield to maturity method—with the exception that it allows an enterprise to elect to use the market expectations basis 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.

6.70 The current yield to maturity basis is the fair value equivalent of the historical cost effective interest method. This method largely overcomes the major problem with the historical cost method illustrated in paragraphs 6.58-6.64 above. However, as with the historical cost method, it ignores the effects of a rising or falling yield curve. As a consequence, as the term to maturity of an interest-bearing financial instrument reduces, the current yield to maturity can be expected to change (as it reflects a different average rate for the reduced term) even if there has been no change in the rates along the yield curve. Nevertheless, this method is a substantial improvement over the historical cost method within a fair value measurement system, and the JWG believes that it will provide a reasonable determination of fair value interest revenue and expense in most circumstances.

6.71 However, the JWG concluded that some flexibility should be permitted at this stage of the development of fair value interest determinations. It concluded that the market expectations basis should be permitted on the conditions set out in the Draft Standard because it is the only method that can claim to be fully consistent with the objective of measuring fair value and its income effects against market expectations.

Computational issues

6.72 The JWG is concerned that the determination of fair value interest, and gains and losses relating to changes in market interest rates, not be unduly complex and costly to determine on an ongoing basis. The Application Supplement provides for approximations based on accruing interest on average quarterly fair value balances of groups of similar interest-bearing financial instruments, adjusted where major transactions or changes in market rates have taken place near the beginning or end of a quarter. The JWG believes that the effectiveness and practicality of such approximate calculations can only be thoroughly evaluated on the basis of experience and field tests.

The information value and difficulties of determining interest on a fair value basis

6.73 Some are not convinced that interest determined on a fair value basis is of sufficient conceptual and practical merit to warrant it being required by the Draft Standard. Some believe that "fair value interest" is of doubtful relevance. Some argue that the uncertainties and unresolved issues relating to its basis of determination (discussed in paragraphs 6.65-6.72) and to defining "interest-bearing financial instruments" (discussed in paragraphs 6.50-6.57) may nullify any usefulness that it might have. Further, some believe that the complexity and cost of the computations necessary to determine fair value interest with an acceptable degree of precision are likely to exceed possible benefits.

6.74 The determination of interest on a fair value basis is, as noted earlier, a new concept for financial reporting that has not been seriously examined or tested before. The JWG has considered the conceptual and practical difficulties and uncertainties relating to its determination. The Draft Standard provides that a degree of flexibility and approximation be permitted in its calculation, pending further study and experience.

6.75 The JWG is concerned that, if no requirement for the presentation of fair value interest is put in place, a significant source of information about interest and gains and losses would be missing, and there would be no basis from which to develop knowledge and experience on its usefulness and on the conceptual and practical calculation issues. It concludes that, although imperfect, the interest revenue and expense determinations required in the Draft Standard should provide a basis for analysis that is superior to (a) no requirement (which could result in no information, or information on possibly widely different bases), or (b) historical cost interest (which, as demonstrated in paragraphs 6.58-6.64, is not appropriate within a fair value model). Many enterprises and investors believe it important to manage fair value interest rate risk, and in order to do so they must develop reasonable bases for determining the gain or loss effects of changes in interest rates in order to be able to assess the effectiveness of their management efforts.

6.76 The JWG believes that fair value interest is important and that it is also important that the JWG's proposals for its computation, and possibly other alternatives, be extensively field tested to enable a full assessment of its usefulness and practicality.

Application of Fair Value Interest Determinations in Some Countries

6.77 In some countries there may be no readily observable basic ("risk-free") interest rate, because government bonds may carry a significant credit risk. Some enterprises in these countries may have better credit standings than the government, and thus be able to command a lower borrowing rate than can the government. In such a case, government borrowing rates may not provide a useful, stable benchmark. Nevertheless, interest is still comprised of the elements set out in the Draft Standard definition of "interest revenue (expense)"—that is, the basic interest rate, a credit rate premium, and any premiums for liquidity risk and risks of adverse variability of expected cash flows apart from credit risk. Fair value interest is still determined by equating the contracted cash flows of an interest-bearing financial asset or liability with its fair value. The problem is that there may be no observable market rate of basic interest for enterprises reporting in that currency. Sub-paragraph 346(a) of the Application Supplement provides that in such a case observable market interest rates for the highest rated corporate bonds issued in the currency may be used as the benchmark rate.

Disclosure of the Fair Value Effects of Changes in the Issuer's Credit Risk on Financial Liabilities.

6.78 The amounts required to be disclosed by the Draft Standard (sub-paragraph 137(d) and paragraph 138) combine the income effects of (a) changes in the credit risk of an enterprise's financial liabilities with (b) changes in market credit risk spreads. Some believe that the disclosure should be in respect of (a) alone because it is only these effects that are relevant to users (see paragraphs 4.50-4.62). However, the JWG believes that the determination of (a) alone would be unduly burdensome and open to additional measurement variability. It believes that the amounts to be disclosed by the Draft Standard, along with the required supporting qualitative information (paragraphs 141-142), provides sufficient basic information.

Net Gain or Loss Resulting from Changes in Interest Rates

6.79 The Draft Standard (sub-paragraph 137(e)) would require disclosure of a gain or loss that will largely reflect the effect of changes in market interest rates (that is, the net gain or loss arising from changes in basic interest rates and from changes in the credit risk premiums of financial assets). This gain or loss includes the total income effect of derivative financial instruments with underlying variables that are based on interest rates or credit risk. This amount will therefore include a (usually small) interest revenue or expense element because, as explained in paragraphs 6.51-6.54, the JWG does not believe it practicable at this time to require interest to be determined on derivative financial instruments.

6.80 The Draft Standard (paragraphs 143-144) would require only disclosure of narrative information identifying the significant factors that contributed to this net gain or loss. The JWG believes that it would be desirable for there to be separate disclosure of the income effect of changes in credit quality and basic interest rates. However, it believes that these amounts should not be required at this time because it is concerned that there are unresolved questions relating to their cost-effective calculation. It believes that the usefulness and practicality of extending the disclosures provided for in the Draft Standard may be best addressed after a period of experience with these disclosures.

Net Gain or Loss on Impaired Loans

6.81 Some advocate requiring more detailed information about gains and losses on impaired loans. This might include the nature and amount of impairment losses and, separately, reversal of losses, recognised in the reporting period, for each significant class of financial assets. The JWG believes that such additional disclosures may provide useful information, but they are not essential to a basic understanding of an enterprise's income results in most situations. There may be merit in developing requirements for enterprises with extensive lending activities to provide additional information.

Foreign Currency Denominated Financial Instruments

6.82 The only income disclosure required in respect of foreign currency-denominated financial instruments is the net gain or loss on those instruments due to changes in exchange rates in the reporting period (with separate disclosure of any amount presented outside the income statement) (see paragraph 148). Some believe that there should also be disclosure of the income effects of foreign currency-denominated financial instruments on the amounts reported for interest revenue and expense, gains and losses on interest-bearing financial instruments, and gains and losses on other financial instruments. They point out that the disclosure of the net gain or loss on foreign currency-denominated financial instruments resulting from changes in exchange rates has limited information value in itself, because this amount is likely to have a high degree of interdependency with these other income statement effects. For example, an enterprise may achieve a higher interest return on a foreign currency-denominated bond investment than could be achieved on a domestic bond of equivalent risk, but incur a significant exchange loss on that bond. The JWG agrees that this additional information would be useful. However, it concluded that it would be difficult and costly for enterprises to calculate and provide it, and that disclosure of information about foreign currency risk positions (required by paragraph 171 of the Draft Standard) would provide improved bases for assessing these risks and their income implications. It believes that the possibility of expanding required disclosures of the income effects of foreign currency denominated financial instruments may warrant consideration in future based on experience with the required disclosures and inputs from financial statement users.

6.83 Moreover, a fully informative basis for analysis would require that the net gain or loss due to changes in exchange rates be presented for each currency in which the enterprise has significant transactions or exposure. For similar reasons to those noted above, the JWG concluded that this extent of detail should not be required, but that it is sufficient to require only the net gain or loss in a period for all currencies taken together, along with some information about the primary currencies involved.

6.84 Some have advocated determining interest revenue and expense of foreign currency-denominated interest-bearing instruments on the basis of the market rates of interest in the reporting currency jurisdiction, on the grounds that forward exchange contract prices imply the expectation that any interest differential between the reporting currency and the foreign currency will be offset by an exchange gain or loss. In other words, a foreign currency exchange gain or loss is expected if it is implicit in the forward exchange rate at the beginning of a reporting period, since the forward rate reflects the current spot rate adjusted for the difference between interest rates in the domestic and foreign jurisdictions. The argument is that it follows from this that an expected gain or loss implicit in the forward rate should be treated as an adjustment of the interest return on an interest-bearing instrument denominated in a foreign currency. The JWG believes that the fuller presentation is to reflect fair value interest return on the basis of the prevailing rates of interest in the foreign jurisdiction, and disclose the foreign currency gain or loss.

Statement of Cash Flows

6.85 The JWG concluded that no changes are necessary to existing standards for the presentation of the statement of cash flows to accommodate a fair value model for financial instruments.

6.86 The JWG notes, however, that some have raised questions with respect to the appropriate allocation of cash receipts and payments on interest-bearing financial instruments between principal and interest for the purposes of distinguishing cash flows from operating, investing and financing activities in the statement of cash flows. Standards in most jurisdictions provide no guidance on making this allocation. The JWG believes that any guidance to be provided on this matter should give consideration to the context of the fair value representation of interest and principal. It further suggests that consideration be given to revising standards for the presentation of the statement of cash flows to require that the full amount of such receipts and payments be presented as investing or financing activities as appropriate, with no allocation of an interest portion to operating activities. However, the JWG recognises that such a change would require consideration of principles for the presentation of cash flows that are beyond those necessary to accommodate the implementation of the Draft Standard on accounting for financial instruments.

7. Hedges

Introduction

7.1 An enterprise may use financial instruments in managing existing or anticipated future risks. Enterprises have commonly employed various forms of hedge accounting, that is accounting that alters the normal recognition, measurement or income statement presentation of designated hedging instruments or hedged items so that gains and losses on the hedging instruments are recognised in the income statement in the same period(s) as the hedged items enter into the determination of income. The Draft Standard does not permit special accounting for financial instruments that are hedging instruments or hedged items.

7.2 The preclusion of hedge accounting for financial instruments follows from two fundamental principles of the Draft Standard (a) the measurement of financial instruments at fair value, and (b) the recognition of resulting gains and losses in the income statement in the reporting period(s) in which they arise. The JWG has given extensive consideration to whether any exceptions to these principles may be justified on conceptual or practical grounds, so as to provide for some form of hedge accounting for certain hedging relationships involving financial instruments. Its conclusion, that no exceptions should be made, is explained in the following paragraphs.

The Demand for Hedge Accounting

7.3 Hedge accounting practices have developed to address two types of situations.

(a) Where accounting inconsistencies exist, so that existing risk exposures in respect of like assets and liabilities are not recognised and measured on the same basis—with the consequence that counterbalancing gains and losses on the hedging instrument and on the hedged item are recognised in the income statement in different periods. The objective of hedge accounting is to correct this inconsistent income reporting.

(b) Where an enterprise acquires a financial instrument with the purpose of hedging the variability of future cash flows that are expected to arise in a future transaction. In these situations hedge accounting involves deferring gains and losses on the hedging instrument to be treated as credits or charges to income in the future period(s) in which the hedged transaction is recognised in the income statement.

Hedge Accounting to Correct Accounting Inconsistencies

7.4 Accounting inconsistencies are of two types. *Recognition inconsistencies* arise when some assets and liabilities that are subject to financial risks are recognised in the balance sheet while others are not. *Measurement inconsistencies* arise when assets and liabilities that are subject to financial risks are measured on different bases. In both cases gains and losses on counterbalancing risk positions are recognised in the income statement in different accounting periods. For example, an enterprise may enter into a fixed-to-floating interest rate swap to manage the interest rate exposure of its fixed coupon debt. If the swap is accounted for on a fair value basis and the debt on an amortised cost basis, an accounting inconsistency arises, because changes in market rates of interest would give rise to gains or losses on the swap that would be recognised immediately in the income statement, while there would be no recognition of the reciprocal losses or gains on the debt.

Implications of fair value model

7.5 Accounting for all financial assets and financial liabilities at fair value, with changes in fair value recognised immediately in the income statement, eliminates three major sources of demand for hedge accounting to correct for accounting inconsistencies.

(a) There is no need for hedge accounting where an existing financial instrument is used to manage risks arising from other financial instruments. In the example in the preceding paragraph, there is no need for "fair value" hedge accounting for the debt that is hedged by the fixed-to-floating swap,[38] because both the hedge and the hedged item are accounted for at fair value with counterbalancing gains and losses recognised immediately in the income statement.

(b) There is no need or justification for hedge accounting for gains and losses on hedges of anticipated future transactions to acquire assets or issue liabilities that will be measured on a fair value basis.

> Example: On December 1, 2000, Company X anticipates that it will issue debt of 1,000,000 on March 31, 2001. Suppose it enters into a forward contract on December 1, 2000 to sell a bond for 1,000,000 on March 31, 2001, with the objective of hedging the risk that interest rates will rise prior to issuing the debt. Suppose that interest rates do rise and that the forward contract has an asset fair value of 15,000 on December 31. The resulting gain of 15,000 could not qualify for hedge accounting.[39] The gain cannot be deferred to adjust the initial value of the debt on its issuance because the debt will be marked to fair value. There is no future income-earning event to which the gain can be allocated. (It could only be spread over the life of the debt, as an adjustment to interest, if the debt were to be accounted for on a cost basis.) The real effect of this "hedge" is that Company X is subject to the fair value risk of interest rate changes from the moment it enters into the forward contract. It is, therefore, appropriate that gains and losses on the forward contract be recognised in the income statement when they occur.

[38] IAS 39 provides for "fair value" hedge accounting in situations such as that of this example because the standard requires non-hedged debt to be carried at amortised cost and swaps to be measured at fair value.

[39] See, for example, IAS 39 which permits hedge accounting only if certain conditions are met, including that the forecasted future transaction "must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss" (sub-paragraph 142 (c)).

(c) There is no need or justification for hedge accounting for "cash flow" hedges of existing financial assets and liabilities under a fair value measurement model—because the deferral of the gains and losses on the hedging instrument to be recognised in the income statement as the future hedged cash flows are recognised in the income statement would effectively result in restating the income statement to a cost basis.

> Example: Accounting standards in some jurisdictions have allowed enterprises to apply hedge accounting in respect of cash flow risk related to existing floating rate interest-bearing financial assets and liabilities.[40] To illustrate, an enterprise with a floating rate interest-bearing financial asset may acquire a receive-fixed, pay-variable swap to "fix" the interest receipts and thus eliminate the exposure to risk of changes in cash flows due to changes in the market rate of interest. [It is to be noted that in so doing the enterprise creates a fair value risk—because the fair value of the swap will change with changes in interest rates.] The swap may be considered to be analogous to a hedge of future transactions (the future "transactions" being the stream of variable future interest receipts on the asset). Under "cash flow hedge accounting", gains and losses on the swap are presented initially outside the income statement and are transferred to the income statement in future periods to achieve the effect of adjusting the variable interest revenues of the asset to fixed rate revenues—i.e. to adjust reported interest revenue in the income statement to the equivalent of historical cost basis accounting for a "fixed rate" loan. The effect of the swap is to convert a floating rate asset into a net fixed rate asset position. Since fixed rate assets are to be measured at their fair value under the Draft Standard, a gain or loss resulting from a change in the fair value of the swap is properly recognised immediately in the income statement so as to reflect the income statement effects of changes in interest rates on the fair value of the net fixed rate asset position.

Hedges of non-financial assets, liabilities or commitments

7.6 Hedge accounting also is used to address perceived accounting inconsistencies that arise when financial instruments accounted for at fair value are used as hedges of non-financial assets, liabilities or commitments that are not recognised and measured at fair value. In a number of jurisdictions "fair value hedge accounting" is required or permitted where financial instruments are designated as hedges of such non-financial items, provided that certain qualifying conditions are met. This special accounting involves adjusting the carrying amounts of these non-financial items so that they reflect the fair value of the risks that are the subject of the designated hedges. The JWG concludes that this type of special accounting is outside the scope of this Draft Standard because it involves modifying the

[40] For example, IAS 39 provides for "cash flow hedge accounting" in such situations. See IAS 39 sub-paragraph 137(b) and paragraph 158.

accounting only for the non-financial items. Accounting for the financial instruments is unaffected.

7.7 Some believe, however, that "fair value hedge accounting" using financial instruments should be considered to be within the scope of the Draft Standard, and should not be permitted by it. They argue that "fair value hedge accounting" results in selectively recognising and measuring non-financial items as though they were financial instruments with respect to the risks that are designated as being hedged by financial instruments. This, they claim, is inconsistent with the conclusion that non-financial items are outside the scope of the Draft Standard. Further, this special accounting has the unsatisfactory result, in their view, of piecemeal revision of the cost-realisation basis of accounting for non-financial items based on fair value accounting for financial instruments. In their view, a designated financial instrument in this case should be considered to be managing the variability of expected future cash flows of the anticipated future transaction that is expected to arise when the designated non-financial item is realised—that is, it should be treated as the equivalent of a hedge of an anticipated future transaction. The JWG rejects this view for the reason noted above, that the special accounting results only in modifying the accounting for the designated non-financial item and is therefore not within the scope of this Draft Standard.

7.8 The JWG considered whether there are situations in which non-financial items should be recognised and measured as if they were financial instruments. It concluded that certain types of contracts to buy or sell non-financial items are so similar in substance to financial instruments that they should be included in the scope of the Draft Standard (see paragraph 2). In addition, the JWG concluded that consideration of changes to presently accepted accounting for other non-financial items is beyond the scope of this Draft Standard, because the issues are significantly different from those applicable to financial instruments.

Hedges that do not involve financial instruments

7.9 The Draft Standard does not affect the accounting for hedging relationships that involve both a hedging instrument and a hedged item that are not financial instruments and are not otherwise included in the scope of the Draft Standard.

Hedges of Anticipated Future Transactions

7.10 An important aspect of many enterprises' risk management activities relates to the variability of expected cash flows related to anticipated future transactions. Enterprises commonly use financial instruments to offset that variability. Hedge accounting has generally been permitted for such activities if certain qualifying conditions are met. Gains and losses due to changes in fair value of the financial instrument used as the hedging instrument may be deferred by reporting them as assets and liabilities. Alternatively, changes in the expected cash flows from the future transactions are reported in earnings when an event occurs that causes the expectations to change. Those supporting this hedge accounting may argue that it is appropriate because the gains or losses on the designated financial instruments can be expected to be offset by counter balancing changes in the value of the anticipated future transactions. They also argue that it reflects management's intentions in using financial instruments to mitigate anticipated future risks.

7.11 The JWG concluded that special accounting for hedges of anticipated future transactions should not be permitted because it would be inconsistent with accepted concepts and principles of financial accounting for the following reasons.

(a) A change in the fair value of a financial instrument is an event that should be recognised in the income statement in the period in which the change occurs. Those gains and losses should not be deferred because a gain is not a liability and a loss is not an asset. Gains and losses on existing financial instruments cannot meet the accepted definitions of "liabilities" and "assets" in accounting conceptual frameworks. Specifically, gains do not represent probable future sacrifices and losses do not represent probable future benefits.

(b) An expected change in the value of a future transaction cannot qualify for recognition as an existing asset or liability. The argument made for treating gains as if they were liabilities and losses as if they were assets is based on anticipating offsetting effects on the values of future transactions. In other words, to be treated as a liability, it must be anticipated that an existing gain on a hedging instrument will be "paid" by incurring an offsetting loss on a future transaction. But, an enterprise has no basis for anticipating and recognising any obligation for an expected loss on a future transaction. This is because another necessary condition of "assets" and "liabilities" is that they represent existing rights and obligations arising from past events. Changes in the value of anticipated future transactions do not meet this condition for recognition as existing assets or liabilities.

(c) Adjusting the recorded amount of a transaction by the amount of a gain or loss on a hedging instrument results in not recording the transaction at the fair value of the consideration given or received. To defer a gain or loss on a hedging instrument to "basis adjust" the amount actually paid for the hedged asset, or received for assuming the hedged liability, has the effect of measuring that asset or liability as if it had been acquired or issued when the hedging instrument was acquired, rather than when the hedged transaction actually took place.

(d) Management intention is not sufficient to create a right or obligation. An enterprise may take on a financial instrument price risk position now in anticipation of taking an offsetting position in a future transaction. However, an intention to carry out a future transaction is not sufficient to fix a price or create an obligation to carry out a transaction and recognise the expected value changes as current income statement effects.

7.12 Nevertheless, despite these arguments, many believe strongly that some form of hedge accounting is appropriate in respect of hedges of future transactions meeting certain qualifying conditions. Advocates of hedge accounting have raised a number of arguments that need to be carefully addressed against the concepts and principles set out above. These are set out in paragraphs 7.13-7.15, below.

7.13 Some believe that the deferral of a loss on a hedging instrument in anticipation of a future transaction is no different than incurring costs (such as costs of plans to construct an asset, or prepaid transportation costs) which are capitalised as assets. The JWG believes that there is a major distinction between costs and losses. Costs incurred in anticipation of acquiring a future asset are recognised as an asset if they give the enterprise some useful right, for example, a useable plan, or a transportation right that has value. A loss, on the other hand, provides an enterprise with no rights to anything and thus has no value.

7.14 Some are of the view that an investment in a derivative to hedge a future transaction risk is analogous to a prepaid insurance contract, which is recognised and measured as an asset on the balance sheet. Again the JWG believes a clear distinction may be made. An insurance policy is a financial instrument, and its fair value is dependent upon the probability that an insured event of loss to the insured party will occur and the amount that would be payable if it does.[41] In contrast, the fair value of the derivative financial instrument is not contingent on any future event of loss to the holder of the derivative, but is valued on the basis of the price of the variable that is the subject of the derivative.

7.15 Some believe that hedge accounting should be permitted for gains and losses arising on financial instruments designated as hedges of the exchange risk in commitments to acquire non-financial assets for fixed amounts of foreign currency. An enterprise may, for example,

[41] Insurance contracts are excluded from the scope of the Draft Standard, pending further study, as explained in paragraphs 2.23-2.30.

acquire a forward exchange contract with the intention of locking in the local currency amount to be paid for the non-financial asset under such a commitment. The problem is that the commitment is normally accounted for as a non-financial contract with no recognition of an existing foreign exchange risk. It has been argued that in this case hedge accounting should be followed for the gains and losses arising on the forward exchange contract so as to reflect properly the effects of this hedge in the reporting period.

(a) The first question to be asked in relation to this belief is whether the accounting for the commitment is incorrect, that is, whether accounting standards should require that it be recognised as a foreign currency risk exposure to be translated at current exchange rates. If it were to be so treated, there would be no hedge accounting issue. The forward exchange contract and the foreign currency commitment would be accounted for on the same fair value basis in respect of the currency exchange risk, with counter balancing gains and losses recognised immediately in the income statement. The JWG gave extensive consideration to this possibility. It concluded that a commitment to acquire a non-financial item at a fixed price in a foreign currency is a non-financial contract. Further, it concluded that it would not be appropriate to extend the scope of the Draft Standard to treat such a commitment as if it were, or as if it contained, a foreign currency denominated financial instrument (see discussion of this issue in paragraphs 2.58-2.62).

(b) The JWG does not believe that there should be any special accounting for the financial instrument that is designated as a hedge of the exchange risk in this non-financial commitment. This hedging arrangement consists of two separate contracts linked by management's intention:

(i) a firm commitment to acquire a non-financial asset from one party for a fixed amount of foreign currency at a specified future date; and

(ii) a forward currency exchange contract with another party.

The enterprise intends contract (ii) to fix the price of contract (i). However, they are separate contracts with separate parties. Contract (ii) is not part of contract (i), and the enterprise's intention to link the two contracts is not sufficient justification for treating contract (ii) as if it were part of contract (i). However, as explained in paragraph 7.6, the JWG considers possible special "fair value hedge accounting" for the effects of changes in the exchange rate on accounting for the non-financial commitment to be outside the scope of this Draft Standard.

Practical considerations

7.16 Some are of the view that hedge accounting for hedges of anticipated future transactions is justified by its practical benefits in enabling financial statements to portray management's intentions, and that these benefits outweigh the above conceptual problems. The JWG does not accept this view, but believes that these conceptual problems are the source of serious practical problems that stand in the way of reliably implementing any hedge accounting basis. The JWG's most serious practical concerns are summarised below.

(a) Management's identification of a hedge depends on its hedging strategy, and enterprises have different and often conflicting views of future risks. They may manage these risks in directly opposite ways—so that it can be impossible to distinguish speculation or "position taking" from risk reducing hedging strategies. What is viewed to be risk taking by one enterprise may be viewed by another as hedging. To illustrate, one enterprise may wish to hedge the risk that the price to buy a particular commodity in a future period will increase, and it may enter into a forward contract to "fix" that future price in respect of an anticipated future purchase or sale. Another enterprise may have an unrecognised firm commitment to acquire that commodity at a fixed price, and be concerned that it will lose if the price declines. It may then wish to enter into a forward contract to undo that fixed price risk. Thus two enterprises may wish to apply hedge accounting to achieve opposite results.

(b) The number of future risky transactions that could be anticipated by an enterprise may be very large. There may be almost unlimited combinations of streams of future transaction cash flows that will expose the enterprise to various future price risks. A particular existing financial instrument may be capable of being related in many different ways to a wide variety of expected future transactions. For example, debt denominated in a foreign currency may be considered to have an offsetting hedging relationship with a variety of possible configurations of anticipated future foreign currency revenues or other foreign currency cash flow streams.

(c) Management may choose to designate a particular hedge for special hedge accounting, or may elect not to present and disclose it as a hedge.

(d) It is very difficult to define in a clear and operational way what constitutes an effective hedge. For example, many contend that for a hedge to be effective (that is, for it to mitigate a future price risk), the future risk must not be expected to already be reduced by some other existing or likely future offsetting risk exposure. This assessment of net risk exposure would be made on a total enterprise basis. However, standard setters have concluded that it is not practicable to make a total enterprise risk assessment a qualifying condition, because it can not be objectively assessed given the range and complexity of possible future transactions affecting possible future risk exposures.

Income–adjusted approaches to hedge accounting for anticipated transactions

7.17 Recognising the indefensibility of deferring gains and losses on the balance sheet, accounting standards setters have looked for ways to accommodate demands for hedge accounting for future transactions by presenting gains and losses on hedging instruments outside the income statement. Various approaches have been considered. IAS 39 and FASB Statement 133 require that gains and losses on designated hedges of future transactions be initially classified in a special category of equity (IAS 39) and in "other comprehensive income" (FASB Statement 133). These gains and losses are then transferred to the income statement in the future period or periods in which the hedged items are recognised in the income statement. The objective of these standards has been to try to meet the demands for hedge accounting adjusted income statement results, while providing sufficient information to enable users to evaluate management's hedge accounting strategies and their effects, without compromising the balance sheet. Supporters of these standards argue that presentation of gains and losses on qualifying hedges of future transactions outside the income statement enables financial statement users to distinguish the results of these activities. Such reporting could be made fully transparent with disclosure of the objectives of the hedges, the amounts of gains and losses presented outside the income statement, and the effects of subsequent transfers to the income statement.

7.18 These approaches are open to concerns that they result in conceptually unsound representations of income. It is difficult to explain why accounting that is unacceptable for balance sheet purposes can be acceptable for income statement presentation, because the same conceptual and practical problems with hedge accounting outlined in earlier paragraphs also apply to income statement presentation. The JWG is concerned that deferring gains and losses on hedging instruments from recognition in the income statement complicates and confuses the fair value measure of income, because it mixes some anticipated gains and losses on expected future risk exposures with income resulting from actual financial instrument positions in the reporting period. Furthermore, any form of hedge accounting requires complex rules, which, for the reasons set out in paragraph 7.11, must be arbitrary to a significant degree to be operational. The JWG believes that the goals of understandability and transparency can be best accomplished by presenting relevant information about these hedging arrangements in notes to the financial statements without complicating income statement presentation.

7.19 Some contend that precluding hedge accounting income statement adjustments could undermine an enterprise's efforts to use financial instruments to mitigate risks expected to arise in future transactions, by presenting income statement results that are inconsistent with management's intentions and expectations. The JWG does not agree with this contention. It believes that the measurement of financial instruments at fair value, and the recognition of gains and losses in the income statement in the periods they arise, best represents what has actually happened, and does not misrepresent or detract from the economic purpose of these hedging activities. A financial instrument may be considered to serve its purpose as a hedge of a risk that is expected to arise as a result of a future transaction, if it helps to stabilise the value of the enterprise with respect to that risk in that transaction.

7.20 To illustrate, suppose that an enterprise anticipates selling 1,000 units of a commodity in one month's time. Assume that it is concerned that the price of the commodity may decrease between now and then and so acquires an option to sell 1,000 units of the commodity at the current price of 10 per unit for settlement net in cash at any time in the next month. Suppose that the price decreases to 9 per unit one week later. In this example the combined value of the option and the amount of the expected future revenues can be expected to be 10,000 whether or not there is a decline in the price of the commodity. Thus the acquisition of the option enables a stabilisation of the expected future value to the enterprise with respect to the effect of that price risk on that anticipated sale. This is demonstrated when the commodity price changed, because it resulted in a gain on the option of 1,000 and expectations that future revenues will decline by a commensurate amount. This expected stabilisation effect depends on management not changing its intention and on the expected sale taking place. Thus, it cannot be known whether the expected stabilisation effect is actually achieved until the future events take place, and it is not appropriate to recognise the anticipated effects of these future events until they take place. The enterprise's intention to continue to hold the option and its expectations for the future sale do not in any way affect the actual balance sheet and income statement results at the end of that week. What is known is that the option had a fair value of 1,000 and the enterprise experienced a 1,000 increase in the fair value of that financial instrument during that period.

Foreign Currency Hedges of the Net Investment in a Foreign Entity

7.21 Exchange differences arising on the translation of net investments in foreign entities from functional currencies to the reporting currency are required to be presented outside the income statement by most standards of accounting for foreign operations. It has been common for enterprises to designate financial instruments denominated in the foreign currency of a foreign entity as hedges of the "translation risk" on these net investments. Accounting standards and practice have sanctioned or required that gains and losses on these designated financial instruments also be presented outside the income statement.[42]

7.22 The Draft Standard makes no exception for gains and losses on these financial instruments; they are to be recognised in the income statement in the period in which they arise. The JWG believes that their presentation outside the income statement is not justified by the designation of the financial instruments as hedges in this case any more than in other hedging situations.

[42] See, for example, paragraph 19 of IAS 21, The Effects of Changes in Foreign Exchange Rates.

8. Disclosure

Objectives of the Disclosure Requirements

8.1 One of the JWG's fundamental principles underlying the Draft Standard is that financial statement presentation and disclosure should provide an information base that enables evaluation of risk positions and performance for each of an enterprise's significant financial risks in relation to its financial risk management objectives and policies (see paragraphs 1.31-1.37).

8.2 A number of accounting standards and certain securities regulations presently require reasonably extensive narrative and numerical disclosures about financial instruments and certain financial risks. On the one hand, the Draft Standard brings forward those disclosures from existing standards that the JWG believes continue to be relevant to financial statements prepared on the basis of the Draft Standard recognition and fair value measurement principles.[43] A number of the disclosure requirements of existing standards are no longer necessary because they were instituted to help compensate for shortcomings in recognition and measurement practices. In particular, supplementary disclosures of the fair value of recognised and non-recognised financial instruments, of situations where carrying values exceed fair values of financial assets, of unrealised gains and losses presented outside the income statement on "held-for-sale" financial instruments, and descriptions of non-recognised financial instruments, are no longer necessary. In addition, it is expected that disclosure of accounting policies would be simplified, because they will not need to explain complex, mixed measurement accounting.

8.3 On the other hand, the Draft Standard puts in place some extensions to existing disclosure requirements to provide more comprehensive information about financial risks. The adoption of a consistent fair value measurement basis for financial instruments provides a foundation for disclosing additional information about the effects of financial risks and changes in market risk conditions.

8.4 The JWG believes that the Draft Standard's disclosure requirements should be evaluated as a package. They are intended to provide an integrated set of disclosures that complement and reinforce each other. The disclosures of the financial risks that are significant to an enterprise, and of the role of financial instruments in changing the risks the enterprise faces in its activities, and the disclosures of the enterprise's financial risk management objectives and policies, all provide context to enhance a user's ability to evaluate disclosures about the financial instruments held, financial risk positions, and income statement results.

[43] The disclosures in this Draft Standard would replace, for example, those presently contained in IAS 32, Financial Instruments: Disclosure and Presentation.

Significant Financial Risks

8.5 The JWG believes that a description of the financial risks that were significant to an enterprise during the reporting period provides a fundamental underpinning for an understanding of an enterprise's use of financial instruments. From information about the significant financial risks faced by an enterprise financial statement users can understand the significance of the enterprise's financial risk management objectives and polices and can assess whether the enterprise has generated returns that are acceptable for the level of risk.

8.6 Many existing accounting standards already call for general disclosure of financial risks.[44] However, most of these disclosures do not require a comprehensive description of an enterprise's significant financial risks. Furthermore, existing accounting standards do not define what is meant by "financial risk".

8.7 An enterprise's activities could be subject to many different risks that may be managed by financial instruments. For example, revenues from sales denominated in foreign currency would be affected by changes in foreign exchange rates and the value of commodity inventories might be affected by changes in commodity prices. However, this Draft Standard is concerned with accounting for financial instruments. Therefore, financial risk disclosure in accordance with this Draft Standard is required only to the extent that a financial instrument is subject to the risk or the enterprise manages the risk by using a financial instrument. Other risks related to non-financial items are not addressed.

8.8 Many believe that it is not sufficient to provide information about financial risks only. They advocate that to understand fully the risks that affect an enterprise, information is also needed about non-financial risks—particularly since, in many businesses, these risks are more significant than the financial risks. The JWG agrees that information about non-financial risks is important. However, it believes that it is beyond the scope of this Draft Standard to require disclosures about non-financial risks. However, the Draft Standard does require that sufficient information be provided about an enterprise's primary activities to provide context for evaluating financial risks and an enterprise's financial risk management objectives and policies.

Financial Risk Management Objectives and Policies

8.9 Disclosure of an enterprise's objectives and policies for using financial instruments to manage each of the significant financial risks that affect its activities provides a benchmark against which to assess performance during, and the position at the end of, the reporting period. The disclosures help users of financial statements to evaluate the implications of an enterprise's risk management objectives and policies for future expectations about financial

[44] See, for example, IAS 32, Financial Instruments: Disclosure and Presentation.

risk and return. They also enable users to assess the enterprise's effectiveness during the reporting period in using financial instruments to achieve a return that is commensurate with the risk taken.

8.10 Some existing accounting standards already require a description of financial risk management objectives and policies.[45] The JWG proposes a more comprehensive disclosure of objectives and policies in respect of existing risk positions as well as those relating to the use of financial instruments in managing risks associated with transactions expected to occur in future reporting periods. This includes placing this description within the context of the primary business and financial activities that give rise to these risks.

8.11 Significant changes in an enterprise's financial risk management objectives and policies could have major implications for a user's evaluation of future risk and return expectations. Therefore, it is important for financial statement users to know whether significant changes in risk management objectives and policies have been made during the reporting period or have been decided upon for future reporting periods. Paragraph 162 of the Draft Standard would require disclosure of such changes.[46]

8.12 The Draft Standard and Application Supplement do not provide extensive guidance about the precise nature and detail of the disclosures to be provided about financial risk management objectives and policies. The JWG believes that each enterprise will need to evaluate this for themselves, in relation to the extent and significance of its financial risks and its use of financial instruments. The JWG believes that these disclosures can be provided at a sufficiently general level to avoid concerns about releasing proprietary information about an enterprise's risk management strategies, while at the same time providing useful information to financial statement users. The JWG does not believe that the required disclosures should be overly onerous to prepare and present because they are based on an enterprise's established objectives and policies and, in many cases, are already required by existing standards. It is expected that experience with these disclosures over time will provide the basis for subsequent evaluation of their effectiveness and possibly enable future improvements in the standards and supporting material.

Terms and Conditions of Financial Instruments

8.13 The JWG believes that information about the terms and conditions of financial instruments is important for an understanding of an enterprise's financial risk position and objectives and policies for managing that position. The contractual terms and conditions of a financial

[45] For example, paragraph 43A of IAS 32, Financial Instruments: Disclosure and Presentation, was added in 1998 to require disclosure of financial risk management objectives and policies, including the enterprise's policy for hedging each major type of forecasted transaction for which hedge accounting is used.

[46] Decisions to change significantly risk management objectives or policies made in the period after the reporting date would be disclosed in accordance with standards for post-balance sheet events. See, for example, IAS 10, Events After the Balance Sheet Date.

instrument are an important factor affecting the amount, timing and certainty of future cash flows. Some believe that much of the information that is provided in accordance with this kind of disclosure requirement has little information value. However, requirements are presently in place in many jurisdictions to provide such information.[47] The JWG does not have evidence to support abandoning these disclosures and does not believe that they become any less relevant as a result of adoption of the recognition and measurement principles in the Draft Standard.

8.14 One aspect of existing disclosures that is no longer necessary is the requirement to separate such descriptions between those relating to recognised and those relating to unrecognised financial instruments. All such instruments would be recognised in accordance with this Draft Standard. Disclosure about the currency in which receipts or payments are required is also unnecessary since, when currency risk is significant, this information would be provided in accordance with the disclosures about currency risk (see paragraph 171(a)).

8.15 Some advocate that information about notional principal amounts of derivative instruments is unnecessary. They claim that, when all financial instruments are recognised and measured at fair value, such a disclosure conveys little useful information and could, therefore, be deleted from existing disclosures. They also claim that, since many derivative financial instruments can be cancelled by issuing offsetting instruments, the reported nominal amount actually increases while exposures are reduced. Supporters of this disclosure believe that it provides information about the volume of activity in financial instruments, as well as a useful benchmark against which to assess the potential significance of changes in risk conditions for changes in the fair value of derivative instruments. The JWG does not believe that the information is less relevant because of adoption of the Draft Standard. The Draft Standard, therefore, continues to require this disclosure.

8.16 One additional disclosure proposed by the JWG is to require information about any features of a financial instrument that significantly concentrate or leverage risk. This is a disclosure that has been called for by securities regulators. Not only is risk concentration or leverage prevalent in certain derivative instruments, but securitisation and similar transactions often leave the transferor with a residual interest that, while being small in fair value terms, bears most of the potential for gains and losses on the transferred assets. Disclosure of the relative riskiness of such interests is needed for users of the financial statements to understand the nature of the transactions entered into and of the assets and liabilities held.

8.17 The JWG also proposes that information about restrictions on an enterprise's ability to dispose of or use financial assets as a result of requirements outside the financial

[47] See, for example, paragraphs 47-51 of IAS 32, Financial Instruments: Disclosure and Presentation.

instrument contract is important. Such information provides users with information about the extent to which the enterprise's use of the instruments is limited.

Financial Risk Position at the Reporting Date

8.18 The objective of disclosures about an enterprise's financial risk position is to provide qualitative and quantitative information to assist financial statement users in assessing the extent of the significant financial risks that affect an enterprise at the reporting date.

Basic Interest Rate Risk

8.19 The proposed disclosure for basic interest rate risk presents information about fair values in a similar manner to that presently required in some accounting standards[48] for historical cost-based amounts. The proposed disclosure complements information that is to be provided about interest on a fair value basis, in accordance with the income statement presentation requirements of the Draft Standard.

8.20 The interest rate re-pricing information provides users of financial statements with information about the extent of the enterprise's exposure to future changes in interest rates. Those financial assets and financial liabilities that have interest rates fixed for longer periods of time are likely to be subject to more variability in their fair values as a result of future changes in interest rates.

8.21 In order to provide a complete picture of the enterprise's interest rate risk positions it is important that this disclosure includes derivative financial instruments that are subject to basic interest rate risk. Therefore, even though such instruments are excluded from the requirement to calculate fair value based interest revenue and expense on practicality grounds (see paragraphs 6.51-6.54), they are required to be included in this disclosure.

Currency Risk

8.22 Very little disclosure is typically required about currency risk by existing accounting standards. However, many financial instruments are subject to currency risk and it is not possible to fully understand other risk disclosures—particularly those relating to interest rate risk—without some information about related currency risks. Accordingly, the JWG would require that, when currency risk is significant, an enterprise should provide additional analysis of its interest rate risk exposures by principal currency. In order to keep this disclosure at a reasonable level for enterprises that undertake transactions in multiple currencies, the Draft Standard allows this additional analysis to be restricted to the main currencies in which the enterprise does business.

[48] See, for example, paragraph 56 of IAS 32, Financial Instruments: Disclosure and Presentation.

8.23 In accordance with most foreign currency accounting standards,[49] gains and losses arising on translating financial assets and financial liabilities from the functional currency of certain foreign operations into the reporting currency of the reporting enterprises are presented outside the income statement. Accordingly, the analysis of fair value by the main currencies of denomination, required by sub-paragraph 171(a), separately identifies financial assets and financial liabilities of foreign entities, so that a financial statement user can understand the extent to which changes in currency positions are likely to result in income statement effects or equity effects.

8.24 The Application Supplement suggests that it could be useful to supplement information about interest rate and currency risk with an analysis of the fair value of financial assets and financial liabilities according to the time periods in which cash flows are contracted to occur, in order to portray any significant timing mis-matches in net cash flows. While often useful, the JWG was not convinced that the benefits of providing this information would exceed the costs in all cases.

Credit Risk

8.25 Disclosures about credit risk have, to date, tended to focus both on maximum credit risk exposure and significant concentrations of credit risk.[50] However, since the maximum credit risk exposure is, to a considerable extent, captured by the fair value of financial instruments reported on the balance sheet, the JWG has refocused the credit risk disclosures on those instances where the fair value differs from the maximum exposure and on significant concentrations of credit risk and arrangements entered into to manage those risks.

8.26 Users of financial statements have indicated that they need to understand the maximum credit exposure in the event that other parties fail to perform their obligations—including failing to deliver collateral. Accordingly, the JWG believes that disclosure of the maximum credit risk exposure arising as a result of financial guarantees written or of failure to recover the value of collateral held in the event that other parties fail to perform their obligations, is necessary for all such financial instruments, and separately for significant concentrations.

8.27 The JWG considered whether the fair value of financial instruments should also be disclosed by category of credit quality. However, it believes that it would be difficult to require such information in a consistent manner without specifying the credit rating categories that should be used (which is not required for measurement purposes—see paragraph 4.39). The JWG believes that, without further development of a consistent basis

[49] See, for example, IAS 21, The Effects of Changes in Foreign Exchange Rates.
[50] See, for example, paragraph 66 of IAS 32, Financial Instruments: Disclosure and Presentation.

for disclosure, the benefits of such information would not outweigh the costs of preparation.

Other Significant Financial Risks

8.28 Rather than specify detailed disclosures for each additional type of significant financial risk, which would go beyond that required by any existing accounting standards, the Draft Standard would require a general disclosure of quantitative information about the extent to which an enterprise is affected by other significant financial risks at the reporting date. Depending on the significance of the risk, the Application Supplement provides some examples of the manner in which such disclosures might be provided. However, other significant financial risks could take many different forms and the best manner in which to disclose such information has not been the subject of sufficient accounting study or experience to prescribe specific requirements. Best practices for such disclosures are likely to evolve with experimentation and the JWG does not believe that it should specify precise disclosures for such risks at this time, although it encourages further work to develop these disclosures in the future.

Financial Risk Position at the Reporting Date Compared with that During the Reporting Period

8.29 With the ready availability of financial instruments in today's markets, the financial risk profile of an enterprise can change significantly over a short period of time. Users of financial statements need information about the risk profile during the reporting period, from which the enterprise has generated returns. The Draft Standard would meet that need by requiring information to help them understand whether the risk profile at the reporting date is representative of that throughout the reporting period. The JWG considered requiring disclosure of maximum, minimum and average positions during the reporting period, as is encouraged or required by some existing accounting standards.[51] However, information of that kind is currently captured by only a few enterprises. For many other enterprises, significant time and costs might be needed to calculate and maintain the information. Furthermore, average values can vary considerably depending upon the intervals used for calculation of averages. As the interval becomes narrower the average becomes more precise, but the cost of calculation also increases. The JWG, therefore, decided to propose a more general requirement for information about the amount by which risk positions during the reporting period vary from the position at the end of the reporting period, while noting that such information might be provided by disclosing highest and lowest, or average, positions.

[51] See, for example, sub-paragraph 94(c) of IAS 32, Financial Instruments: Disclosure and Presentation.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

8.30 Financial statement users widely believe that, in order to fully understand financial risk exposures, it is not only necessary to report the fair value of financial instruments, but it is also essential to provide information about the extent to which fair value could change as a result of changes in the underlying risk conditions.

8.31 A number of methods of providing such information are used presently, including sensitivity analysis and value-at-risk—particularly in the financial services industry. However, these measures are subject to a number of drawbacks. For example, sensitivity analysis shows the effect only of the enterprise's chosen changes in market prices, focuses only on a single risk and takes no account of the likelihood of a particular change occurring. Similarly, value-at-risk methodologies are continuing to evolve and are criticised by some because the calculation is complex and different results can be obtained depending on the assumptions used. While many enterprises are interested in value-at-risk as a way of monitoring and managing risk, there is presently little consensus on a single methodology for performing the calculations. Finally, some believe that while value-at-risk is a good way of measuring the market risk of instruments that are held for trading, it is less appropriate for an enterprise's other financial instruments.

8.32 Some believe that it could be useful to require enterprises to make disclosures about the potential effects of changes in risk conditions on financial position, in spite of the lack of standardised models or assumptions. They believe that inter-period comparability of such disclosures, consistently applied within an enterprise, has information value even if comparability between enterprises is not possible. However, others note that as techniques develop enterprises would probably enhance them considerably, impairing even inter-period comparability.

8.33 The JWG concurs that such information is important. However, most commentators would agree that existing methods have shortcomings. In addition, techniques in this area are continuing to evolve and the JWG believes that it is still too early in the development of risk management technologies to attempt to specify a single disclosure approach or to require standardised models or assumptions. To do so might inhibit the development and implementation of superior methodologies. For these reasons disclosure of sensitivity to changes in market risk is encouraged, rather than required.

8.34 The JWG considered requiring enterprises that already use such risk measures to disclose information about the measures that they use. However, the JWG was concerned that such an approach might be seen to penalise those that are at the leading edge of such developments and might inhibit others from experimenting in this regard.

8.35 The JWG also considered whether an enterprise that changes the methodology, parameters or assumptions used in calculating a disclosed risk measure should restate the risk measure for the comparative prior period. The JWG concluded that such disclosure would be unduly onerous—particularly since the JWG is seeking to encourage voluntary reporting of risk measures.

Financial Instruments Used to Manage Risks Associated with Transactions Expected to Occur in Future Reporting Periods

8.36 The JWG believes that many enterprises that have established objectives and policies for using financial instruments to manage risks associated with transactions expected to occur in future reporting periods will wish to disclose information about the effects of those policies on the enterprise's financial position and performance. Some believe that, in order to provide adequate information for financial statement users to understand the effects of such objectives and polices, an enterprise should be required to provide certain information about the financial instruments and future transactions to which that policy applies whenever it has such a policy. However, others believe that it is inconsistent to require disclosure of information about financial instruments that are used to manage future risks when the Draft Standard prohibits hedge accounting for the financial instruments involved in such a relationship.

8.37 The JWG believes that when an enterprise chooses to separately identify the amounts of gains and losses in the reporting period on financial instruments identified as entered into to manage risks associated with transactions expected to occur in future reporting periods, users need sufficient additional information to understand the context of those gains and losses. The JWG, therefore, would require certain disclosures in such circumstances.

8.38 In developing these disclosures, the JWG has attempted to balance the need for a reasonable level of accountability with the desire to keep disclosure requirements as straightforward as possible. The JWG believes that the basic information that would be required by paragraph 181 should not be onerous for an enterprise. An enterprise should be expected to have this information available for internal management purposes because it simply reflects the implementation of management's policy for using financial instruments to manage future risks. The JWG also believes that the disclosures are sufficiently general to minimise any concern that they could result in releasing commercially sensitive information.

8.39 The JWG also considered whether the Draft Standard should contain provisions to help ensure that such disclosures are provided in a consistent manner from period to period. It considered whether, if an enterprise makes such disclosures, it should be required to provide information about all similar risk management relationships and continue to provide that information unless the enterprise changes its financial risk management objectives and policies, in which case such a change in policy would be disclosed in accordance with paragraph 162. However, the JWG concluded that this would be too onerous and that it is sufficient to require disclosure only until the future transactions related to the identified hedging instrument occur or are no longer anticipated to occur.

8.40 Some believe that an enterprise should be required to provide certain minimum information about financial instruments used to manage risks associated with future transactions whenever it has a disclosed risk management objective and policy related to such risk management. They disagree that such a disclosure requirement would be inconsistent with the prohibition of hedge accounting for financial instruments. They believe that these are two distinctly different matters. Hedge accounting for financial instruments is precluded for the reasons set out in section 7 of this Basis for Conclusions. However, this does not mean that the use of financial instruments to help manage future risks is not a justifiable activity or that users do not need information about these activities. They believe that users should be provided with complete and consistent information about all of an enterprise's uses of financial instruments to manage risks associated with future transactions, so that they can fully understand its disclosed policies and the effect that they have had on its financial position and performance. Further, those who favour this broader disclosure requirement are concerned that an approach based on whether an enterprise elects to disclose gains and losses on certain financial instruments that were intended to manage risks associated with future transactions could be applied in an incomplete and inconsistent manner from period to period.

8.41 The JWG considered whether to require an enterprise to disclose information about whether financial instruments identified in prior periods as being used to hedge risks associated with future transactions were effective in managing future risk positions. However, the JWG was not convinced that the benefits of such disclosure would always outweigh the costs of preparation.

8.42 The JWG does not believe that there is any need to prescribe rules for when a financial instrument may be considered by the enterprise to manage future risks, or for what may constitute an effective risk management strategy. Rather, it believes that the disclosures required when an enterprise separately identifies gains and losses provide information to help users to make these evaluations for themselves. In addition, since there is no hedge accounting for financial instruments, the effects of these risk management practices do not affect financial instrument balance sheet positions or reported financial performance results.

8.43 The JWG believes that enterprises should assess, depending on their individual circumstances, the significance to users of making additional disclosures. The JWG believes that, in some cases, additional information could be useful, but it is not convinced that the benefits from additional disclosure would, in all cases, justify the preparation costs. Accordingly, paragraph 182 of the Draft Standard only encourages such additional disclosures.

Accounting Policies

8.44 The Draft Standard does not explicitly address disclosure of accounting policies. These would be disclosed in accordance with other accounting standards.[52] The disclosure of accounting policies would be expected to be less complex than the disclosures necessary in accordance with existing accounting standards. This is because the proposed recognition and measurement principles would result in more uniform and consistent accounting than current practices involving a mix of methods. The policy disclosures based on existing mixed measurement accounting standards would be replaced by policies that focus on the methods used to determine fair value.

Methods Used to Estimate Fair Value

8.45 Policies and assumptions used in estimating the fair value of financial assets and financial liabilities are critical to the balance sheet measurement and resulting gains and losses under the Draft Standard. The proposed disclosures focus on the methodology for estimating fair values in order to give users of financial statements an indication as to which measurements are based on the usually more reliable measures of fair value (observable market exit prices) and which are based on valuation techniques.

8.46 When valuation techniques are used, fair values would often be sensitive to key assumptions. In some instances, a choice might exist between equally valid assumptions to determine the fair value of a particular instrument. In such circumstances, the JWG believes that users need to understand which assumption has been chosen and what the effect would have been if an alternative assumption had been adopted. It believes that the importance of this information outweighs any concern that such information is not presently required in most accounting standards for other financial statement items that might be subject to similar measurement uncertainties.

8.47 In order to aid financial statement users' understanding of the effects of changes in an enterprise's own credit risk on the fair value of its own financial liabilities the Draft Standard would require disclosure of the events that the enterprise has taken into account.

8.48 Paragraph 102 of the Draft Standard precludes an enterprise from adjusting observable market exit prices for the potential effect of selling a different quantity of the financial instrument from that for which a market exit price is observable. The primary reason for this preclusion is that market information necessary to estimate any adjustment is not likely to be available (see paragraphs 4.34 and 4.35). The JWG believes that, in such circumstances, the fact that a large block of financial assets might not be capable of immediate realisation at its recorded fair value should be disclosed. This disclosure allows users of financial information to understand the fact that there could be some variability in

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[52] See, for example, IAS 1, Presentation of Financial Statements.

the measurement amount from that recorded, even though the precise amount of the variability cannot be quantified with sufficient reliability for accounting measurement.

8.49 If an enterprise determines that it is not practicable to make a reliable fair value estimate of an investment in a private equity instrument, paragraph 122 of the Draft Standard permits those financial assets to continue to be carried at their previous carrying amounts. The JWG believes that in such circumstances, financial statement users need to know that the measurement basis for such financial assets differs from that for other financial instruments. If a reliable measurement subsequently becomes available, or the financial asset is sold, disclosure would be required of the adjustment to the carrying amount of the instrument to put it back on a comparable basis with other financial instruments, since that adjustment would occur entirely in the period of sale or re-measurement, rather than in the period(s) in which economic events affected the fair value of the financial asset.

8.50 The JWG concluded that some of the existing disclosures for such items, like information about the reasons why fair value could not be determined, and the principal characteristics of the instrument pertinent to its fair value, provide little information of relevance to enable users to estimate future cash flows. It, therefore, decided not to require such disclosures.

Derecognition Disclosures

Sale and Repurchase Transactions and Stock Lending Transactions

8.51 A transferor might transfer a financial asset to a transferee that has the practical ability (which can be exercised unilaterally and without attaching additional restrictive components) to further transfer the entire asset to a third party. However, the transferor might simultaneously enter into an agreement with the transferee that ensures that the transferor is both entitled and obligated to receive the transferred asset back, in exchange for a sum that reflects the original transfer price plus what amounts to interest on the cash paid at that time by the transferee. (Many sale and repurchase transactions and stock (or securities) lending transactions meet this description.) The "repurchase agreement" means that, although the transferor will derecognise the asset in accordance with the Draft Standard, it will continue to have much the same exposure to the asset as it did prior to the transfer. In such circumstances, the JWG believes that, to help users understand the nature of the transaction and the relationships between the assets involved, it is useful to provide information about the assets recognised and derecognised as a result of the transaction.

Retained Interests in Transferred Assets

8.52 The unbundling and rebundling of contractual rights and contractual obligations arising from financial instruments that now takes place means that users cannot make traditional assumptions about the amount and type of risk inherent in certain balance sheet items. For example, in some securitisations the originator may derecognise a portfolio of receivables and recognise instead a residual interest that has a greater risk of variability in value than the portfolio of receivables. To help users understand the amount and type of risk inherent in such items separately from the enterprise's overall financial risk profile, the Draft Standard would require disclosures about such assets and the risks underlying them.

Location of Disclosures

8.53 The JWG considered whether some of the disclosures might be provided in management discussion and analysis or similar documents that accompany the financial statements, rather than in the notes to the financial statements. The JWG believes that each of the proposed disclosures is necessary for full and fair presentation, as opposed to being supplemental. Furthermore, not all enterprises are required to provide additional management discussion and analysis. Therefore, if the Draft Standard allowed such disclosures to be provided outside the financial statements valuable information could be omitted from many financial reports. Accordingly, the JWG believes that all of the proposed disclosures should be provided within the financial statements.

Historical-cost-based Disclosures

8.54 The JWG considered whether certain disclosures of a historical cost nature should be required in order to provide users with familiar information—perhaps for a transitional period. The JWG concluded that some information of this nature would be determinable from disclosures of terms and conditions of financial instruments and that to require additional information that is not consistent with the recognition, fair value measurement and presentation model imposes an unnecessary burden on preparers of financial statements. Any enterprise that wishes to provide such additional information is, of course, not precluded from doing so.

8.55 Some enterprises might wish to separately disclose realised and unrealised gains and losses, particularly when they have some significance for purposes such as determining distributable income or taxable income. However, since such information is not relevant to the fair value measurement model on which this Draft Standard is based, the JWG does not believe that such disclosures should be required of all enterprises—rather that they should be optional.

Specific Industry Disclosures

8.56 The JWG believes that the disclosures in this Draft Standard are appropriate for all enterprises. It has not considered whether additional disclosures might be useful in certain industries to explain the specific nature of that industry's use of financial instruments. Some standard setters have additional disclosure requirements for certain industries.[53]

[53] For example, additional requirements for disclosures of financial instruments are contained in IAS 30, Disclosures in the Financial Statements of Banks and Other Financial Institutions.

9. Effective Date and Transition

Effective Date

9.1 The choice of an effective date will involve consideration of the current need for improved recognition and measurement standards and the extent of preparation necessary for enterprises to be in a position to adopt the standard. The JWG believes that enterprises may need up to two years from the date of issuance of a standard to make the necessary changes to their accounting and reporting systems and to identify any implementation problems in sufficient time to ensure that they can be satisfactorily addressed and resolved. The JWG believes that a delay of more than about two years would be undesirable, given the need for comprehensive recognition and measurement standards on financial instruments.

9.2 The Joint Working Group believes that early adoption should be encouraged. This would enable those that wish to apply the standard to do so, and also provide an opportunity for those that do not choose early adoption to learn from the experiences of those that do. Since the requirements of the Draft Standard are, in many cases, interdependent, the JWG does not believe that an enterprise should be permitted to adopt parts of the Draft Standard at differing times. However, for those parts of the Draft Standard that are not interdependent, the JWG believes that enterprises should be permitted to adopt these parts early, as long as they do not contravene accounting standards existing at the date of adoption. For example, many of the disclosure requirements are in accordance with existing accounting standards and might be adopted early.

9.3 Further, the Joint Working Group believes that the standard should be adopted only at the beginning of a financial year. To adopt the standard at a date within a financial year would result in inconsistent principles being applied within one fiscal period.

9.4 Some do not believe that the need for new accounting standards for financial instruments is as urgent for smaller or non-public enterprises as it is for public enterprises. They recommend that, as a minimum, implementation by smaller or non-public enterprises should be deferred to enable a period for education and an opportunity to benefit from the experience of more sophisticated public enterprises. The JWG believes that about two years is sufficient time for all enterprises to implement the Draft Standard and does not believe that the need for a standard based on this Draft Standard is any less urgent for these enterprises than it is for the biggest, most sophisticated enterprises. The JWG, therefore, believes that differential implementation dates are unnecessary. The JWG also notes that, if differential implementation dates were to be adopted, then a definition of what constitutes smaller or non-public enterprises would be necessary. It believes that this is an issue best left for individual jurisdictions to consider (see also paragraphs 2.10 to 2.12).

Supplemental Financial Statements

9.5 The JWG considered whether to require preparation of comprehensive, supplemental, fair value financial statements for a period—say, a year or two—in parallel with financial statements prepared in accordance with existing practices. Under such an approach, the supplemental financial statements would replace the existing financial statements after the transitional period. The advantages of such an approach include:

(a) a period of time to gather information and resolve issues;

(b) opportunities for further evaluation and field tests, with the subsequent ability to improve the Draft Standard and supporting material in light of this experience;

(c) time for preparers and users to become familiar with the information provided; and

(d) when the time comes to replace the primary financial statements prepared in accordance with existing practices, comparative information will be available.

9.6 On the other hand, such an approach has a number of disadvantages, including:

(a) the need to maintain existing standards and practices;

(b) the cost of preparing two sets of financial statements; and

(c) potential confusion as to which are the "real" numbers.

9.7 The JWG has not attempted to reach a conclusion as to whether supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices. However, the JWG believes that it is important, whether supplemental or primary financial statements are prepared, that they are complete and rigorously apply the requirements of the Draft Standard.

Transition

Transition—Overall Approach

9.8 The JWG has provided general standards only for the most common situations that will arise on transition, since existing accounting standards and statutory requirements for recognition and measurement of financial instruments vary considerably by jurisdiction. As a result, individual jurisdictions may have to develop more specific principles to deal with transition in the context of their particular situations.

9.9 The Joint Working Group believes that standard setting bodies should implement the Draft Standard comprehensively rather than in a piecemeal manner. A major benefit of the Draft Standard is that it reflects a consistent set of requirements, based on a coherent framework. This benefit would be eroded by piecemeal implementation resulting in an inconsistent mix of recognition and measurement requirements. The experience of leading standard setters in developing piecemeal approaches also indicates that they result in significantly greater complexity and costs for both preparers and users.

9.10 If a jurisdiction were to decide that it wished to adopt only parts of the Draft Standard, then additional considerations would have to be taken into account by that jurisdiction. These would include defining the parts that should be implemented and considering the need for additional requirements to address the consequences of omitting any parts of the Draft Standard.

Transition—Valuation Adjustments

9.11 When the Draft Standard is first applied many financial instruments will be measured at fair value for the first time. A one-time adjustment will be necessary to restate the value of these financial instruments. The JWG believes that the simplest and clearest presentation of gains and losses arising from that adjustment is to adjust the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied.

9.12 Enterprises that already record certain items at fair value may need to change their accounting policies to reflect the fair value measurement principles required by the Draft Standard. The JWG believes that such changes in the measurement of fair value arising from implementation of this Draft Standard are little different from the adjustments that would arise on measuring items, previously carried at cost, at fair value for the first time in accordance with this Draft Standard. Therefore, for purposes of implementing this Draft Standard all such transitional valuation adjustments are treated as an adjustment to the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied.

Transition—Unwinding Existing Hedge Accounting

9.13 Existing hedge accounting practices generally involve one of four approaches:

(a) deferral of gains and losses on hedging instruments on the balance sheet;

(b) deferral of gains and losses on hedging instruments in equity or in a performance statement separate from the income statement;

(c) deferral of gains and losses on hedging instruments as basis adjustments of the hedged item; or

(d) deferral of gains and losses by maintaining the hedging instrument at cost.

Implementation of this Draft Standard would no longer permit any approach that modifies the accounting for financial instruments.

9.14 Three possible approaches might be considered to unwinding such accounting.

(a) Accept prior accounting for all previous transactions and apply the new standard only to transactions occurring after the effective date. This would require no opening adjustments to reverse deferred gains and losses on hedging instruments.

(b) Adjust opening retained earnings for any gains and losses not recognised in the income statement under previous accounting. This would require identification of those gains and losses that relate to hedges that have not unwound at the beginning of the period in which the Draft Standard is adopted.

(c) Adopt an approach somewhere between (a) and (b), above.

9.15 The JWG does not believe that the approach described in paragraph 9.14(a) is appropriate. This is primarily because it would involve retaining the effects of past hedge accounting practices for what could be a prolonged period, in parallel with the accounting in accordance with the Draft Standard, thus detracting from comparability and understandability of the financial statements. On the other hand, the JWG believes that adjusting the carrying amount of hedged items to eliminate the deferred gains and losses referred to in paragraph 9.13(c) would often be burdensome. It is also possible that records would not have been maintained to separately track the amounts that would need to be adjusted. The JWG, therefore, proposes to require adjustments to opening retained earnings for any gains and losses of the types referred to in paragraphs 9.13(a), 9.13(b) and 9.13(d). Gains and losses of the type referred to in paragraph 9.13(c) would not be adjusted. Although this approach retains some balance sheet items carried at amounts inconsistent with those that would be required under this Draft Standard, the JWG believes that this approach represents a practical compromise, the effects of which will become insignificant over time.

Transition—Gains and Losses Previously Recorded Directly in Equity

9.16 In addition to gains and losses from hedge accounting, certain gains and losses on financial instruments from periods prior to adoption of a new standard might have been presented directly in equity or in a performance statement separate from the income statement—for example those arising on "available-for-sale" assets under IAS 39. The JWG believes that these gains and losses should be transferred as an adjustment to the balance of retained earnings at the beginning of the financial year in which the Draft Standard is initially applied. This is the simplest and clearest approach, and also avoids future adjustments to the income statement for the effects of past accounting.

Transition—Derecognition

9.17 Ideally, assets and liabilities that would not be derecognised under the Draft Standard should be reinstated on adoption of the Draft Standard. However, the JWG believes that it is likely to be unduly onerous to expect enterprises to change the accounting for derecognition transactions that occurred prior to the effective date of the Draft Standard. Accordingly, if a transaction undertaken prior to the beginning of the financial year in which the Draft Standard is initially applied resulted in derecognition of transferred assets, the JWG believes that the accounting for that transaction should not be changed to conform to the requirements of the Draft Standard. However, the JWG believes that any financial instruments resulting from the previous accounting for derecognition transactions should be identified and recognised and measured at their fair value on initial adoption of this Draft Standard, either separately or as part of a financial asset or financial liability incorporating other rights or obligations.

9.18 To enable users to understand what might be "missing" from the financial statements, the Draft Standard would require a general description of the financial assets or financial liabilities that have been derecognised that would not have been derecognised under the Draft Standard. The JWG considered also requiring disclosure of the unrecognised fair value at the end of each reporting period, but concluded that in many cases it would be unduly onerous to determine this amount for assets and liabilities that had been transferred.

Transition—Hybrid contracts

9.19 An enterprise might have to separate the financial and non-financial sets of rights and obligations in a hybrid contract on application of the Draft Standard that had not been previously separated. Two possible methods might be considered for doing that:

(a) determine values based on the fair values of the rights and obligations at the date of initial application of the Draft Standard; or

(b) determine values based on the fair values of the rights and obligations at the date of initial acquisition or issuance of the hybrid contract.

9.20 The first alternative is clearly the simplest. It might not always produce perfect results (since the non-financial sets of rights and obligations might be allocated a value different from that which they would have been allocated at the date the hybrid contract was acquired or issued). However, for practical purposes, the Joint Working Group proposes that this is the alternative that should be adopted.

Transition—Restatement of Prior Period Financial Statements

9.21 The JWG proposes that prior period financial statements should not be restated on initial adoption of the proposals in a standard. To restate prior period financial statements to unwind the effects of basis adjustments to hedged items not measured at fair value and prior derecognition transactions often would be unduly onerous, and in many cases would be impractical. To only partially restate prior period financial statements would be to provide comparative information that is neither on the basis of accounting in this Draft Standard, nor that used previously.

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APPENDIX A

Dissenting Views

A.1 Members of two delegations of the JWG dissent to the document as a whole. However, both of those delegations support publication of the document. They believe that the document represents an important contribution to the debate on a comprehensive standard on accounting for financial instruments, and that it provides a basis for further discussions with constituents. Furthermore, they believe that the comment process is important to promoting a better understanding of the issues and constituent views.

Dissenting Views of the French Delegation

A.2 The members of the French delegation dissent because they believe fair value is not relevant for measuring all business activities and transactions. While accepting the objectives and terms of reference of the JWG, the dissenting delegation concluded, based on the work of the JWG, that fair value is not relevant for certain business transactions and activities that are not managed or subject to performance measurement based on fair values. This specifically applies to financial instruments in the banking book of banks, including demand deposits and other financial instruments used in asset and liability management (ALM). [This issue is analysed in paragraphs 1.6-1.13 of the Basis for Conclusions, especially 1.10-1.11.] The issues related to the application of fair value principles to the business activities of banks are discussed in the Joint Working Group of Banking Association's paper of October 1999 (referred to in paragraph 2.3 of the Basis for Conclusions).

A.3 Other circumstances, business activities, or transactions for which the delegation believes fair value is not relevant include those in the following paragraphs (the sequence of individual points follows the structure of the Draft Standard and does not represent a sequence by priority).

Certain Financial Instruments for which there are No Liquid Markets

A.4 Based on research carried out by the JWG, the delegation believes the lack of reliability of fair value measurement and valuation techniques for financial instruments for which there are no observable market prices, and for certain quoted financial instruments traded on illiquid markets, is such that it compromises the accuracy, reliability and comparability between enterprises and the consistency between periods for the same enterprise. This outweighs any benefit that might be derived from a fair value basis of accounting for these instruments. Comparability is a very important qualitative characteristic of financial statements and, based on the JWG research and on past experience, it is the delegation's view that the guidelines provided cannot be sufficient to overcome this issue and achieve comparable results. [Considerations relating to reliability generally are discussed in paragraphs 1.14-1.21 of the Basis for Conclusions. See also discussions in the Draft Standard, Application Supplement and Basis for Conclusions about the use of market prices for similar instruments and the use of valuation techniques in circumstances where quoted market prices may be infrequently available or not determined by normal market interactions.]

Debt Financing Non-financial Assets Carried at Cost

A.5 The delegation believes such debt should not be measured on a fair value basis with the change in fair value recognised in the income statement as this is inconsistent with the measurement and accounting for the non-financial assets, which continue to be on a cost-based accounting basis. The same comments as those on mis-matches in respect of hedging of future transactions (see paragraph A.9 below) apply to this situation. [This issue is analysed in paragraphs 4.49 and 6.15-6.16 of the Basis for Conclusions.]

Application of the Fair Value Model to Own Credit Risk in respect of an Enterprise's Financial Liabilities

A.6 The delegation points out that effects of changes in own credit risk of the reporting enterprise reflect changes in its internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. Therefore, they see a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's financial liabilities, while not reporting potential offsetting changes in unrecognised goodwill. Furthermore, taking into account an enterprise's own credit risk, which reflects the possibility of an insolvency, might contradict the general presumption that the enterprise will continue as a going concern. [This issue is analysed in paragraphs 4.56-4.58 of the Basis for Conclusions.]

Fair Value Interest

A.7 The delegation believes that fair value interest does not provide useful or relevant information to users or for management purposes, as fair value interest has no relationship with contractual cash flows. The delegation believes that interest on interest-bearing financial instruments measured at fair value should continue to be determined on the historical cost "effective interest" basis. They point out that this basis is familiar to users and that this method has important information value because it reflects the contracted interest rate inherent in an interest-bearing financial instrument. They do not see a convincing demonstration of the practicability of calculating fair value interest nor of the feasibility of reconciling fair value interest with historical cost-based interest or cash flows. Further, they do not believe that fair value interest has a better predictive value compared to historical cost-based interest. [This issue is analysed in paragraphs 6.58-6.76 of the Basis for Conclusions.]

Hedging of Future Transactions

A.8 An important aspect of many enterprises' risk management activities relates to the variability of expected cash flows related to anticipated future transactions. Enterprises commonly use financial instruments to offset that variability. It is the delegation's view that not deferring gains and losses due to changes in fair value of the financial instrument used as the hedging instrument, or not using an alternative method of accounting that reflects management's intentions in using financial instruments to mitigate anticipated future risks, results in an inconsistency in reporting the effects of changes in the fair value of the hedging instrument and the counter balancing changes in the value of the anticipated future transaction. The delegation recognises the practical problems in implementing such hedge accounting, but believes that its benefits, in portraying management's decisions and in allowing a proper matching of gains and losses, outweigh the practical problems and the mis-match that will result from the JWG proposal. [This issue is analysed in paragraphs 7.10-7.20 of the Basis for Conclusions.]

A.9 Also, the JWG concluded that a commitment to acquire a non-financial item at a fixed price in a foreign currency is a non-financial contract. Further, it concluded that it would not be appropriate to extend the scope of the Draft Standard to treat such a commitment as if it were, or as if it contained, a foreign currency denominated financial instrument. Although the delegation recognises that the objective of the JWG was not primarily directed to non-financial items, the mis-match problem should have been addressed and resolved by the JWG. [This issue is analysed in paragraphs 2.58-2.62 and 7.15 of the Basis for Conclusions.] In this context, the delegation refers to the fact that the JWG has accepted a similar exception from the basic requirements of the Draft Standard in that the effects of foreign currency translation do not have to be reflected in the income statement as long as the standards for foreign currency translation have not been revised. They believe that, without a resolution of this mis-match problem financial accounting will be even further removed from reflecting the economics of sound risk management.

Concluding Comment

A.10 It is the member's belief that implementation of a full fair value model which does not recognise specific business activities or transactions where a fair value basis of accounting is not relevant may have broad macro economic and financial stability implications on certain markets, which are not understood.

Dissenting Views of the German Delegation

A.11 The members of the German delegation support the basic premise that fair value measurement of financial instruments has major conceptual advantages since it provides to the users of financial statements a more faithful representation of the amounts, timing and probabilities of future cash flows. However, in the view of the members of that delegation, this Draft Standard does not meet the objective set for the JWG, which was to make operational the fair value framework outlined in the March 1997 IASC Discussion Paper, Accounting for Financial Assets and Financial Liabilities. Some significant implementation questions are not addressed in sufficient detail in the Draft Standard, and it leaves too many questions to be resolved by individual financial statement issuers and their auditors. Also, in their view some major conceptual issues have not been properly analysed by the JWG. The German delegation believes that before the requirements in the Draft Standard could be implemented on a reasonable and consistent basis, those conceptual issues must be reconsidered and additional guidance on implementation issues must be provided.

A.12 The major specific reasons for the German delegation's dissent from the Draft Standard are outlined in the following paragraphs (the sequence of individual points follows the structure of the Draft Standard and does not represent a sequence by priority).

Scope

A.13 The delegation emphasises—according to the JWG's definition of financial instruments—the need for a strict distinction between financial instruments and non-financial assets and liabilities. The distinctive feature of financial instruments is that they are not exposed to operational risks of the reporting enterprise. Accordingly it is their belief that paragraphs 2, 3, 5 and 76 of the Draft Standard inappropriately extend its scope to servicing assets and liabilities and to non-financial portions of certain contracts, which the JWG acknowledges are not financial instruments according to its own definition. [These issues are analysed in paragraphs 2.16-2.19 and 2.37-2.52 of the Basis for Conclusions.]

Derecognition

A.14 Paragraphs 64-65 provide that, in certain situations, a transferor of financial assets with an obligation to repay consideration received at the time of the transfer must recognise as a liability the maximum amount that might have to be repaid. The transferor also continues to recognise a corresponding portion of the assets that were transferred. In the view of the dissenting delegation this represents an exception to the components approach that the JWG has adopted for derecognition of financial instruments, solely to maintain the presentation of secured borrowings. This presentation and accounting respectively ignores the contractual agreements and results in the situation that the respective derivative financial instruments (for example, repayment options) are not recognised even though they clearly represent financial assets or liabilities. The JWG's justifications for this exception, in paragraphs 3.38-3.71 and 3.93-3.102, are not seen as compelling by the dissenting delegation, who feel that the Basis for Conclusions presents many good arguments in favour of the components approach.

A.15 Furthermore, in their view, the non-recognition of financial assets and financial liabilities in the case of specific sub-participations and similar transactions is not compatible with the general offsetting rules (see, for example, paragraph 33 of IAS 32). [This issue is analysed in paragraphs 3.36 and 3.37 of the Basis for Conclusions.]

Fair value measurement

A.16 The delegation advocates that, in all cases where bid and asked prices exist, fair value should principally be determined by using mid-point prices, since, in their view, they reflect the assessments of all market participants and not only the assessments of one side of the market (i.e., of those who sell for the purpose of measuring financial assets or of those who settle for the purpose of measuring financial liabilities). Furthermore, the application of mid-point prices would be more consistent with the decision of the JWG that transaction costs should not be included in the fair value measurement. [This issue is analysed in paragraph 4.17 of the Basis for Conclusions.]

Measurement of financial liabilities—Own credit risk

A.17 The delegation points out that effects of changes in own credit risk of the reporting enterprise reflect changes in its internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. Therefore, they see a fundamental inconsistency in reporting the effects of changes in credit standing on an enterprise's financial liabilities, while not reporting potential offsetting changes in unrecognised goodwill. Furthermore, taking into account an enterprise's own credit risk, which reflects the possibility of an insolvency, might contradict the general presumption that the enterprise will continue as a going concern. [These issues are analysed in paragraphs 4.56-4.58 of the Basis for Conclusions.]

Reliability and feasibility of fair value measurement—Implementation Guidance

A.18 It is the delegation's view that it is the mandate and objective of the JWG to operationalise the full fair value model on the basis of the framework outlined in the March 1997 Discussion Paper. This includes the provision of appropriate and useful valuation guidance. In their view the Application Supplement includes only a very general description of how the fair values of non-traded financial instruments should be determined. Not only with regard to the practicability of fair value measurement, but also with regard to the comparability of financial statements, they doubt whether reporting enterprises should be able to choose between different types of valuation techniques and to determine without detailed guidance the appropriate inputs to the applied valuation models. They point out that comparability is a very important qualitative characteristic of financial statements and that, based on past experience, it would be doubtful whether the setting of general principles only is sufficient to achieve comparable results. [This issue is analysed in paragraphs 1.38-1.40 and throughout Section 4 of the Basis for Conclusions.]

Income presentation and cash flow statement

A.19 The delegation does not see a convincing demonstration of the practicability of calculating fair value interest. Further, they are not convinced that fair value interest has a better predictive value compared to historical cost-based interest. In their view, the results of the proposed field testing, as well as further discussions with users of financial statements, would be necessary to clarify the practicability as well as the relevance of this approach. [This issue is analysed in paragraphs 6.58-6.77 of the Basis for Conclusions.]

A.20 Further, the Draft Standard does not specify how payments on interest-bearing financial instruments should be presented in the statement of cash flows. The dissenting delegation believes that the Draft Standard should have addressed whether the payments should be divided between interest and principal and, if so, whether, for purposes of cash flow presentation, interest should be based on fair value, historical cost, or contractual payments. They point out that this lack of guidance is likely to result in inconsistent application by financial statement issuers. [This issue is analysed in paragraphs 6.85 and 6.86 of the Basis for Conclusions.]

"Mis-match problems" between financial instruments and other balance sheet items or transactions

A.21 Despite the basic differences between financial instruments and non-financial assets and liabilities, there are close relationships between the two. The delegation is of the opinion that in certain situations, those relationships might justify exceptions to the basic requirement that all changes in fair values of financial statements should be recognised immediately in income in order to avoid recognising in different periods gains and losses on closely related items. Some major examples are debt financing non-financial assets and hedges of non-financial assets/liabilities or firm commitments.

A.22 Taking into account its restricted objective to develop a comprehensive accounting standard for financial instruments, the JWG has concluded that the individual standard setters should consider whether it would be necessary to resolve mis-match problems by modifications of the accounting standards for non-financial assets and liabilities. However, the delegation believes that, although it is recognised that the objective of the JWG was not primarily directed to non-financial items, the apparent mis-match problems should have been addressed and resolved by the JWG. In this context the delegation notes that the JWG has accepted a similar exception from the basic requirements of the Draft Standard in that the effects of foreign currency translation do not have to be reflected in the income statement as long as the standards for foreign currency translation have not been revised.

A.23 They believe that, without a resolution of the mis-match problem, financial accounting will be even further removed from reflecting the economics of sound risk management. [This issue is analysed in paragraphs 4.49, 6.15 and 6.16 and Section 7 of the Basis for Conclusions.]

APPENDIX B

Consequential Amendments

B.1 This appendix identifies the main areas where amendments would be necessary to existing accounting standards as a result of adopting the JWG Draft Standard. Specific amendments will differ by jurisdiction. The objective of this appendix is to highlight only the general nature of the main amendments that are likely to affect most jurisdictions.

Presentation of Financial Statements

B.2 The proposals in the Draft Standard for balance sheet and income statement presentation would necessitate consequential changes to existing requirements for presentation of items on the face of the financial statements.[54]

Leases

B.3 Lease accounting standards for finance leases typically require historical cost accounting for the lease receivable by the lessor and lease payable by the lessee. Under this accounting, lease income and lease payments are required to be apportioned between principal and interest, with the finance charge allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance for each period.[55] The Draft Standard would require that finance lease receivables and payables be accounted for in the same way as other financial instruments (see paragraphs 211-213). Accordingly, amendments to lease accounting standards would be necessary to implement this.

Revenue

B.4 Existing requirements for revenue recognition from financial instruments, particularly those related to recognition of interest income and expense,[56] would require amendment to be consistent with the income statement presentation requirements of the Draft Standard.

Foreign Currency Translation

B.5 In most jurisdictions, existing accounting for foreign currency translation requires that monetary items be translated at each reporting date to reflect the exchange rate in effect at that date, as applied to the foreign currency market price.[57] However, international practice is not consistent with respect to the treatment of forward exchange contracts. Conforming

[54] See, for example, IAS 1, Presentation of Financial Statements.
[55] See, for example, paragraphs 17 and 30 of IAS 17, Leases.
[56] See, for example, IAS 18, Revenue.
[57] See, for example, IAS 21, The Effects of Changes in Foreign Exchange Rates.

amendments to accounting standards for foreign currency translation would, therefore, be necessary.

B.6 In addition, the JWG proposes no exception for income statement recognition of gains and losses arising on financial instruments designated as hedging translation risks on net investments in foreign entities (see Basis for Conclusions, paragraphs 7.21-7.22). This would necessitate change to those foreign currency translation standards that permit such special accounting.

Business Combinations, Accounting for Investments in Associates and Financial Reporting of Interests in Joint Ventures

B.7 Standards for business combinations and equity accounting[58] would require amendment to address the determination of the amount to be used for the equity shares acquired in a step-acquisition. This Draft Standard does not cover subsidiaries and equity accounted investees, but in step acquisitions, the Draft Standard will normally require that investments are accounted for at fair value before significant influence, control, or joint control is obtained.

Borrowing Costs

B.8 Existing standards that permit, or require, borrowing costs to be capitalised[59] would require reconsideration to take into account the consequences of presenting interest income and expense on a fair value basis.

Financial Instruments: Disclosure and Presentation

B.9 The JWG has not comprehensively reconsidered existing standards for an issuer's classification of financial instruments between liabilities and equity, including the classification of compound instruments by the issuer, or for when a financial asset and a financial liability may be offset[60]. Accordingly, the JWG has not considered whether changes might be necessary to existing presentation standards[61] to be consistent with the Draft Standard.

B.10 The JWG believes that the scope and definitions in the Draft Standard should replace those in existing standards that address presentation and recognition and measurement of

[58] See, for example, IAS 22, Business Combinations, IAS 28, Accounting for Investments in Associates, and IAS 31, Financial Reporting of Interests in Joint Ventures.

[59] See, for example, IAS 23, Borrowing Costs.

[60] However, paragraph 3.37 of this Basis for Conclusions does note that implementation of the JWG's proposals for arrangements to pass cash flows through one enterprise to another would enable the three party offset provisions to be deleted from paragraph 36 of IAS 32 and put in what some would consider to be a more appropriate recognition and derecognition context.

[61] See, for example, IAS 32, Financial Instruments: Disclosure and Presentation.

financial instruments. Changes to the definition of a financial instrument would also necessitate some changes to other existing standards that use different definitions.

B.11 The JWG expects that the comprehensive disclosure requirements in this Draft Standard would replace existing disclosure requirements.

Financial Instruments: Recognition and Measurement

B.12 This Draft Standard is intended to comprehensively address recognition, derecognition and measurement of financial instruments. Accordingly, other standards addressing these subjects,[62] including those relating to measurement of specific financial instruments, such as impaired loans or investments, would be withdrawn or significantly amended.

[62] See, for example, IAS 39, Financial Instruments: Recognition and Measurement.

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APPENDIX C

Glossary of Terms

This appendix contains definitions of terms or phrases as used in this Draft Standard.

Adequate compensation ***is the amount of benefits of servicing that the market believes would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.***

Basic (or "risk-free") interest ***is the amount of interest that compensates the lender for the time value of money.***

Basic (or "risk free") interest rate risk ***is the risk of changes in the fair value or cash flows of an asset or liability due to changes in the basic interest rate.***

Benefits of servicing ***are revenues from contractually specified servicing fees, late charges and other ancillary sources, including any float, that the servicer is entitled to receive only if it performs the servicing of the financial assets.***

Cash ***comprises cash on hand and demand deposits.***

Cash equivalents ***are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.***

A clean-up call option is a call option (or similar right) held by a servicer of transferred components, or its affiliate, to purchase the remaining transferred components if the amount of those remaining components falls to a level at which the cost of servicing them becomes burdensome in relation to the benefits of servicing. The servicer of transferred components or its affiliate may be the transferor.

The components of a financial instrument are the contractual rights to future economic benefits and the contractual obligations to transfer economic benefits that make up the financial instrument.

A conditional financial instrument is a financial instrument that requires delivery of another financial instrument or exchange of financial instruments only if specified future events occur.

Contractually specified servicing fees ***are all amounts that, according to the contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to exercise their actual or potential authority under the contract to have the financial assets serviced by another servicer.***

Credit risk ***is the risk that one party will fail to discharge its contractual obligation and thereby cause another party to incur a loss.***

Credit risk premium ***is the premium over the basic interest rate that the market requires to cover (a) the effects of expected defaults due to the failure of the borrowing party to discharge its contractual obligation and (b) compensation for assuming the risk of default. The credit risk premium includes any interest rate spread over the basic interest rate for risks relating to industry or geographic sectors.***

Currency risk ***is the risk of changes in the value of an asset or liability due to changes in exchange rates.***

Current market expectations rate of interest ***is the current per period rate of interest reflected in current interest forward rates implicit in observable market interest yield curves.***

Current yield to maturity ***is the average per period rate of interest that equates the fixed or determinable cash flows of an interest-bearing financial asset or liability with its fair value.***

Derecognition ***of an asset or liability or component thereof is ceasing to recognise that asset, liability or component on an enterprise's balance sheet.***

An equity instrument is a financial instrument that represents a residual interest in the assets of an enterprise after deducting all its liabilities.

Fair value ***is an estimate of the price an enterprise would have received if it had sold an asset or paid if it had been relieved of a liability on the measurement date in an arm's-length exchange motivated by normal business considerations.***

A financial asset is a financial instrument that is an asset.

A financial guarantee is a contract that requires payments to be made to a creditor if a debtor fails to make payment when due.

A financial instrument is one of the following:

(a) ***cash;***

(b) ***an equity instrument;***

(c) ***a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to receive that financial instrument in exchange for no consideration other than release from the obligation; or***

(d) ***a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party.***

A financial liability is a financial instrument that is a liability.

A financial risk of an enterprise is any risk to which a financial instrument held or issued by that enterprise is subject.

Float is the amount of funds available to an enterprise between the time that money is received and the time that the enterprise is required to make payment using those funds.

Foreign currency—according to the context a currency may be foreign with respect to either:

(a) ***the functional currency of a foreign entity; or***

(b) ***the reporting currency of the reporting enterprise.***

A foreign currency denominated financial instrument is one for which the settlement amount at any given time is determined in terms of a foreign currency.

A foreign entity is an operation (for example, a subsidiary, division, branch, joint venture, etc.) whose financial statements (a) are prepared in a currency other than the reporting currency of the reporting enterprise and (b) are consolidated with or accounted for under the equity method in the financial statements of the reporting enterprise.

The functional currency of an entity is the currency of the primary economic environment in which the entity operates. Normally, that is the currency of the environment in which that entity primarily generates and expends cash. A reporting enterprise may have multiple functional currencies, one of which is normally the same as the reporting currency.

A hybrid contract is a contract that has one or more sets of rights and obligations that, if they were separated from the contract would be accounted for as financial instruments that fall within the scope of this Draft Standard, and one or more sets of rights and obligations that do not fall within the scope of this Draft Standard.

An impaired loan asset is a loan asset whose credit quality has deteriorated to the extent that it is 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 terms of the loan contract.

An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest

rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).

Interest-bearing financial assets (liabilities) comprise all financial instruments except cash on hand, equity instruments, and forward contracts (including swaps), options and similar derivative financial instruments.

Interest revenue (expense) is the return to the lender (cost to the borrower) for the temporary use of money. Within the context of measuring financial instruments at fair value, it is the market return (cost) on the fair value of an enterprise's interest-bearing financial assets (liabilities) for a reporting period. It includes (a) basic interest; (b) credit risk premium; (c) liquidity risk premium; and (d) any premium to the lender for bearing risks of adverse variability of expected cash flows apart from credit risk and liquidity risk.

Liquidity risk is the risk that a loss may be incurred because a position cannot be eliminated quickly.

A loan asset is a contractual right, that is not traded on an exchange or in dealer markets, to receive cash or other financial instruments of fixed or determinable amounts and timing in exchange for no consideration other than releasing the borrowing party from its obligations to the enterprise.

The reporting currency is the currency in which the reporting enterprise presents its financial statements.

The reporting enterprise is the enterprise whose financial statements are addressed in this Draft Standard.

A servicing asset results from a contract to service financial assets if the benefits of servicing are more than adequate compensation.

A servicing liability results from a contract to service financial assets if the benefits of servicing are less than adequate compensation.

A transfer occurs when one party passes to another party or parties the whole, or some component, of one or more of its assets.

APPENDIX D

Members of the Financial Instruments Joint Working Group of standard setters

Name	Position	Country/Organisation
Alex Milburn (Chair)	Former Board Member, International Accounting Standards Committee	IASC
Wayne Lonergan	Former Board Member, Australian Accounting Standards Board	Australia
Patricia Stebbens	Senior Project Director—Accounting, Australian Accounting Standards Board	Australia
Tricia O'Malley	Chair, Accounting Standards Board, Canadian Institute of Chartered Accountants	Canada
Ian Hague	Principal, Accounting Standards, Canadian Institute of Chartered Accountants	Canada
Gerard Gil	Representative of the Conseil National de la Comptabilité (French Accounting Standards Committee)	France
Etienne Boris	Representative of the Conseil National de la Comptabilité (French Accounting Standards Committee)	France
Jochen Pape	Representative of the Institut der Wirtschaftsprüfer & Board Member, International Accounting Standards Committee	Germany
Günther Gebhardt	Chair, Financial Instruments Task Force, German Accounting Standards Committee	Germany
Norbert Breker	Project Manager, Institut der Wirtschaftsprüfer	Germany
Shigeo Ogi	Japanese Institute of Certified Public Accountants	Japan
Tatsumi Yamada	Member, Business Accounting Deliberation Council, Japanese Institute of Certified Public Accountants & Board Member, International Accounting Standards Committee	Japan

Appendix D – JWG Members

Mike Bradbury	Board Member, New Zealand Financial Reporting Standards Board	New Zealand
Craig Heppleston	Representative of the New Zealand Financial Reporting Standards Board	New Zealand
Erik Mamelund	Board Member, Norwegian Accounting Standards Board & Board Member, International Accounting Standards Committee	Nordic Federation
Allan Cook	Technical Director, U.K. Accounting Standards Board	United Kingdom
Paul Ebling	Project Director, U.K. Accounting Standards Board	United Kingdom
James Leisenring	Director of International Activities, Financial Accounting Standards Board	United States
Halsey Bullen	Senior Project Manager, Financial Accounting Standards Board	United States
Ronald Lott	Project Manager, Financial Accounting Standards Board	United States

The JWG also recognises the significant time and effort contributed to this project by the following individuals.
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