Financial Instruments

JWG

Joint Working Group of standard setters

FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

SUMMARY

This Draft Standard proposes far-reaching changes to accounting for financial instruments and similar items. These include:

(a) measurement of virtually all financial instruments at fair value;

(b) recognition of virtually all gains and losses resulting from changes in fair value in the income statement in the periods in which they arise;

(c) preclusion of special accounting for financial instruments used in hedging relationships;

(d) adoption of a components approach for accounting for transfers of financial assets; and

(e) some expansion of disclosures about financial instruments, financial risk positions and income statement effects.

Background

Advances in financial risk management and information technology, globalisation of capital markets, and accelerated use of sophisticated derivatives and other complex financial instruments have combined to change fundamentally the business and investment environment. It has become apparent that traditional accounting concepts for the recognition and cost-based measurement of financial instruments need to be rethought.

Accounting standard setting bodies around the world are at different stages in considering and addressing the issues. Many standard setters have required disclosures about financial instruments, and a few have issued standards for recognition and measurement of financial instruments that adopt mixed cost—fair value approaches. Those recognition and measurement standards are highly complex, and those issuing them have indicated that they are intended to be interim standards pending further study. Studies by several major accounting standard setting bodies and others have recommended the adoption of a comprehensive fair value measurement model for financial instruments that would be consistent with accepted capital markets practices and finance concepts for pricing financial instruments.

Recognising the world-wide importance of the issues, the Financial Instruments Joint Working Group of standard setters (JWG) was established to develop a proposed comprehensive standard on accounting for financial instruments based on fair value measurement principles. The JWG's charge was to propose a standard that would implement the fair-value-based principles set out in the Discussion Paper, Accounting for Financial Assets and Financial Liabilities, issued by the International Accounting Standards Committee (IASC) and Canadian Institute of Chartered

Accountants (CICA) in 1997, with such further development or amendment as the JWG considered appropriate based on its work and deliberations.

The JWG comprises representatives or members of accounting standard setters or professional organisations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, the United States, and the IASC. The views expressed by JWG members in preparing the Draft Standard were their own and in most cases the standard setters and professional organisations themselves have not fully deliberated or developed official views on the positions taken in the Draft Standard.

Scope

The Draft Standard would apply to all enterprises.

The Draft Standard would apply to all financial instruments except for certain financial instruments that have unique aspects:

(a) for which there are accounting standards (for example, investments in subsidiaries and associates, and equity instruments issued by the reporting enterprise); or

(b) that are the subject of separate study (in particular, most insurance contracts).

The scope of the Draft Standard includes certain non-financial contracts that are considered to be very similar to financial instruments (including certain commodity contracts that can be settled net by financial instruments and separate assets and liabilities resulting from contracts to service financial assets).

Financial instrument components of contracts that also have components falling outside the scope of the Draft Standard ("hybrid contracts") would generally be separately accounted for as free-standing financial instruments.

The Principal Provisions

The Draft Standard is founded on four basic principles.

1. Fair Value Measurement Principle

The JWG accepted the Discussion Paper conclusion that fair value is the most relevant measurement attribute for all financial instruments, and has concluded that sufficiently reliable estimates of the fair value of financial instruments are obtainable for financial reporting purposes, with the exception of certain private equity investments. [The basic case for fair value measurement of financial instruments is set out in the Basis for Conclusions paragraphs 1.6-1.26]

Draft Standard and Basis for Conclusions – Summary

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

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

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

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

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

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

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

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

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

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

2. Income Recognition Principle

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

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

3. Recognition and Derecognition Principle

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

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

4. Disclosure Principle

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

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

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

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

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

Hedges

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

Implementation and Transition

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 has very significant deficiencies and is not sustainable in the longer term;

(b) an accounting system based on the four principles is superior in relevance and, therefore, in the usefulness of the information that can be derived from it; and

(c) the Draft Standard is capable of reasonable and reliable implementation.

In the JWG's view, it is the last of these reasons (the capability of reasonable and reliable implementation) that presents the most difficult challenge. The development of a fully effective standard requires addressing a number of issues that have not been subject to accounting consideration to date, and it will require application experience and field testing to fully resolve and perfect. The Basis for Conclusions discusses the more significant issues identified by the JWG and the reasons for the positions taken in the Draft Standard. The JWG believes that these issues can be reasonably accommodated within the Draft Standard and that they are no more serious than many difficult issues that are presently accommodated within existing standards in other areas of financial reporting. In a number of areas the Draft Standard would require only basic levels of presentation and disclosure that can be further built upon as experience is gained. The Draft Standard places much importance on enterprises establishing policies and procedures appropriate to ensuring reliable and consistent fair value estimations.

The effective implementation of the Draft Standard requires integrating knowledge of certain finance and capital markets concepts and practices with financial accounting objectives and framework concepts. This requires a somewhat different "mind-set" and expertise base from that appropriate to traditional recognition and historical-cost-based accounting for financial instruments. The JWG believes that it is of utmost importance to put in place a well planned and internationally co-ordinated implementation process, including education and field testing, and that there should be a sufficient transition period to enable this.

The Next Steps

The Draft Standard, Application Supplement, and Basis for Conclusions are being issued for comment by each of the participating standard setters. Each participating standard setting body intends to take into account this document's proposals, and comments received, in developing standards that will be applicable in its jurisdiction. It is expected that the participating standard setters will make their best efforts to work together towards achieving the same accounting for financial instruments in each jurisdiction.

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FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

PREFACE

P1. Advances in financial risk management and information technology, globalisation of capital markets, and accelerated use of sophisticated derivatives and other complex financial instruments, have combined to change fundamentally the business and investment environment. It has become apparent that traditional accounting concepts for the recognition and cost-based measurement of financial instruments need to be rethought.

P2. Accounting standard setting bodies around the world are at different stages in considering and addressing the issues. Many standard setters have required disclosures about financial instruments, and a few have issued standards for recognition and measurement that adopt mixed measurement cost—fair value approaches. Those recognition and measurement standards are highly complex, and those issuing them have indicated that they are intended to be interim standards pending further study. Studies by several major accounting standard setting bodies and others have recommended the adoption of a comprehensive fair value measurement model for financial instruments that would be consistent with accepted capital markets practices and finance concepts for pricing financial instruments.

P3. Recognising the world-wide importance of the issues, in October 1997, a number of standard setters agreed to establish the Financial Instruments Joint Working Group of standard setters (JWG), with the following objectives:

(a) to develop a proposed comprehensive standard on accounting for financial assets and financial liabilities, supported by a basis for conclusions and appropriate guidance material and examples;

(b) to put in place a coherent framework of principles for the recognition and fair value measurement of financial assets and liabilities, and for the presentation and disclosure of gains and losses and hedging activities; and

(c) to base the principles of the standard on those set out in the International Accounting Standards Committee's (IASC) and Canadian Institute of Chartered Accountants' (CICA) Discussion Paper, Accounting for Financial Assets and Financial Liabilities, March 1997, as further developed or amended as a result of the work programme and deliberations of the JWG.

P4. The JWG comprises representatives or members of accounting standard setters or professional organisations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, the United States, and the IASC (see Appendix D for a list of members). The views expressed by JWG members in preparing the Draft Standard were their own and in most cases the standard setters and professional organisations themselves have not fully deliberated or developed official views on the positions taken in the Draft Standard.

P5. On a number of topics, some members hold views different from the proposals made in the Draft Standard. References in the Basis for Conclusions to the JWG's conclusions on individual issues reflect the majority view. Arguments and issues underlying minority views are also discussed in the Basis for Conclusions, together with the reasons why the majority does not accept them.

P6. All members of the JWG agree that the document should be issued for comment. The French and German delegations dissent from the conclusions of the Draft Standard (see Appendix A).

P7. The JWG has carried out an extensive work programme, with input from participating standard setting bodies and other organisations. The proposals are presented in the form of:

(a) a Draft Standard, which is prepared in the style of, and within the context of, existing International Accounting Standards;

(b) an Application Supplement, which provides additional material that explains how certain aspects of the Draft Standard apply. The Application Supplement is an integral part of the Draft Standard; and

(c) a Basis for Conclusions, which summarises considerations that members of the JWG deemed significant in reaching the conclusions in the Draft Standard.

P8. The JWG's proposals are being issued in each participating jurisdiction for comment. All comments received will be shared between JWG members unless confidentiality is requested. Each participating standard setting body intends to take into account the JWG document, and comments received, in developing standards that would be applicable in its jurisdiction. It is expected that the participating standard setting bodies will make best efforts to work towards achieving the same accounting for financial instruments in each jurisdiction.

Request for Comments

Comments are sought on any aspect of this Draft Standard and Basis for Conclusions. Commentators are requested to indicate:

(a) whether they support the proposals in the Draft Standard and, if not, why not and what changes they would propose, together with the reasons for those changes; and

(b) any additional principles and guidance that they consider necessary, together with reasons.

Answers to the following questions and the reasons for those answers would be particularly helpful.

Scope and Definitions

Q1. The Draft Standard would apply to all enterprises (see Draft Standard paragraph 1 and Basis for Conclusions paragraphs 2.1-2.12). Do you agree? If not, please specify which enterprises you believe should be excluded from the scope (and why), and the basis on which you would distinguish those enterprises that should apply the Draft Standard from those that need or should not.

Q2. The definition of a financial instrument would differ somewhat from the present IASC definition (see Draft Standard paragraph 7 and Basis for Conclusions paragraphs 2.13 and 2.14). Do you agree with the definition in the Draft Standard? If not, what changes would you make, and why?

Q3. The Draft Standard would apply to all financial instruments except for those referred to in paragraph 1 (see also Basis for Conclusions paragraphs 2.20-2.36).

(a) Do you agree with the proposed scope exclusions and the manner in which they are defined? If not, why not?

(b) Are there other items that should be excluded from the scope of the Draft Standard? If so, why, and how should those items be defined?

Q4. The definition of an insurance contract used in the IASC Insurance Steering Committee's, Issues Paper: Insurance, November 1999, is used as the basis to exclude insurance contracts from the scope of the Draft Standard. However, financial guarantees and certain contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events would not be excluded (see Draft Standard paragraphs

1(d), 17-19 and Basis for Conclusions paragraphs 2.23-2.30)? Do you agree with this approach and definition? If not, what approach and definition would you propose?

Q5. The scope of the Draft Standard would include certain additional items, including certain contracts to buy or sell a non-financial item and servicing assets and servicing liabilities (see Draft Standard paragraphs 2 and 3, Application Supplement paragraphs 197-210, and Basis for Conclusions paragraphs 2.37-2.47).

(a) Do you agree that these additional items should be included in the scope? If not, why not?

(b) Are the additional items included defined in a manner that can be clearly applied? If not, how would you amend the requirements?

(c) Are there other items that should be included in the scope of the Draft Standard and, if there are, how should they be defined?

Q6. The Draft Standard would require an enterprise, with certain exceptions, to separately account for sets of contractual rights and contractual obligations in a hybrid contract that, if they were separated, would fall within the scope of the Draft Standard (see Draft Standard paragraphs 4-6 and 25 and Basis for Conclusions paragraphs 2.48-2.52). Do you agree with this proposal? Is the definition of a hybrid contract clear and operational? If you disagree with either of these two questions, what alternative would you suggest?

Recognition and Derecognition

Q7. The basic recognition principle is that an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in an asset or liability (see Draft Standard paragraphs 31-34, Application Supplement paragraphs 214-220, and Basis for Conclusions paragraphs 3.1-3.8). Do you agree? If not, why not? How would you amend the principle?

Q8. The Draft Standard would require that a transfer that does not have substance not affect the assets and liabilities recognised. It proposes that a transfer has substance only if either the transferee conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor, or the components transferred have been isolated from the transferor (see Draft Standard paragraphs 35 and 36, Application Supplement paragraphs 222 and 223, and Basis for Conclusions paragraphs 3.72-3.80). Do you agree? If not, how would you propose to limit the potential for non-substantive transactions that might occur without such a test?

Q9. The basic derecognition principle is that an enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component (see Draft Standard paragraphs 37-40, Application Supplement paragraphs 224-231, and Basis for Conclusions paragraphs 3.1-3.8 and 3.15-3.30). Do you agree? If not, why not? How would you amend the principle?

Q10. The Draft Standard would require that, in certain circumstances, when cash flows are passed through one enterprise to another, the assumption of a contractual obligation to make payments that fully reflect the amount of the cash flows being received from another enterprise would qualify as a transfer of the contractual right to receive the cash flows (see Draft Standard paragraphs 41-48, Application Supplement paragraphs 309-314, and Basis for Conclusions paragraphs 3.32-3.37).

(a) Do you agree? If not, why not? How would you amend the requirement?

(b) Is the requirement and implementation material workable? If not, what changes do you believe are necessary to make them workable?

Q11. The JWG has developed criteria to be used to determine whether a financial asset (or a component thereof) should be derecognised by the transferor when a transfer of substance involving a financial asset takes place. In particular, the Draft Standard would require the whole of the financial asset previously recognised by the transferor to be derecognised if either the transferor no longer has a continuing involvement in that asset or the transferee has the practical ability, which it can exercise unilaterally and without imposing additional restrictions, to transfer the whole of that asset to a third party (see Draft Standard paragraphs 51-62, Application Supplement paragraphs 236, 237 and 242-250, and Basis for Conclusions paragraphs 3.50 and 3.81-3.92).

(a) Do you agree? If not why not? How would you amend the requirement?

(b) The JWG has developed some material to determine whether the transferee has the practical ability described above (see paragraphs 56-61 and 244-249). Is this material appropriate, clear and operational? If not, how would you amend it?

Q12. The Draft Standard also would require, in the case of a transfer that does not result in the transferee having the practical ability described in Q11, if the transferor is left with either (a) an obligation that could or will involve the repayment of consideration received or (b) a call option over a transferred component that the transferee does not have the practical ability to transfer to a third party, some or all of the transaction to be treated as a loan secured by the transferred component (see Draft Standard paragraphs 63-67, Application Supplement paragraphs 251-258, and Basis for Conclusions paragraphs 3.38-3.71 and 3.93-3.102).

(a) Do you agree? If not, why not? How would you amend the requirement? In particular, if you believe that some transfers involving financial assets are loans secured by the transferred asset, how would you differentiate between those transfers and transfers that are, in effect, sales of the transferred asset? If you do not believe that some transfers involving financial assets are loans secured by the transferred asset, or do not believe that some transfers are sales of the transferred asset, please explain your reasoning.

(b) The Draft Standard would require the liability to be recognised in such circumstances to be measured initially at the maximum amount that might need to be repaid under the obligation or the amount of the consideration received in respect of the transferred component over which the transferor has the call option. To the extent that the obligation and call option overlap, only the larger of the two liabilities would be recognised (see Draft Standard paragraph 64 and Basis for Conclusions paragraphs 3.93-3.98). Do you agree with this approach to determining the amount of the liability? If not, how would you change the approach?

(c) The Draft Standard would require, in the case of transfers that the Draft Standard would require the transferor to treat in part or entirely as loans secured on the transferred asset, the transferee not to adopt accounting that is the mirror-image of the transferor's (see Application Supplement paragraphs 238-241 and Basis for Conclusions paragraphs 3.64-3.68). Do you agree with this approach? If not, why not? How would you amend the Draft Standard?

Q13. The Draft Standard would require the basic recognition and derecognition principles set out in paragraphs 31 and 37 to be applied to all transfers not falling within paragraphs 51-67 (see Draft Standard paragraph 68 and Basis for Conclusions paragraph 3.62). Do you agree with this proposal? If not, why not? How would you amend the Draft Standard?

Measurement

Q14. The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognised initially and to re-measure them at fair value at each subsequent measurement date, with one exception (see Draft Standard paragraph 69, Application Supplement paragraphs 315-317, and Basis for Conclusions paragraphs 1.6-1.26). Do you agree? If not, what other approach would you suggest and why?

Q15. The Draft Standard would require the fair value of a financial instrument to be an estimate of its market exit price determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction (see Draft Standard paragraphs 28, 70 and 71 and Basis for Conclusions paragraphs 4.1-4.10). The JWG also proposes that any expected costs that would be incurred to exit a financial instrument at that market exit price should not be taken into account in arriving at fair value (see Draft Standard paragraphs 72 and 73 and Basis for Conclusions paragraph 4.11).

(a) Do you agree with the market exit price objective? If not, how would you amend it and why?

(b) Do you agree with the proposed treatment of direct costs to sell or obtain relief from a financial instrument? If not, how would you amend it?

Q16. The Draft Standard would require an enterprise to measure a part of a hybrid contract that is to be separately accounted for as if it were a free-standing financial instrument, except if the enterprise determines that it cannot reliably identify and measure the separate sets of financial instrument rights and obligations in the hybrid contract. In the latter case the enterprise would account for the entire contract in the same manner as a financial instrument falling within the scope of the Draft Standard (see Draft Standard paragraphs 74-76 and Basis for Conclusions paragraphs 4.12-4.16). Do you agree with this proposal? If not, what alternative would you suggest?

Q17. The Draft Standard sets out principles for estimating the fair value of financial instruments within a hierarchy. First, observable market exit prices for identical instruments are to be used if available. If such prices are not available, market exit prices for similar financial instruments are to be used with appropriate adjustment for differences. Finally, if the fair value of a financial instrument cannot be based on observable market prices, it should be estimated using a valuation technique that is consistent with accepted economic pricing methodologies (see Draft Standard paragraphs 77-86 and 104-117, Application Supplement paragraphs 320-327 and 344-369, and Basis for Conclusions paragraphs 4.17 and 4.36-4.47). Do you agree with this hierarchy? If not, how would you amend the proposals, and why?

Q18. The Draft Standard addresses a number of circumstances requiring special consideration in using observed market prices to determine fair value (see Draft Standard paragraphs 87-103, Application Supplement paragraphs 328-343, and Basis for Conclusions paragraphs 4.18-4.35).

(a) Do you agree with the Draft Standard's conclusions in these circumstances? Are there additional circumstances that should be addressed (please specify)?

(b) Is the conclusion that value that is not directly attributable to a financial instrument should not enter into the determination of the fair value of a financial instrument (see Draft Standard paragraphs 92-94, Application Supplement paragraphs 331-339, and Basis for Conclusions paragraphs 4.18-4.32) appropriate and operational, in particular as it applies to demand deposit and credit card relationships? If not, why not?

(c) Do you agree with the conclusion that, if an enterprise holds a large block of financial instruments and market exit prices are available only for individual instruments or small blocks, the available price should not be adjusted for the potential effect of selling the large block (see Draft Standard paragraphs 102 and 103 and Basis for Conclusions paragraphs 4.34 and 4.35)? If not, in what circumstances would you require adjustment, and how would you ensure consistency of the amount of adjustments that would be made?

Q19. The Draft Standard would require an enterprise that cannot estimate fair value using observable market exit prices of identical or similar financial instruments to estimate fair value by using a valuation technique. The Application Supplement includes material explaining how valuation techniques would be used in a number of situations (see Draft Standard paragraphs 104-117, Application Supplement paragraphs 344-369, and Basis for Conclusions paragraphs 4.36-4.47).

(a) Is this material clear and operational? If not, how would you modify it?

(b) Is this material sufficient, or do you believe that more detailed material is necessary? Please specify what additional material you believe to be necessary.

(c) Are there other significant circumstances (please specify) on which guidance should be provided?

(d) Is the proposed material consistent with market pricing practices? If not, how should it be modified?

Q20. The JWG believes that fair values are, generally, reliably determinable, at reasonable cost, for all financial instruments except certain investments in private equity instruments (see Draft Standard paragraphs 122-125 and Basis for Conclusions paragraphs 1.14-1.21 and 4.64-4.67). Do you agree? If not, why not? If you believe that other items are not capable of reliable fair valuation, what are they, what factors cause their fair values not to be reliably determinable, and how should these items be measured?

Q21. The Draft Standard would require the reported value of an enterprise's financial liabilities to reflect the enterprise's own creditworthiness and changes in it (see Draft Standard paragraphs 118-121, Application Supplement paragraphs 370-372, and Basis for Conclusions paragraphs 4.50-4.62).

(a) Do you agree? If not, why not? How do you propose that the effect of changes in the enterprise's own credit worthiness could be excluded without giving rise to the difficulties noted in Basis for Conclusions paragraph 4.59?

(b) Is the material in paragraph 370 of the Application Supplement, explaining how an enterprise can establish whether there has been a change in its own creditworthiness affecting its financial liabilities when there is no observable market exit price, appropriate and operational? If not, why not? How could it be improved?

Q22. The Draft Standard would require an enterprise to establish appropriate policies and procedures for estimating fair value of financial instruments (see Draft Standard paragraphs 129 and 130, Application Supplement paragraphs 376-379, and Basis for Conclusions paragraphs 4.68 and 4.69). Do you agree with this proposal? If not, how would you change it in a manner that provides reasonable assurance of reliable and consistent fair value estimates?

Balance Sheet Presentation

Q23. The Draft Standard would require that minimum categories of financial assets and financial liabilities be distinguished on the face of the balance sheet and in the notes to the financial statements (see Draft Standard paragraphs 131-135 and Basis for Conclusions paragraphs 5.1-5.5). Do you agree with the categories proposed? Are the categories clear and useful? If not, how would you amend them and why?

Income Statement Presentation

Q24. The Draft Standard would require an enterprise to recognise all changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise, with one exception (see Draft Standard paragraph 136, Application Supplement paragraphs 380 and 381, and Basis for Conclusions paragraphs 6.1-6.29) Do you agree? If not, how should such gains and losses be treated, and why?

Q25. The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value (see Draft Standard paragraphs 137-152, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.30-6.84).

(a) Do you agree with the proposed disaggregation? If not, why not? What other basis of disaggregation would you propose to provide information about the components of changes in fair value of financial instruments?

(b) Do you believe that any other gains and losses arising on fair value measurement of financial assets and financial liabilities should be separately presented in the income statement or notes thereto? If so, which gains and losses, and why do you believe that they should be shown separately? On what basis should such gains and losses be distinguished?

Q26. The Draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis, except that an enterprise may use the current market expectations basis if the chief operating decision maker relies primarily on that 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 (see Draft Standard paragraphs 139 and 140, Application Supplement paragraphs 382-390, and Basis for Conclusions paragraphs 6.46-6.77).

(a) Do you agree that interest income and expense should be separately presented?

(b) Do you agree with the proposed method of determination? If not, how would you propose that interest revenue and interest expense be determined in a fair value model?

(c) Is the guidance clear and operational? If not, what additional guidance is necessary?

Hedges

Q27. The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities (see Draft Standard paragraph 153 and Basis for Conclusions paragraphs 7.1-7.22). Do you agree? If not, why not? How would you address the issues raised in paragraphs 7.1-7.22 of the Basis for Conclusions?

Disclosure

Q28. The Draft Standard would require disclosure of an enterprise's significant financial risks and of the enterprise's financial risk management objectives and policies (see Draft Standard paragraphs 154-163, Application Supplement paragraphs 393 and 394, and Basis for Conclusions paragraphs 8.5-8.12). Do you agree 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? If not, how would you change these disclosures?

Q29. The Draft Standard would require disclosures about financial instruments used to manage risks associated with transactions expected to occur in future reporting periods only when an enterprise separately discloses gains or losses on those financial instruments (see Draft Standard paragraphs 181 and 182 and Basis for Conclusions paragraphs 8.36-8.43). Do you agree with this approach? If not, how would you change it?

Q30. The Draft Standard encourages, but does not require, disclosures about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions (see Draft Standard paragraphs 179 and 180, Application Supplement paragraphs 409-411, and Basis for Conclusions paragraphs

8.30-8.35). Do you agree that these disclosures should be encouraged? If not, why not, and what alternative would you propose?

Q31. Do you agree with the other disclosures proposed in Draft Standard paragraphs 164-178 and 183-189 (see also Application Supplement paragraphs 391 and 392 and 395-408 and Basis for Conclusions paragraphs 8.13-8.29 and 8.44-8.56)? If not, how should the disclosures be amended, while maintaining a balance between the need to inform users about an enterprise's financial risk position and the concern of causing competitive harm to the enterprise or unnecessary burden for preparers?

Implementation Recommendations

Q32. The JWG proposes that about two years is a suitable period of time between issuance of a final standard and the effective date to balance preparation time with the need for standards (see Basis for Conclusions 9.1-9.4). Do you agree? Do you believe that certain enterprises need additional time to prepare for implementation? If so, please specify which enterprises and how they should be differentiated from those that apply a final standard initially. Also, please specify why these enterprises may need more time and the length of time that may be required.

Q33. Some suggest that a comprehensive fair value model for financial instruments should be first introduced in supplemental financial statements, presented in parallel with financial statements prepared in accordance with existing practices. Only after a period of time would such financial statements replace financial statements prepared in accordance with existing practices (see Basis for Conclusions paragraphs 9.5-9.7). Do you believe that supplemental financial statements should be introduced before replacing financial statements prepared in accordance with existing practices? If so, how would you overcome the disadvantages of such an approach, which are identified in Basis for Conclusions paragraph 9.6?

Q34. The Draft Standard includes a number of transitional provisions to be taken into account in adopting it (see Draft Standard paragraphs 192-195 and Basis for Conclusions paragraphs 9.8-9.21). Do you agree with these provisions? If not, why not? How would you amend them?

Q35. What steps need to be taken to assist in implementing a comprehensive fair value model for financial instruments? Please comment on any significant legal or other obstacles to implementing a final standard based on this Draft Standard and on how they might be best addressed.

Q36. Are there other issues that must be resolved before the Draft Standard could be implemented? If so, what are they and what steps should be taken to resolve them?

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FINANCIAL INSTRUMENTS AND SIMILAR ITEMS

DRAFT STANDARD

The principles, which have been set in bold italic type, should be read in the context of the supporting paragraphs and the accompanying Application Supplement. This Draft Standard does not apply to immaterial items. Terms or phrases defined in paragraphs 7-30 of this Draft Standard are underlined the first time they appear and where their significance is particularly important.

Objective

This Draft Standard establishes principles for recognition, derecognition, measurement, presentation and disclosure of financial instruments and similar items in the financial statements of all enterprises. The primary objective is to prescribe accounting that reflects, in an enterprise's balance sheet and income statement, the effects of events on the fair value of an enterprise's financial instruments and certain similar items, in the periods in which those events occur.

Scope

Enterprises and Financial Instruments Included in Scope

1. ***This Draft Standard applies to all enterprises in accounting for all <u>financial instruments</u>, except for those financial instruments that are:***

   (a) ***equity interests in subsidiaries, associates or joint ventures that are accounted for in accordance with other accounting standards;***[1]

   (b) ***employers' assets and liabilities under employee benefit plans;***[2]

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[1] The IASC requires most equity interests in subsidiaries, associates or joint ventures to be accounted for in accordance with IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries; IAS 28, Accounting for Investments in Associates; or IAS 31, Financial Reporting of Interests in Joint Ventures. However, equity interests in subsidiaries, associates and joint ventures that are acquired and held exclusively with a view to their disposal in the near future or that operate under severe long-term restrictions that significantly impair the ability to transfer funds to the parent, investor or venturer are not accounted for in accordance with those standards. Therefore, in accordance with International Accounting Standards (IASs), such equity interests would fall within the scope of this Draft Standard. These IASs also permit a parent or investor to present separate (rather than consolidated) financial statements and to carry investments in subsidiaries, associates or joint ventures at cost in those separate financial statements. Although the requirements of this Draft Standard do not apply to such investments, they do apply to all other financial instruments presented in separate financial statements.

(c) ***retirement benefit obligations of defined benefit plans;***[3]

(d) ***rights and obligations with insurance risk, resulting from <u>insurance contracts</u>,***[4] ***except for:***

(i) ***<u>financial guarantees</u>; and***

(ii) ***contracts that require payment based on the occurrence of uncertain future climatic, geological or other physical events, if that payment is made regardless of any effect of the event on the contract holder;***

(e) ***<u>equity instruments</u> issued and classified as equity by the reporting enterprise;***

(f) ***business combination contracts involving contingent consideration;***[5]***or***

(g) ***contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, certain licence fees, royalties and similar items)***[6] [see Application Supplement paragraphs 196 and 213]**.**

Additional Items Included in Scope

2. ***This Draft Standard applies to the following, which should be accounted for in the same manner as financial instruments that fall within the scope of this Draft Standard:***

(a) ***contracts to buy or sell a non-financial item that can be settled net by a financial instrument, except for contracts that were entered into and continue to be for the purpose of delivery of a non-financial item in accordance with the enterprise's normal purchase or sale requirements*** [see Application Supplement paragraphs 197-207]***; and***

(b) ***<u>servicing assets</u> and <u>servicing liabilities</u>*** [see Application Supplement paragraphs 208-210].

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2 The IASC requires employer's assets and liabilities under employee benefit plans to be accounted for in accordance with IAS 19, Employee Benefits.

3 The IASC requires retirement benefit obligations of defined benefit plans to be accounted for in accordance with IAS 26, Accounting and Reporting by Retirement Benefit Plans.

4 An IASC Steering Committee is developing proposals for accounting for insurance contracts. See IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999.

5 The IASC requires business combination contracts involving contingent consideration to be accounted for in accordance with paragraphs 65-76 of IAS 22, Business Combinations.

6 The IASC requires revenue on licence fees and royalties to be recognised in accordance with paragraph 20 of IAS 18, Revenue.

3. Servicing assets and servicing liabilities are accounted for as separate assets and liabilities only if they are (a) retained when serviced financial assets are derecognised or (b) acquired in a separate purchase or assumption of servicing rights. Servicing assets and servicing liabilities that are not separated from the financial instrument being serviced are accounted for as part of that financial instrument.

Hybrid Contracts

4. ***This Draft Standard applies to sets of contractual rights and obligations in a hybrid contract that, if they were separated from the contract, would fall within the scope of this Draft Standard.***[7]

5. ***If the sets of rights and obligations in a hybrid contract that, if they were separated from the contract would not fall within the scope of this Draft Standard would be measured at fair value in accordance with other accounting standards, then an enterprise should account for the entire contract in the same manner as financial instruments that fall within the scope of this Draft Standard.***

6. Examples of hybrid contracts include:

   (a) a contract, such as a convertible debt instrument, that comprises both a financial liability that falls within the scope of this Draft Standard and equity of the issuer (which is excluded from the scope of this Draft Standard by paragraph 1(e));

   (b) a contract that comprises an equity instrument of another enterprise that falls within the scope of this Draft Standard and a right to non-financial benefits, such as a right to purchase goods or services from the investee at a discount from market prices (which is excluded from the scope of this Draft Standard because it does not meet the definition of a financial instrument); and

   (c) a contract that comprises rights or obligations with insurance risk resulting from insurance contracts that is excluded from the scope of this Draft Standard by paragraph 1(d), and an equity instrument of another enterprise that falls within the scope of this Draft Standard.

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7 See paragraphs 74-76 regarding measurement of contractual rights and obligations in a hybrid contract.

Definitions

Definitions relating to Financial Instruments

7. ***The following terms relating to financial instruments are used in this Draft Standard, with the meanings specified.***

A <u>financial instrument</u> is one of the following:

(a) <u>cash</u>;

(b) an <u>equity instrument</u>;

(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 <u>financial asset</u> is a financial instrument that is an asset.

A <u>financial liability</u> is a financial instrument that is a liability.

An <u>equity instrument</u> is a financial instrument that represents a residual interest in the assets of an enterprise after deducting all its liabilities.

A <u>conditional financial instrument</u> is a financial instrument that requires delivery of another financial instrument or exchange of financial instruments only if specified future events occur.

<u>Cash</u> comprises cash on hand and demand deposits.

<u>Cash equivalents</u> 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 <u>financial guarantee</u> is a contract that requires payments to be made to a creditor if a debtor fails to make payment when due.

A <u>loan asset</u> 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.

An <u>impaired loan asset</u> 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.

8. Parts of the definition of a financial instrument include the term financial instrument, but the definition is not circular. If there is a contractual right to receive and an obligation to deliver, or to exchange financial instruments, the instruments to be received and delivered or exchanged give rise to other financial instruments. A chain of contractual rights or obligations may be established, but it ultimately leads to receipt or payment of cash or to acquisition, disposition or issuance of an equity instrument.

9. Rights or obligations that make up financial instruments are derived from the contractual provisions that underlie them. The term "contractual" refers to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, because the agreement is enforceable at law. Contractual rights and obligations, and thus financial instruments, are created by contracts that may take a variety of forms including written or oral agreements and contracts implied by an enterprise's actions or by virtue of custom or practice.

10. An asset or liability that is not contractual in nature, such as an income tax asset or liability that is created as a result of statutory requirements imposed by governments, or a legal liability arising from breach of a duty (such as a duty of due consideration to others), does not meet the definition of a financial instrument and is not included within the scope of this Draft Standard. Even after such an asset or liability has been reduced to a fixed payment schedule, it is not a financial instrument.

11. A minority interest in a consolidated subsidiary is not a financial instrument.

12. Some related party balances might take the form of receivables or payables but have the basic attributes of equity instruments. If so, they are accounted for as equity instruments. Balances arising from capital transactions with owners and distributions to owners that are classified as equity or that represent equity investments in a subsidiary, associate or joint venture fall outside the scope of this Draft Standard[8]. Other financial instruments of related parties would be accounted for in accordance with the requirements of this Draft Standard.

[8] In accordance with IASs, certain equity investments in a subsidiary, associate or joint venture would fall within the scope of this Draft Standard. See the footnote to paragraph 1(a).

13. A financial instrument is conditional on a specified event if the occurrence or non-occurrence of that event determines whether the delivery or exchange of financial instruments will be required, rather than determining only the timing and amounts of financial instruments to be delivered or exchanged. Financial guarantees payable in the event of default by a borrower and weather derivatives payable in the event that certain weather conditions occur are examples of conditional financial instruments. A loan that has a prepayment option is not conditional because the prepayment option simply defines the timing and amounts to be paid, not whether the borrower has an obligation to repay the loan.

Definitions of Financial Risks

14. ***The following terms dealing with financial risks are used in this Draft Standard, with the meanings specified.***

    A financial risk of an enterprise is any risk to which a financial instrument held or issued by that enterprise is subject.

    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.

    Currency risk is the risk of changes in the value of an asset or liability due to changes in exchange rates.

    Credit risk is the risk that one party will fail to discharge its contractual obligation and thereby cause another party to incur a loss.

    Liquidity risk is the risk that a loss may be incurred because a position cannot be eliminated quickly.

15. In general usage, risk is the possibility of adverse consequences. In this context, exposure to risk is the condition of being unprotected against adverse consequences. In economic terms, risk is the possibility of economic loss. Risk exists where there is variability of financial outcomes, since variability contains the possibility of economic loss. In efficient financial markets there will normally be a direct relationship between risk and the potential for gain—the greater the risk taken the greater the potential for gain. Risk-averse investors require a higher rate of return to accept higher risk. Thus, this Draft Standard uses the term "risk" in the context of the relationship of risk and return.

16. Financial risks include basic interest rate risk, currency risk, credit risk, liquidity risk, and other price risks, such as commodity price risks and equity price risk, where a financial instrument held or issued by an enterprise is subject to that risk. Financial risks do not include operational risks, such as the risk that a share certificate might be lost or the risk

that cash flows might be misappropriated. Risks affecting the activities of an enterprise are considered to be financial risks of that enterprise only to the extent that the enterprise holds or issues financial instruments that are subject to those risks. For example, an enterprise that manufactures goods using a particular commodity may be affected by price changes in that commodity. If the enterprise does not have financial instruments that are subject to that commodity price risk, it is not considered to have any financial risk related to the commodity's price. Rather, any commodity price risk is considered to be one of the broader business risks of the enterprise. Financial instruments are commonly used in managing certain types of business risks (for example, certain commodity price risks). In this case, the price risks to which these financial instruments are subject are considered to be financial risks of the enterprise.

Definition of an Insurance Contract

17. ***The following definition of an insurance contract is used in this Draft Standard, with the meaning specified.***

An <u>insurance contract</u> 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).[9]

18. Insurance risk includes the risk that the number of insured events will differ from that expected (occurrence risk), the risk that the cost of events will differ from expected cost (severity risk) and the risk of changes in the amount of an insurer's obligation after the end of a contract period (development risk). A contract that exposes the insurer to <u>financial risk</u> without insurance risk is not an insurance contract.

19. All warranty contracts, whether required to be settled with products or services, or with cash or another financial instrument, are considered to meet the definition of an insurance contract.

Definitions relating to Servicing Assets and Servicing Liabilities

20. ***The following terms dealing with servicing assets and servicing liabilities are used in this Draft Standard, with the meanings specified.***

A <u>servicing asset</u> results from a contract to service financial assets if the <u>benefits of servicing</u> are more than <u>adequate compensation</u>.

[9] This definition, and the elaboration in paragraph 18, is the same as that used in the IASC Insurance Steering Committee, Issues Paper: Insurance, November 1999. Further elaboration is contained in that Issues Paper.

A servicing liability results from a contract to service financial assets if the benefits of servicing are less than adequate compensation.

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.

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.

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.

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.

21. Benefits of servicing arise from the servicing contract. The contractual terms may, or may not, be based on conditions in the current market for servicing.

22. Adequate compensation, on the other hand, is generally observable in the market for servicing. It depends largely on the nature of the underlying assets being serviced and the amount of effort required to service the assets. Adequate compensation does not depend on the servicing costs of a specific servicer. As a result, for example, an inefficient servicer might initially record a servicing asset when serviced financial assets are derecognised, even though it anticipates incurring a loss from carrying out the servicing itself over the term of the contract because its enterprise-specific costs are greater than the benefits of servicing. That inefficient servicer does not have a liability because it could avoid that loss by selling the servicing to an efficient servicer.

23. Contractually specified servicing fees may include some or all of the difference between the amounts collectible on the asset being serviced and the amounts to be paid to the beneficial owners of the assets, depending on the servicing contract**.**

24. An interest-only strip, or similar retained interest, arises if the servicer is entitled to cash flows from the serviced assets that are expected to exceed the contractually specified servicing fees, and the servicer has the right to that excess income, even if it ceases to perform the servicing. An interest-only strip or similar retained interest is a financial asset, rather than a servicing asset.

Definition of a Hybrid Contract

25. ***The following definition of a hybrid contract is used in this Draft Standard, with the meaning specified.***

    A <u>hybrid contract</u> 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.

Definitions relating to Recognition and Derecognition

26. ***The following terms dealing with recognition and derecognition are used in this Draft Standard, with the meanings specified.***

    <u>Derecognition</u> of an asset or liability or <u>component</u> thereof is ceasing to recognise that asset, liability or component on an enterprise's balance sheet.

    The <u>components</u> 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 [see Application Supplement paragraphs 224-226]**.**

    A <u>transfer</u> occurs when one party passes to another party or parties the whole, or some component, of one or more of its assets.

    A <u>clean-up call option</u> 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.

27. The term "transfer" is used broadly in this Draft Standard to include all forms of sale, assignment, provision of collateral, sacrifice, distribution and other exchange. It does not include origination, issuance or expiry.

Definition of Fair Value

28. ***The following definition of fair value is used in this Draft Standard, with the meaning specified.***

    <u>Fair value</u> 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.

Definitions relating to Foreign Currency Items

29. ***The following terms dealing with foreign currency items are used in this Draft Standard, with the meanings specified.***

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.

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.

Definitions relating to Income Statement Presentation

30. ***The following terms dealing with income statement presentation are used in this Draft Standard, with the meanings specified.***

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.

<u>Interest-bearing financial assets (liabilities)</u> comprise all financial instruments except cash on hand, equity instruments, and forward contracts (including swaps), options and similar derivative financial instruments.

<u>Basic (or "risk-free") interest</u> is the amount of interest that compensates the lender for the time value of money.

<u>Credit risk premium</u> 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.

<u>Current yield to maturity</u> 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 [see Application Supplement paragraph 382].

<u>Current market expectations rate of interest</u> is the current per period rate of interest reflected in current interest forward rates implicit in observable market interest yield curves [see Application Supplement paragraphs 383-385].

Recognition and Derecognition

Recognition

31. ***An enterprise should recognise:***

    (a) ***a financial asset when, and only when, it has contractual rights under a financial instrument that result in an asset; or***

    (b) ***a financial liability when, and only when, it has contractual obligations under a financial instrument that result in a liability.***

32. ***If a contractual right under a financial instrument has arisen from, or been affected by, a transfer that has substance (as set out in paragraph 36), the transferor should follow paragraphs 49-68 in applying paragraph 31 to determine whether and in what form to recognise any retained components of that asset and any new contractual rights acquired and obligations assumed in connection with that asset.***

33. After a transfer involving financial assets, determining what the transferor would derecognise will sometimes help in understanding the character of the transfer consideration received and, as a result, in determining what would be recognised. Accordingly, paragraph 32 requires the transferor to apply the more detailed principles on transfers to determine whether and in what form to recognise any retained components and any new rights acquired and obligations assumed.

34. An enterprise has the contractual rights and/or contractual obligations that make up a financial instrument from the time that it becomes a party to the relevant contractual provisions of the instrument. This means that:

    (a) an enterprise that becomes a party to a *new* financial instrument recognises any resulting assets and liabilities at the inception of the instrument; and

    (b) an enterprise that becomes a party to an *existing* financial instrument recognises any resulting assets and liabilities when it obtains—receives—the contractual rights and obtains—assumes—the contractual obligations that comprise the financial instrument.

35. ***A transfer that does not have substance should not affect the recognised financial assets and liabilities of the transferor or transferee*** [see Application Supplement paragraphs 222 and 223].

36. ***A transfer has substance only if either:***

    (a) ***the transferee is an enterprise that conducts substantial business, other than being a transferee of financial assets, with parties other than the transferor; or***

    (b) ***the components transferred have been isolated from the transferor, i.e., have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.***

    [See Application Supplement paragraphs 214-220 for application of the recognition principles to forward contracts and other executory contracts, regular way security transactions, security interests and hybrid contracts.]

Derecognition

Basic Requirements

37. ***An enterprise should derecognise a financial asset or financial liability or a component thereof when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that asset, liability or component*** [see Application Supplement paragraphs 224-231].

38. ***If contractual rights under a financial instrument have been transferred in a transfer that has substance (as set out in paragraph 36), the transferor should follow paragraphs 49-68 in applying paragraph 37 to determine whether some or all of that asset should be derecognised.***

39. An enterprise ceases to have a contractual right when the right expires or is fulfilled in accordance with the terms of the contract, or when control of the right is transferred to another party, i.e., when the right is transferred and relinquished.

40. An enterprise ceases to have a contractual obligation when the obligation expires or is fulfilled. An obligation is fulfilled only if the enterprise that had the obligation has obtained release from primary responsibility for that obligation by settlement, by accommodation with the creditor, or by process of law [see Application Supplement paragraphs 227-230].

Arrangements to Pass Cash Flows Through One Enterprise to Another

41. Sometimes an enterprise acting as a principal that has a contractual right to receive the cash flows that arise from a financial asset also has a contractual obligation to pay to another enterprise cash flows that reflect the collections from that asset. Examples include back-to-back loan arrangements and sub-participations in which the payments an enterprise makes reflect the payments it receives on a specific loan asset. It will usually be appropriate for

the enterprise to recognise such contractual rights and contractual obligations separately. However, in certain limited circumstances, instead of assuming a new free-standing obligation, the enterprise has transferred and relinquished part or all of the contractual rights related to an asset. In those circumstances, the enterprise would derecognise the part or all of the asset related to the contractual rights relinquished.

42. If an enterprise with a contractual right to receive cash flows from a financial asset assumes a contractual obligation to pay cash flows to a second enterprise, it would apply paragraphs 43-48 to determine whether a transfer has occurred. If it is determined that a transfer has occurred, the enterprise would apply paragraphs 49-68 to determine whether control of the transferred contractual right to receive cash flows has been relinquished and, therefore, whether the contractual right would be derecognised. On the other hand, if it is determined that either:

    (a) no transfer has occurred, or

    (b) although there has been a transfer, control has not been relinquished,

    the contractual right to receive cash flows and the contractual obligation to pay cash flows to another enterprise would be recognised separately (assuming that they meet the criteria for recognition set out in paragraph 31).

43. ***An enterprise (the collector) with a contractual right to receive cash flows from a financial asset (the original asset) that assumes a contractual obligation to pay cash flows to a second enterprise (the eventual recipient) should treat the transaction as the transfer of the contractual right (or a proportion of that contractual right) if, and only if, the cash flows to be paid to the eventual recipient are required to reflect in full, or on a pro rata basis, the collections from the original asset.***

44. ***The cash flows to be paid to the eventual recipient will not reflect in full, or on a pro rata basis, the collections from the original asset if:***

    (a) the collector has the right to retain, for its own benefit, cash flows from the contractual rights involved in excess of its fees for collection services;

    (b) the collector has the right to temporarily use, outside the normal settlement period, some or all of the cash flows from the contractual rights involved for its own benefit;

    (c) the collector is obliged to pay amounts to the eventual recipient even if equivalent amounts have not been collected from the original asset, other than short-term advances with full right of recovery; or

(d) the collector has a right to renegotiate the contractual terms of the original asset and the right does not arise from an interest in the original asset that is unrelated to its role as collector, and the collector is not obliged to reflect the wishes of the eventual recipient in exercising that right.

45. The collector is not prevented from treating a transaction as the transfer of contractual rights solely because it has one or more of the following rights or obligations.

    (a) A right to retain reasonable and customary fees for collection services from the cash it collects.

    (b) A right to retain some or all of the future cash collections in the event of its own bankruptcy or other receivership.

    (c) A right to deposit the cash collected in a commingled deposit account and to use funds drawn from that account for its own benefit. However, if the collector has—and exercises—such a right, it will be necessary to ensure that, from the end of the normal settlement period (which is a period defined by the market rather than, for example, the terms of the transfer) steps are taken to ensure that cash equal in amount to the amount collected is no longer being used for the collector's benefit. Such steps will usually include either paying the amount to the eventual recipient or moving the amount to a segregated deposit account where it is not commingled with the collector's other assets.

    (d) An obligation to make short-term advances against future collections from the assets on terms that require the recovery in full from the eventual recipient of any amounts not subsequently collected from the original asset.

46. Some enterprises act as collectors of original assets in which they also hold a beneficial interest and, therefore, have renegotiation rights as beneficial interest holders. Such renegotiation rights do not prevent a collector from treating a transaction as the transfer of contractual rights if the powers of the collector in a renegotiation are proportionate to its beneficial interest holdings in the original assets.

47. For similar reasons, a right of veto over renegotiations of the original assets also would not preclude treating a transaction as the transfer of contractual rights if the collector has that right only because it retains a beneficial interest in the original assets and each beneficial interest holder in the original assets has a similar right of veto.

48. The requirements of paragraphs 43 and 44 for treating a transaction as the transfer of contractual rights will usually be met if either:

    (a) the cash that is paid to the eventual recipient comes only from a segregated fund comprising the original asset and cash collections from those assets and that fund is not commingled with the collector's other assets; or

    (b) the eventual recipient has the ability to insist that cash collections from the original asset are not commingled with those of the collector or are to be paid directly to itself or another party rather than the collector.

Transfers involving Financial Assets

Introduction

49. When accounting for a transfer that has substance and involves a financial asset, the transferor of the financial asset (or component thereof) involved would apply paragraphs 51-68; the transferee would apply paragraph 31.

50. For the purposes of paragraphs 51-68:

    (a) retention by the transferor of the right to service a transferred financial asset will not in itself represent a continuing involvement of the type referred to in paragraph 51, nor will it prevent the transferee from having the practical ability referred to in paragraph 55; and

    (b) retention by the transferor of a clean-up call option over some or all of the transferred components will not in itself represent a continuing involvement of the type referred to in paragraph 51. Furthermore, references in these paragraphs to "call options" are to call options other than clean-up call options.

    [See Application Supplement paragraphs 234-241 for a summary of the accounting]

Transfers Where the Transferor Has No Continuing Involvement in the Asset

51. ***An enterprise (the transferor) that is a party to a transfer that involves one of its financial assets should derecognise that asset in its entirety if it has no continuing involvement in the asset.***

52. A transferor will have no continuing involvement in a financial asset if it neither retains any of the contractual rights that resulted in that asset nor obtains any new contractual rights or contractual obligations relating to the asset, i.e., if it has no interest in the future performance of that asset and no responsibility to make payments in the future in respect of the asset under any circumstance.

53. New contractual rights or contractual obligations relating to a previously recognised financial asset that are sometimes received or assumed as part of a transfer include recourse provisions and other guarantees against the unfavourable performance of the asset, agreements to reacquire the asset, and options written or held relating to the asset.

54. Paragraphs 55-68 do not apply to a transfer that results in the transferor having no continuing involvement in its previously recognised financial asset.

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

55. ***An enterprise (the transferor) that is a party to a transfer involving one of its financial assets should derecognise that asset in its entirety if the transferee:***

    (a) has the practical ability to transfer that asset in its entirety to a third party; and

    (b) is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer.

    The transferor should apply paragraph 31 to recognise assets and liabilities relating to any continuing involvement it has in its previously recognised financial asset.

56. Paragraph 55 addresses practical ability and the practical effect of any restrictions. Restrictions on the transferee's right to transfer a financial asset to a third party will not necessarily prevent the transferee from having the practical ability to make such a transfer. For example:

    (a) a prohibition on transfers to third parties may have no practical effect (and may therefore not prevent the transferee from having the practical ability to transfer the asset to a third party) if replacement assets are readily available, because the transferee may be able to transfer the asset and still satisfy the prohibition by obtaining a replacement asset. For similar reasons, a limitation imposed by the transferor on the specific parties to whom the transferee can transfer the asset may have no practical effect if replacement assets are readily available. For this purpose, replacement assets are deemed to be readily available only if the asset is actively traded on an accessible market;

    (b) a restriction or limitation, that is effective, on the number or identity of the parties to whom the transferee can transfer the asset also will have no practical effect if sufficient *other* potential buyers exist to create a market for the transfer of the asset; and

(c) the retention by the transferor of a right to match a bona fide offer received by the transferee from a third party will also not prevent the transferee from having the practical ability to transfer the asset to a third party.

57. If the transferee is not in a position immediately after the transfer to complete a second transfer to a third party, it will not have the practical ability referred to in sub-paragraph 55(a). It will not be in a position to complete the transfer if, for example, it has to exercise a call option to obtain additional rights to be able to transfer the asset or if it has to obtain additional rights before it can insist on the third party paying an amount equal to the fair value of the entire asset.

58. Sub-paragraph 55(b) requires the transferee to be able to exercise its practical ability to transfer the asset to a third party unilaterally. The transferee will not be able to exercise its ability unilaterally if, for example, the terms of the transfer require the transferee to obtain the consent of the transferor to the transfer of the asset, which consent can be withheld without reason, and that restriction is effective in practice. On the other hand, if the transferor's consent is needed but it cannot reasonably be withheld, the transferee may still have the ability to transfer the components unilaterally.

59. The transferee needs also to be able to exercise its ability to transfer the asset to a third party without having to impose additional restrictions on that transfer. It will need to impose additional restrictions on a transfer to a third party if, for example:

(a) the transferor has a call option over the asset, or over a component of the asset, and a replacement for that asset or component is not readily available, unless it is virtually certain that the transferor will not exercise the option. In such circumstances, the transferee is likely to be able to transfer the asset (or component) to a third party without fear of defaulting on the call option only by encumbering the transfer with a similar call option;

(b) the transferee retains a put option over the asset, or over a component of the asset, that it is virtually certain to exercise and a replacement for that asset or component is not readily available. In this case the transferee is likely to be economically impeded from transferring the asset (or component) unencumbered by an option or right to reacquire, since the transferee would not then be able to exercise its retained put option; or

(c) the transferor has imposed obligations on the transferee concerning the servicing of the asset, which the transferee would have to impose on any enterprise to which it transferred the asset. For example, if the transferor stipulates special procedures for collecting the asset, the transferee would need to attach a similar provision to any transfer that it makes to a third party.

60. For the purposes of sub-paragraphs 59(a), 59(b), 64(b) and 64(c):

    (a) an enterprise has a call option (or a put option) over a component or asset if it has a contract that gives it the unilateral right to reacquire (or to insist that another party reacquire) that component or asset;

    (b) an enterprise has a call option (or a put option) over a group or pool of components or assets if, through a contract that gives it the unilateral right to reacquire (or to insist that another party reacquire) some but not all of the components in that group or pool, it has the right to select which components or assets are to be reacquired; and

    (c) an enterprise does *not* have a call option (or put option) over a component or asset or group or pool thereof if, although having a right to reacquire (or to insist that another party reacquire) some but not all of the components or assets in a group or pool of components or assets, it does *not* have the right to select which components or assets are to be reacquired.

61. In the circumstances described in sub-paragraphs 59(a) and (b), the assessment of whether it is virtually certain that a call option will not be exercised or that a put option will be exercised would be made at the time the option is written. Subsequent events that change the probability of the option being exercised generally would not result in any change to the assets and liabilities recognised and derecognised. The only exceptions are:

    (a) if an option previously considered to be constraining the transferee's ability to transfer the asset expires unexercised and, as a result, the transferee is no longer constrained, the transferred asset would be derecognised in its entirety on that date; and

    (b) if an option previously considered not to be constraining the transferee's ability to transfer the asset is exercised, paragraphs 31 and 37 would be applied.

62. Paragraphs 63-68 do not apply if the transferee has the practical ability to transfer the asset in its entirety to a third party, unilaterally and without needing to impose additional restrictions on the transfer.

    [See Application Supplement paragraphs 242-250]

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

63. Paragraphs 51-62 describe transfers that result in the transferor derecognising a previously recognised asset in its entirety and, possibly recognising new components. Paragraph 64 identifies transfers that are to be accounted for in whole or in part as loans secured by the

transferred asset. In such transfers, the transferred asset will not be derecognised entirely or at all, and paragraph 65 establishes the extent to which it would be derecognised.

64. ***If an enterprise (the transferor) is a party to a transfer involving one of its financial assets and as a result:***

    (a) ***the transferor has a conditional or unconditional obligation to repay some or all of the consideration it received in the transfer, it should recognise a liability for the maximum amount of the consideration it could be required to repay;***

    (b) ***the transferor has a call option (or similar right) over a transferred component that the transferee does not have the practical ability to transfer (unilaterally and without imposing additional restrictions) to a third party, the transferor should recognise a liability for the amount of the consideration it received in the transfer of that component; or***

    (c) ***the transferor has both an obligation of the kind described in sub-paragraph (a) and a call option (or similar right) of the kind described in sub-paragraph (b), it should recognise a liability for which the initial measure:***

        (i) ***should not exceed the total amount of consideration received in the transfer; and***

        (ii) ***to the extent that the obligation and call option (or similar right) relate to the same transferred component, should be the larger of the amounts that would be recognised under sub-paragraph (a) or (b).***

65. ***Any consideration received in excess of the liability recognised under paragraph 64 is sales proceeds. The transferor should derecognise the asset or components thereof transferred to the extent of those proceeds and should continue to recognise the remainder of the asset.***

66. A conditional or unconditional obligation to repay some or all of the consideration received in the transfer could take a variety of forms. For example:

    (a) it could be an unconditional obligation to pay a specified amount on a specified future date in exchange for being released from the obligation;

    (b) it could be an obligation to pay a specified amount in exchange for return of the transferred asset arising from a forward purchase agreement or a put option; or

    (c) it could be an obligation to make good the losses of another enterprise arising from recourse arrangements and guarantees.

67. Paragraph 68 does not apply if, after a transfer involving financial assets, the transferor has an obligation to repay some or all of the consideration it received in the transfer, as described in sub-paragraph 64(a), and/or a call option (or similar right) over a transferred component that the transferee does not have the practical ability to transfer to a third party, unilaterally and without needing to impose additional restrictions on the transfer, as described in sub-paragraph 64(b).

[See, also, Application Supplement paragraphs 251-258]

Other Transfer Transactions

68. ***In the case of a transfer that has substance (as set out in paragraph 36) but is not subject to paragraphs 51-67, the transferor should apply:***

(a) paragraph 31 to determine whether to recognise any retained components of that asset and any newly acquired contractual rights relating to the asset; and

(b) paragraph 37 to determine whether some or all of the asset should be derecognised.

[Application Supplement paragraphs 259-314 consider the implications of the recognition and derecognition requirements for various common types of transfer.]

Measurement

Basic Requirements

69. ***An enterprise should measure financial instruments at fair value when recognised initially and, except for certain private equity investments described in paragraph 122, should re-measure financial instruments at fair value at each subsequent measurement date***.

70. For the purposes of measuring a financial instrument, fair value is an estimate of the price an enterprise would have received if it had sold the asset or paid if it had been relieved of the liability on the measurement date in an arm's-length exchange motivated by normal business considerations.

71. The fair value of a financial instrument is, therefore, an estimate of its market exit price, which is determined by interactions between unrelated enterprises that have the objective of achieving the maximum benefit or minimum sacrifice from the transaction. That is, fair value is the price that arm's-length market participants would pay or receive in a routine transaction under the market conditions at the date at which it is to be measured for accounting purposes (the measurement date).

72. ***An enterprise should not adjust the estimated market exit price to reflect expected costs it would incur to sell a financial asset or obtain relief from a financial liability.***

73. Such costs would include, for example, fees and commissions paid to agents, advisors, brokers and dealers, duties, and transfer taxes.

    [See Application Supplement paragraphs 315-317 regarding initial measurement]

Hybrid Contracts

74. ***Except when paragraph 76 applies, an enterprise should measure a part of a <u>hybrid contract</u> that is to be separately accounted for in accordance with paragraph 4 as if it were a free-standing financial instrument at initial recognition and subsequently.***

75. The result is that at initial recognition, the reported amount of the part of the hybrid contract that does not fall within the scope of this Draft Standard would be equal to the fair value of the consideration paid or received for the entire hybrid contract less the fair value of the part of the contract determined as if it were a free-standing financial instrument.

76. ***If an enterprise cannot reliably identify and measure the separate sets of financial instrument rights and obligations in a hybrid contract, it should account for the entire***

hybrid contract throughout the remaining period of the contract in accordance with the requirements of this Draft Standard as if it were a financial instrument falling within the scope of the Draft Standard.

[See Application Supplement paragraphs 318 and 319]

Market Exit Prices of Identical or Similar Instruments

Sources of Market Exit Price Information

77. ***Except as provided in paragraphs 88-94, 100 and 101, if market exit price information in the following list is available, an enterprise should base the fair value of a financial instrument on that information. If information on more than one of the market exit prices in the following list is available, an enterprise should use the price information nearest the top of the list.***

- ***(a)*** **A** ***market exit price for an identical instrument on the measurement date. An identical instrument is exactly the same in denomination and description except for its identifying number or other unique identifier.***

- ***(b) A market exit price for an identical instrument near enough to the measurement date that the effect on fair value of the passage of time and changes in market conditions between the market date and the measurement date can be practicably estimated.***

- ***(c) A market exit price for a similar instrument on the measurement date. Two instruments are similar if they have similar patterns of cash flows that are expected to vary in similar fashion in response to changes in market conditions and other risk factors. In addition, estimation of the effects on fair value of differences between the instruments should be practicable.***

- ***(d) A market exit price for a similar instrument near enough to the measurement date that the effect on fair value of the passage of time and changes in market conditions between the market date and the measurement date can be practicably estimated.***

78. ***An enterprise should adjust a price other than a market exit price for the identical instrument on the measurement date to reflect any differences between the instruments and for the passage of time and changes in market conditions*** [see Application Supplement paragraphs 320-322].

79. Financial instruments may be traded on exchanges, in dealer markets, and in brokered or principal-to-principal transactions. The market exit price of a financial instrument traded on

an exchange or other public market on which last traded prices are quoted daily is the daily closing price.

80. Prices of financial instruments traded in dealer markets are sometimes quoted as bid and asked prices, and actual transaction or closing prices are not reported. The objective in using bid and asked prices as evidence of fair value is to determine the price at which a transaction would occur on the measurement date. That price may differ depending on whether the instrument is an asset or liability to the enterprise, whether the enterprise is a dealer, and other factors specific to the individual market or instrument. The appropriate price on which to base fair value may be the bid price (what the dealer is willing to pay for the instrument), the asked price (the price for which the dealer will sell the instrument), or somewhere between. For instruments that are actively traded and for which the difference between bid and asked prices is small, the price at the mid-point of the range will be acceptable.

81. If the difference between bid and asked prices is large enough that the range is significant to the fair value of a financial instrument, the mid-point price will not be acceptable unless that is the price at which a transaction would occur on the measurement date. If the enterprise cannot determine the price within the range at which a transaction would occur on the measurement date by observing market transactions, the enterprise would base fair value on prices of similar instruments or valuation techniques. The quoted bid and asked prices for a financial instrument would be considered the maximum and minimum limits of the estimated market exit price for that instrument.

82. The bid and asked prices discussed in the preceding paragraphs refer to quotes that are actual offers to buy or sell. Quotes from pricing services may come from observed transactions in identical or similar instruments, or they may depend on internally developed valuation techniques or assumptions [see Application Supplement paragraphs 378 and 379 for considerations relating to quotes from pricing services].

83. The available information about prices in principal-to-principal and brokered transactions varies. For example, some industry groups or pricing services publish price information about certain instruments, while little or no information may be available about prices of other instruments. An enterprise is not required to perform an exhaustive search for price information but would consider any information that is publicly available or that can be obtained reasonably from brokers, industry groups, publications of regulatory agencies, or similar sources.

Using Price Information about Similar Financial Instruments

84. Instruments are considered to be similar if they have contractually specified cash flows that are similar in timing and amounts, are of similar credit risk with similar industry and geographical dependencies, and have similar prepayment expectations. Another factor to

consider is marketability. For example, one instrument might be traded readily at an observable market price and a second, otherwise similar instrument might be rarely traded. If it is not reasonable to assume that the effect of a difference in marketability is immaterial, an enterprise would apply a valuation policy that is consistent with available information that market participants would use.

85. Value enhancements, such as guarantees or securitisations, that an enterprise plans to obtain in the future, would not enter into the estimation of the market exit price. An observed price of an instrument that is similar to the measured instrument except for value enhancements would be used to estimate the fair value of the measured instrument provided that the effect of the enhancements can be estimated and the price can be adjusted accordingly. For example, the observed price of securitised loans receivable could be used as a basis for estimating the market exit price of non-securitised loans of the same type if the enterprise can determine the effect on fair value of the liquidity, security and other benefits added by the securitisation. The effect of the securitisation on the price of the securitised assets must be removed.

86. The market exit price of a similar instrument would not be the primary basis for estimation of a market exit price if recent prices for an identical instrument are available. However, if a market exit price is available nearer the measurement date for a similar instrument than for an identical instrument, the similar instrument's price would be considered in determining how to adjust the less timely price of the identical instrument for changes in market conditions.

[See Application Supplement paragraphs 323-327]

Identifying Appropriate Prices in Special Situations

Introduction

87. The following circumstances require special consideration in using observed exit prices to determine fair value.

    (a) Prices not determined by normal market interactions.

    (b) Infrequent transactions.

    (c) Prices that include value that is not directly attributable to the financial instrument.

    (d) Prices from more than one market for the same instrument.

    (e) Effect of an embedded option on the enterprise holding the option.

    (f) Large blocks of instruments.

Prices Not Determined by Normal Market Interactions

88. ***If available information indicates that an observed exit price is not determined by normal market interactions, an enterprise should not use that observed exit price as the primary basis for determining fair value. The following list identifies the only circumstances in which observed exit prices should be presumed not to have been determined by normal market interactions. If an observed exit price is not suitable as the primary basis for determining fair value, it may be useful in providing corroborative evidence to support an estimation of fair value developed from other sources.***

    (a) The observed exit price reflected transaction(s) between enterprises, one or more of which were experiencing severe financial difficulties, such as bankruptcy, orders from courts or regulators or other extreme legal or financial pressures.

    (b) The observed exit price would have been different if not for other transactions, contracts or agreements between the transacting parties.

    (c) The observed exit price would have been different if it had not occurred in a transaction between related parties.

    (d) Publicly acknowledged pricing errors or illegal pricing acts affected the observed exit price for a particular instrument.

89. In accordance with sub-paragraph 88(a), urgency of one or both parties may have caused the price to be different from the price the reporting enterprise could have obtained in a more orderly transaction executed under the same market conditions. This sub-paragraph applies only to individual transactions and not when an entire market is affected by similar difficulties.

90. The following are three examples of situations in which the condition in sub-paragraph 88(b) is likely to exist.

    (a) The observed exit price reflected a transaction that was previously specified in a contract such as a forward contract or option. Such prices generally are affected by market conditions when the original contract was signed.

    (b) The observed exit price reflected a transaction that involved extinguishment of an existing obligation before its contractually specified settlement date. An example is a debtor settling a non-prepayable loan with the creditor. If a debtor is settling with a creditor and the contract does not provide for assumption of the liability by another debtor, the negotiations are not made on an equal footing. The creditor has a superior bargaining position and may be able to demand more than a market price if the debtor needs to get out of the contract and cannot do it any other way.

(c) The transacting parties have entered into other recent or simultaneous transactions or have agreed to enter into future transactions that affected the observed exit price of the instrument being measured. For example, a seller may discount the price of one item if it can recoup its loss on other transactions with the same counter-party.

[See Application Supplement paragraphs 328-330]

Infrequent Transactions

91. ***If a market exit price for an identical or similar financial instrument is seldom available on a measurement date, an enterprise may determine that it should use a valuation technique (see paragraphs 104-117). If a valuation technique is used, an enterprise should carefully evaluate any significant difference between the estimated fair value resulting from the valuation technique and an observed market exit price to determine whether the valuation technique requires adjustment (see paragraph 108).***

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

92. ***Values that are included in a market exit price that are not directly attributable to the rights and obligations that constitute a financial instrument should not enter into the determination of the fair value of that financial instrument.***

93. Certain financial instruments establish relationships with customers that are expected to result in future cash flows that are not directly attributable to the existing financial instruments themselves. An enterprise can sometimes realise the value of those expected future cash flows (or a portion of that value) when the financial instrument is sold to or assumed by another enterprise. That is, the price received on sale may be greater than (or paid on assumption may be less than) the value that is directly attributable to the rights and obligations that constitute the financial instrument. The portion of an observable market exit price that is not directly attributable to the financial instrument would not be included in determining a market exit price for the financial instrument.

94. Some examples of values included in market exit prices that are not directly attributable to financial instruments include the value of:

(a) expected cash flows from expected renewals or extensions of an existing financial instrument that the enterprise does not have a contractual right or obligation to renew or extend;

(b) expected cash flows from future transactions with the customer that do not result directly from the financial instrument contract but are expected to occur because of a relationship established by the existence of the financial instrument contract; and

(c) any net cash flow benefits expected by the writer of free-standing options to result from holders' future decisions to exercise or not exercise the options. (However, the fair value of an existing financial instrument, such as a loan asset, that contains an embedded written option, such as a prepayment option, would reflect market expectations of the holder's future decisions to exercise or not exercise that option.)

[See Application Supplement paragraphs 331-339 on credit card contracts and demand deposit liabilities.]

Prices from More than One Market for the Same Instrument

95. ***If an enterprise has access to more than one exit market for a financial instrument and prices in those markets are different, the instrument's fair value should be based on the most advantageous market exit price. "Most advantageous" means the optimum market exit price obtainable for that financial instrument in a market to which the enterprise has access. A market exit price is not a more advantageous price for the same instrument if the price advantage results from enhancements that are not present in the enterprise's financial instrument.***

96. The most advantageous price would be the highest market exit price for an asset and the lowest market exit price for a liability, after taking into account any significant differences in costs that would have to be incurred to sell a financial asset or obtain relief from a financial liability.

97. "Most advantageous" does not refer to an enterprise's goals or expectations that differ from market expectations. As an example, an enterprise might determine that its best course of action is to withdraw from a particular area of activity quickly, even though it will not realise the most advantageous price for its assets and liabilities. If the enterprise were to sell an asset for less than the most advantageous price or settle a liability for more than the most advantageous price, the enterprise would report a loss only when the sale or settlement occurs.

98. ***An enterprise has access to a market if there is no legal impediment to its participation in that market. If only portfolios of instruments (as opposed to individual instruments) are traded in a particular market, the enterprise has access to that portfolio market only if it holds a portfolio that could be traded in that market.***

99. No two portfolios are exactly alike. Therefore, if the most advantageous market exit price is for a portfolio, the enterprise would adjust for the effects on fair value of any dissimilarity between its portfolio and those observed to have been traded.

[See Application Supplement paragraphs 340 and 341]

Effect of an Embedded Option on the Enterprise Holding the Option

100. ***If a financial instrument contains a contractual provision (an embedded option) that gives the enterprise the right to settle or require settlement at a price that is more advantageous than the price in observed arm's-length transactions, the enterprise should measure the instrument at that contractual settlement price (the exercise price of the embedded option) adjusted for the effect of any time period to the exercise date.***

101. This requirement applies only to the enterprise that holds the option. The writer of the option would report the instrument at fair value based on observed transactions or, if necessary, at an estimate of that value determined by a valuation technique.

[See Application Supplement paragraphs 342 and 343]

Large Blocks of Instruments

102. ***In some circumstances, an enterprise might expect the market exit price of a single transaction involving a large number of units of identical instruments (a large block) to be different from the market exit price of a single identical instrument or a small block of identical instruments. However, if market exit prices are available, the enterprise should use them without adjustment for difference between the size of the enterprise's holdings and the quantity exchanged in the observable transaction(s).***

103. In other words, if an enterprise holds a large block of a particular instrument and the only available market exit prices come from transactions involving individual instruments or small blocks, the enterprise would not adjust for the expected effect of selling the large block. That prohibition applies whether the effect is expected to be a discount or a premium. Similarly, if the enterprise holds only a small number of instruments and the available market exit prices come from transactions involving large blocks, the enterprise would not adjust the available price for the potential effect of selling individual instruments.

Estimating Fair Value without Observable Market Exit Prices

Selecting a Valuation Technique

104. ***If an enterprise cannot estimate fair value using the observable market exit prices of identical or similar financial instruments, it should estimate fair value by using a valuation technique that incorporates the factors that market participants would consider in setting a price.***

105. The objective of measuring a financial instrument at fair value using a valuation technique is to estimate the market exit price of the instrument. A technique for measuring a financial

asset would estimate what the enterprise would have received if it had sold a financial asset in an orderly transaction priced under the market conditions that existed on the measurement date. A technique for measuring a financial liability would estimate what the enterprise would have had to pay a third party with the same credit rating to assume the enterprise's financial liability,[10] or what the enterprise would have had to pay to repurchase its liability in an arm's-length exchange motivated by normal business considerations (for example, as if the instrument were traded regularly on an exchange or in a dealer market, with appropriate adjustment for any significant difference in marketability).

106. ***If there is a valuation technique that is commonly used by market participants to price the instrument being measured and that has been demonstrated to provide reliable estimates of market exit prices, the enterprise should use that technique.***

107. For example, there are well-established models for pricing many types of financial options. An enterprise that holds or writes one of those options would use the model best suited for the type of option held or written. It would consistently apply that model, except if a new model or a change in the method of application of the existing model has been demonstrated to result in a more accurate estimate (see paragraphs 129 and 130 on estimation policies and procedures).

108. ***If no technique for pricing an instrument is in common use by market participants, an enterprise should develop its own technique. All valuation techniques should be consistent with accepted economic methodologies for pricing financial instruments of the type being measured and should be tested for validity using prices from actual transactions.***

109. As indicated in paragraph 108, an enterprise is required to test its valuation techniques by comparison to market exit prices in occasional transactions that it can observe or in which it participates. An enterprise would make reasonable efforts to become aware of such transactions between other parties on which information is publicly available.

110. Present value concepts are central to the development of techniques for estimating the fair value of financial instruments because the market exit price of a financial instrument represents market participants' collective estimate of the present value of its expected cash flows. That estimate reflects the amounts, timing, and uncertainty of future cash flows and the price that market participants are able to charge for bearing the uncertainty. Although financial options have certain unique characteristics, present value concepts are also applicable for estimating their fair value. The fair value of a financial option reflects the

[10] The description of this technique is not intended to imply that the creditor would consent to assumption by a party with the same credit risk. Stipulating that the assuming enterprise has the same credit risk is necessary to achieve the objective of measurement based on the enterprise's own credit standing. It avoids including the value of any credit enhancement that would occur if any enterprise with a superior credit standing assumed the liability.

market's estimation of the current present value of its expected cash flows as with any financial instrument, but within the context of the expected effects of the price and volatility of the variable underlying the option.

[See Application Supplement paragraphs 344 and 345]

Inputs to Valuation Techniques

111. ***When using a valuation technique to estimate fair value, an enterprise should use estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument.***

112. Available market information would be supplemented, as necessary, with the enterprise's estimates and assumptions about other information that market participants would be expected to consider in setting a price for the instrument. Some examples of market information that would be used are market interest rates, foreign currency exchange rates, and commodity prices, as well as prepayment and bankruptcy or delinquency statistics and similar government or industry statistics. The enterprise's own assumptions may be the only source of information about some factors that affect fair value, but they would be consistent with the available information about the estimates and assumptions that market participants would use.

[See Application Supplement paragraph 346]

113. ***A present value technique for estimating fair value starts with a set of projected cash flows, expectations about possible variations in the amounts or timing of those cash flows, and the time value of money. An enterprise should incorporate expectations about possible variations in cash flows into either the projected cash flows or the discount rate or some combination of the two. In determining discount rates, an enterprise should use assumptions consistent with those used in estimating the projected cash flows, to avoid the effect of some assumptions being double-counted or ignored.***

114. ***Projected cash flows and discount rates should be free from bias and should not reflect factors unrelated to the assets or liabilities in question. In addition, a present value technique for estimating the fair value of a financial instrument should be based on projected cash flows that are directly attributable to the contractual rights and obligations that constitute the financial instrument, as described in paragraphs 92-94.***

115. The following types of information may be required in estimating projected cash flows, possible variations in those cash flows, and possible adjustments to the discount rate used to determine their present value.

(a) Contractual terms.

(b) Expectations about counter-party behaviour.

(c) Expectations of future market conditions implied by current market data such as yield curves and forward foreign currency prices.

(d) Estimates of the values of other variables or probabilities of future events that affect the contractual cash flows.

(e) Estimates of the net costs of servicing financial assets and financial liabilities that would be considered by market participants.

[See Application Supplement paragraphs 347-354]

116. ***An enterprise should reflect the following information in the fair value estimate, either as a part of the present value computation or as an adjustment of the result:***

(a) the price market participants are able to receive for bearing the uncertainty inherent in the financial instrument (the risk premium); and

(b) other factors market participants would be expected to consider in setting prices, including marketability and profit margins expected by market participants.

117. As an example of sub-paragraph 116(b), a purchaser is not likely to be willing to pay as high a price for an asset that is not readily marketable as for an asset that could be resold

quickly for a determinable price. Similarly, the price that market participants would receive for assuming a liability may include a profit margin for providing this service to the original debtor.

[See Application Supplement paragraphs 355-369 regarding use of valuation techniques to determine fair values of non-traded options and other derivatives, non-traded equity instruments, loan assets and impaired loan assets.]

Financial Liabilities

118. ***The estimated market exit price of a financial liability should reflect the effects of the same market factors as the price of a financial asset, including the credit risk inherent in the liability.***

119. Differences between the fair value of a financial instrument as a liability and its fair value as an asset can arise from:

   (a) bid-asked spreads (see paragraphs 80-82);

   (b) use of the most advantageous market exit price, if there is more than one market (see paragraphs 95-99 and Application Supplement paragraphs 340 and 341); and

   (c) the differing effects of settlement options on the fair value of the same financial instrument as an asset or as a liability (see paragraphs 100 and 101 and Application Supplement paragraphs 342 and 343).

120. Observable market exit prices for financial liabilities (such as traded corporate bonds) reflect the effects of the credit risk inherent in the liabilities. If an enterprise finds it necessary to estimate a market exit price using a discounted cash flow computation, the effect of the enterprise's own credit risk would also be included in either the expected cash flows or the discount rate.

121. An enterprise may be aware of information that would affect its credit standing if that information became known to market participants. An enterprise would not use this information to adjust an observed market exit price of a financial liability. However, if it is necessary to use a valuation technique to estimate the market exit price of a financial liability, an enterprise may not be able to determine what market participants know or would know if they were setting a price to assume the liability. In that situation, an enterprise would make its estimate of fair value using all information that the enterprise would be legally obligated to disclose if the liability were traded, as well as that which market participants would reasonably be expected to discover for themselves.

[See Application Supplement paragraphs 370-375]

Exception for Certain Private Equity Investments

122. ***In rare circumstances, an enterprise may determine that it is not practicable to make a reliable estimate of the fair value of an equity investment in another enterprise for which there is no observable market exit price (private equity investment). In that situation, the enterprise should report the financial instrument at its carrying amount at the time the enterprise determined that it was not practicable to make a reliable estimate of its fair value, or at a lower amount determined under paragraph 125. This exception is not available to an enterprise or unit of an enterprise, such as a venture capital investment enterprise, for which investing in the equity of private enterprises is a significant business activity. The exception also is not available for any derivative that an enterprise holds or writes that is based on the value of a private equity investment, or for any investment that it holds that is the subject of a derivative that it holds or writes.***

123. Paragraphs 183-186 include requirements to disclose information about measurement uncertainties and about private equity investments that have not been measured at fair value.

124. If an enterprise determines that it has become practicable to estimate the fair value of an investment that had been reported under this exception, it would not be acceptable to adopt this exception again at a later date for that investment.

125. ***If there is evidence at a measurement date that the full carrying amount of a private equity investment that is not measured at fair value cannot be recovered, the enterprise should measure the investment at its estimate of the amount that could be recovered at that date. That new amount should not be adjusted unless there is evidence that the amount cannot be recovered or unless it becomes practicable to make a reliable estimate of the fair value.***

Foreign Currency Denominated Financial Instruments

126. ***An enterprise should re-measure the foreign currency fair value of a <u>foreign currency denominated financial instrument</u> to the functional currency using the currency spot rate at the reporting date.***

127. ***An enterprise should determine the fair value of a forward exchange contract on the basis of the forward exchange rate, discounted to reflect the fact that the exchange will not occur until a future date. If a forward exchange contract price is in a currency other than the functional currency, an enterprise should re-measure its foreign currency fair value to the functional currency in accordance with paragraph 126.***

128. In accordance with foreign currency translation standards of many jurisdictions, closing exchange rates for the period are used both for re-measuring foreign currency denominated

assets and liabilities into functional currencies and for translating them from functional currencies to the reporting currency. As a result, foreign currency denominated financial instruments are stated in the balance sheet of a reporting enterprise at the same amounts as if they had been translated to the reporting currency from the currencies of their denomination. The income statement effects, however, vary according to the functional currencies of the entities within the reporting enterprise where the financial instruments are held (see paragraphs 148-151).

Establishing Fair Value Estimation Policies and Procedures

129. ***An enterprise should establish appropriate policies and procedures for estimating the fair value of its financial instruments. An enterprise's fair value estimation policies should be consistent from period to period except when a change will result in more accurate estimates of fair value.***

130. An enterprise's policies and procedures would cover the significant types of financial instruments that it holds and issues. These policies and procedures would be sufficient to provide reasonable assurance of appropriate application of fair value measurement methods meeting the requirements of this Draft Standard. Paragraph 182 requires disclosures about the enterprise's methods for determining fair values.

[See Application Supplement paragraphs 376-379]

Balance Sheet Presentation

131. ***An enterprise should distinguish on the face of the balance sheet:***

  - ***(a)*** ***cash and cash equivalents;***
  - ***(b)*** ***equity instruments held that are not accounted for under the equity method, except for those classified under sub-paragraph (d);***
  - ***(c)*** ***unconditional rights to receive financial instruments, except those classified under sub-paragraph (d);***
  - ***(d)*** ***other financial assets;***
  - ***(e)*** ***unconditional obligations to deliver financial instruments except those classified under sub-paragraph (f); and***
  - ***(f)*** ***other financial liabilities.***

132. Unconditional rights to receive, or obligations to deliver, financial instruments make up those financial instruments that fall within part (c) of the definition of a financial instrument (see paragraph 7) and for which receipt or delivery does not depend on the occurrence of specified events.

133. Other financial assets and liabilities include conditional financial instruments (see paragraphs 7 and 13), as well as financial assets and financial liabilities that are forward contracts, options, financial guarantees, sets of rights or obligations in a hybrid contract that are accounted for as financial instruments that fall within the scope of the Draft Standard in accordance with paragraphs 4 and 5, compound financial instruments (i.e., financial instruments that combine two or more elements of equity instruments, unconditional rights and obligations, and conditional rights and obligations), and non-financial items that are accounted for as financial instruments that fall within the scope of the Draft Standard in accordance with paragraph 2.

134. ***An enterprise should distinguish, either on the face of the balance sheet or in notes to the financial statements referenced from the relevant items in the balance sheet, the following:***

  - ***(a)*** ***significant classes of financial instruments that are unconditional rights to receive financial instruments, in sub-paragraph 131(c), including:***
    - ***(i)*** ***trade receivables;***

(ii) loan assets;

(iii) impaired loan assets;

(iv) bonds and other debt securities held; and

(v) other significant financial assets in sub-paragraph 131(c), by type;

(b) significant classes of financial instruments that are unconditional obligations to deliver financial instruments, in sub-paragraph 131(e), including:

(i) trade payables;

(ii) demand loans payable;

(iii) debt issued; and

(iv) other significant financial liabilities in sub-paragraph 131(e), by type; and

(c) other significant financial assets and financial liabilities, by type.

135. The disclosure required by sub-paragraph 134(c) might include, for example:

(a) analysis of cash and cash equivalents between (i) reporting currency and (ii) foreign currency;

(b) analysis of equity instruments other than those accounted for under the equity method into (i) common stock; (ii) preferred stock; (iii) interests in partnerships; and (iv) shares in equity funds; and

(c) analysis of other financial assets (and, separately, other financial liabilities) into (i) forward contracts; (ii) swaps; (iii) options held (options written); (iv) financial guarantees; (v) hybrid contracts; (vi) servicing assets (servicing liabilities); and (vii) commodity contracts.

Income Statement Presentation

Basic Requirement

136. ***An enterprise should recognise changes in the fair value of financial instruments, after adjustment for receipts and payments, in the income statement in the reporting periods in which they arise—with the exception of gains and losses arising in translating financial instruments from functional currencies to the reporting currency that are presented outside the income statement in accordance with standards of accounting for foreign entities***[11] [see Application Supplement paragraphs 380 and 381].

Income Statement Disclosures

137. ***An enterprise should disclose the following for the reporting period, either on the face of the income statement or in notes to the financial statements referenced from the relevant items in the income statement:***

- ***(a)*** ***interest revenue on the fair value basis from interest-bearing financial assets, separately distinguishing the portion that is attributable to impaired loan assets;***

- ***(b)*** ***interest expense on the fair value basis from interest-bearing financial liabilities;***

- ***(c)*** ***net gain or loss on impaired loan assets after the determination of interest in sub-paragraph (a) above;***

- ***(d)*** ***net gain or loss resulting from changes in the credit risk premiums of interest-bearing financial liabilities;***

- ***(e)*** ***net gain or loss comprising (i) the net gain or loss arising on interest-bearing financial assets and financial liabilities after the determinations of sub-paragraphs (a)-(d) above and after any foreign currency gain or loss and (ii) the change in fair value, after adjustment for receipts and payments, arising on forward contracts (including swaps), options and similar derivative financial instruments that is attributable to underlying variables that are based on interest rates or credit risk;***

- ***(f)*** ***net gain or loss on equity instruments, including dividends; and***

- ***(g)*** ***net gain or loss on other financial instruments.***

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[11] The IASC requires such gains and losses to be classified as equity in accordance with paragraph 30 of IAS 21, The Effects of Changes in Foreign Exchange Rates.

138. ***An enterprise should also disclose the cumulative net gain or loss resulting from changes in the credit risk premiums of interest-bearing financial liabilities outstanding at the reporting date for the period from their dates of issue to the end of the reporting period.***

Interest Revenue and Expense

139. ***<u>Interest revenue</u> and <u>interest expense</u> on the fair value basis should be determined using the <u>current yield to maturity</u> basis, except that an enterprise may use the <u>current market expectations basis</u> if the chief operating decision maker relies primarily on that basis for assessing the performance of the enterprise's significant interest-bearing financial instruments and it is consistent with the enterprise's basis for managing interest rate risk.***

140. An enterprise that meets the conditions of paragraph 139 and elects to use the current market expectations basis would apply it consistently to all its significant interest-bearing financial instruments.

[See Application Supplement paragraphs 382-390]

Information about Net Gains and Losses

141. ***An enterprise should provide information about the primary sources of the net gain or loss amounts reported under sub-paragraph 137(d) and paragraph 138.***

142. The information required to be disclosed by paragraph 141 would indicate whether the amounts reported have been significantly affected by debt repayments or re-financings, changes in the nature or value of collateral provided as security, changes in the credit standing of the enterprise, changes in market credit risk spreads for financial liabilities of equivalent credit risk, or other factors.

143. ***An enterprise should provide information about the significant factors that contributed to the net gain or loss disclosed under sub-paragraph 137(e).***

144. The information required to be disclosed by paragraph 143 would identify at least each of the following factors that had a significant effect on the reported gain or loss and the direction of that effect:

(a) changes in basic interest rates;

(b) changes in credit risk premiums of financial assets, distinguishing effects of changes in credit interest rate spreads and in credit risk; and

(c) changes in other financial risks.

145. ***An enterprise should provide information about the primary sources of the gains or losses disclosed under sub-paragraphs 137(f) and 137(g).***

146. Examples of information required to be disclosed by paragraph 145 would be the significant classes of equity investments and the specific commodities whose price change effects were the primary sources of the reported gains or losses.

147. The information that is required to be disclosed by paragraphs 141-146 would be sufficient to inform users about an enterprise's financial performance in relation to its financial risk management objectives and policies disclosed in accordance with paragraphs 156-163.

Foreign Currency Denominated Financial Instruments

148. ***An enterprise should disclose the net gain or loss recognised in the income statement that arises from re-measuring foreign currency denominated financial instruments into their functional currencies. An enterprise should also disclose the net gain or loss resulting from translating financial instruments from functional currencies to the reporting currency.***

149. For consistency with the foreign currency translation standards of many jurisdictions, the Draft Standard adopts similar definitions and reflects the same two-stage approach found in those standards. Under that approach, assets and liabilities are measured in terms of the functional currency of the entity by which they are held. Gains and losses resulting from re-measuring assets and liabilities denominated in foreign currencies into their functional currencies are recognised in the income statement. As a second stage, the financial statements of all the foreign entities that are part of the reporting enterprise are translated into the reporting currency in order to prepare the financial statements of the reporting enterprise. Gains and losses arising from this second stage are presented outside the income statement.

150. An enterprise would indicate the primary currencies contributing to the two types of net exchange gain or loss disclosed under paragraph 148.

151. The income statement effects of foreign currency denominated financial instruments included in the amounts required to be disclosed by paragraph 137 would have arisen from re-measurements into functional currencies and subsequent translation into the reporting currency at exchange rates prevailing at the times the underlying transactions and events took place. For practical reasons, rates that approximate actual exchange rates at the times transactions and events occurred may be used, and the average rates for a reporting period may be used where rates have not undergone a major change in the period. However, if exchange rates fluctuate significantly, the use of average rates might not be appropriate.

Further Disaggregation

152. An enterprise may choose to disaggregate net gain or loss amounts by sources or types of financial risk, in which case it would disclose the basis on which the disaggregated amounts have been determined. Such risk-based disclosures would be consistent with the financial risks identified in the enterprise's disclosure of significant financial risks and its risk management objectives and policies (see paragraphs 154-163).

Hedges

153. The Draft Standard does not permit special accounting for financial instruments entered into as part of risk management activities. That is, financial instruments that are used for risk management purposes would be measured at fair value and the changes in fair value would be recognised in the income statement in the reporting periods in which they arise (except for certain foreign currency translation gains and losses, see paragraph 136).

Disclosure

Significant Financial Risks

154. ***An enterprise should describe each of the <u>financial risks</u> that was significant to it during the reporting period*** [see Application Supplement paragraphs 393 and 394].

155. An enterprise would evaluate whether a financial risk is significant for disclosure in accordance with paragraph 154 on the basis of its financial asset and financial liability positions related to that risk. This would be assessed taking into account asset and liability risk positions during the reporting period as well as positions at the end of the reporting period. It is not acceptable to view a financial risk as not significant to an enterprise because it has reduced its net risk exposure by having or arranging reciprocal asset and liability positions.

Financial Risk Management Objectives and Policies

156. ***An enterprise should explain the role that financial instruments have had during the period in creating or changing the risks that the enterprise faced in its activities. This should include a description of its objectives and policies for managing each of the significant financial risks identified in paragraph 154.***

157. An enterprise's explanation of the role that financial instruments have had during the period in creating or changing the risks that the enterprise faced in its activities would include (a) identification of the principal groups of financial assets and financial liabilities involved and (b) sufficient information about the primary financial and business activities of the enterprise to provide the context needed to enable users to understand the enterprise's disclosed financial risk management objectives and policies, information about its financial risk positions, and its financial performance.

158. The activities of some enterprises may be such that there are reciprocal asset and liability positions in respect of certain risks. For example, an enterprise may have loan assets financed by debt with similar maturities and contracted cash flows, with the effect of reducing the enterprise's net exposure to basic fair value interest rate risk and basic cash flow interest rate risk. In this case, the description required by paragraph 156 would include the enterprise's basic objectives and policies for matching, and for taking mis-matched positions, with respect to floating versus fixed rate terms and maturities of the asset and liability positions. In describing its objectives and policies for using financial instruments an enterprise would, for example, explain its use of forward contracts or swaps to mitigate its net balance sheet exposure to <u>basic interest rate risk</u> or certain commodity price risks, or its use of credit derivatives to manage certain credit risk exposures. An enterprise would

also explain any significant objectives and policies with respect to transfers of financial assets, such as securitisation transactions.

159. A description of financial risk management objectives and policies will typically include information about the enterprise's policies for:

(a) balancing fixed versus floating interest rate exposures;

(b) setting interest rate re-pricing and maturity dates;

(c) managing currency positions;

(d) setting acceptable risk exposure limits; and

(e) managing credit risk, including requiring collateral or other security to support financial instruments subject to credit risk, or for entering into arrangements (including master netting arrangements and credit guarantees) intended to achieve the same effect. Information about the enterprise's policy concerning access to collateral or other security would also be provided.

160. ***An enterprise should describe its objectives and policies for using financial instruments to manage significant risks associated with transactions expected to occur in future reporting periods.***

161. An enterprise's description of its objectives and policies for managing significant risks associated with transactions expected to occur in future reporting periods would include, for significant risks, identification of (a) the nature of the anticipated future transactions and the risks that are the subject of risk management, (b) the nature of the financial instruments permitted to be used, (c) any policies with respect to the extent of risk management activities and time periods, and (d) policies for monitoring and assessing effectiveness.

162. ***An enterprise should identify and explain any significant changes that it has made to its financial risk management objectives or policies during the reporting period.***

163. The explanation that is required by paragraph 162 would include both those changes that were in effect during the reporting period and those that will be in effect only for future reporting periods.

Terms and Conditions of Financial Instruments

164. ***An enterprise should disclose information about the significant terms and conditions of financial instruments held or issued at the reporting date that may have a significant***

effect on the amounts, timing and certainty of future cash flows to be received from or paid out in respect of those financial instruments.

165. Terms and conditions would be disclosed whenever financial instruments are important, either individually or as a class, in relation to the financial position of an enterprise or its results. If no single instrument is individually significant to the future cash flows of the enterprise, the essential characteristics of the instruments would be described by reference to appropriate groupings of like instruments.

166. Significant terms and conditions of financial instruments that would warrant disclosure, depending on the nature and significance of the financial instruments concerned, include:

(a) the principal, stated, face or other similar amount, which for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based;

(b) the date of maturity, expiry or execution;

(c) the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;

(d) the stated rate or amount of interest (which might be based on benchmarks, such as LIBOR), dividend or other periodic return on principal and the timing of payments;

(e) a description of early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices;

(f) a description of any collateral or other security interest held, in the case of a financial asset, or of any collateral pledged or other security interest given, in the case of a financial liability;

(g) any condition of the financial instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt-to-equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately);

(h) any features of the financial instrument that significantly concentrate or leverage risk (for example, a significant leverage factor in a derivative financial instrument, such as a requirement for payments based on a significant multiple of changes in fair value of an underlying price or index, that, if triggered, could be material to the enterprise's financial performance); and

(i) a description of options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised, the conversion or exchange ratio(s) and information described in items (a)-(h) for the instrument to be acquired in the exchange.

167. The terms and conditions of hybrid instruments would be explained in a manner that highlights not only the financial risks involved but also the fact that those risks are contained in a single instrument. For example, an enterprise that has issued convertible debt would explain that the financial liability and equity instrument components of that debt arise from the same financial instrument.

168. ***When the ability to dispose of or use financial assets is subject to external restrictions, through legal or contractual requirements outside the financial instrument contract, an enterprise should disclose the nature and extent of such restrictions at the reporting date.***

169. An example of the disclosure required by paragraph 168 would be disclosure of the fact that an enterprise is precluded from disposing of certain financial instruments as a result of regulations requiring that it maintain a certain proportion of liquid financial assets. Similarly, an enterprise might disclose that certain financial assets are subject to external stipulations that only the income on the assets be used by the enterprise, with the capital retained for further income generation.

Financial Risk Position at the Reporting Date

Basic Interest Rate Risk

170. ***When an enterprise has identified <u>basic interest rate risk</u> as a significant financial risk in accordance with paragraph 154, it should disclose, for each significant class of financial assets and financial liabilities affected by basic interest rate price risk at the reporting date, an analysis of their fair value, classified according to contractual interest re-pricing dates*** [see Application Supplement paragraphs 395-399].

Currency Risk

171. ***When an enterprise has identified <u>currency risk</u> as a significant financial risk in accordance with paragraph 154, it should disclose, separately for financial assets and for financial liabilities at the reporting date:***

(a) an analysis of their fair value, classified according to the main currencies of denomination involved; and

(b) the fair value of financial assets and financial liabilities of foreign entities, indicating the primary functional currencies involved.

[See Application Supplement paragraphs 397 and 398]

Credit Risk

172. ***When an enterprise has identified <u>credit risk</u> as a significant financial risk in accordance with paragraph 154, it should disclose:***

(a) the amount of the maximum credit risk exposure at the reporting date in the event other parties fail to perform their obligations; and

(b) for those financial instruments for which the maximum credit risk exposure differs from the fair value included on the balance sheet (including financial guarantees provided by the enterprise and similar financial instruments), the nature of the financial instruments giving rise to that exposure.

173. ***When an enterprise has identified <u>credit risk</u> as a significant financial risk in accordance with paragraph 154, it should also disclose, for each significant concentration of credit risk arising from financial instruments at the reporting date:***

(a) a description of the activity, region or economic characteristic that is the basis of the concentration;

(b) information about its maximum credit risk exposure, in accordance with sub-paragraph (a); and

(c) information about collateral or other security held, or other arrangements (including master netting arrangements, set-off arrangements, credit guarantees and credit derivatives) entered into, to manage credit risk, including the extent to which such arrangements would mitigate the probability of loss due to credit risk.

[See Application Supplement paragraphs 400 and 401]

174. Concentrations of credit risk may arise from exposures to a single counter-party or to a group of counter-parties having a similar characteristic such that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions. Characteristics that may give rise to a concentration of credit risk include the nature of the activities undertaken by counter-parties, such as the industry in which they operate, the geographic area in which activities are undertaken and the level of creditworthiness of groups of counter-parties. Concentrations of credit risk might also arise as a result of exposure of collateral or other security held, or other similar arrangements, to similar risk characteristics. For example, significant collateral amounts held might all be in the form of

similar property, or their values might all depend upon the same underlying variable (for example, oil prices).

Other Significant Financial Risks

175. ***For each significant financial risk identified in accordance with paragraph 154 that is not dealt with by the disclosures required by paragraphs 170-173, an enterprise should provide quantitative information about the extent to which the enterprise is affected by that risk at the reporting date*** [see Application Supplement paragraphs 402-408].

176. Other significant financial risks might include other price risks (including commodity price risks, equity price risk, etc.), prepayment risk and liquidity risk, as well as risks of volatility affecting the value of financial options and similar financial instruments.

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

177. ***If an enterprise's financial risk position at the reporting date is not representative of the position at other times during the reporting period, it should disclose information about the amount by which positions during the reporting period vary from the position at the end of the reporting period.***

178. Disclosing the highest and lowest, or average, positions during the reporting period might be appropriate means of providing this information.

Potential Effects of Changes in Risk Conditions on Financial Risk Position

179. An enterprise is encouraged to provide information about the extent to which fair values of financial instruments and income and cash flows could change as a result of changes in underlying financial risk conditions. This information might be provided by measures such as sensitivity analysis, value-at-risk, or other established risk measurement techniques.

180. When an enterprise makes such disclosures it would explain:

(a) the methodology, main parameters and assumptions used to calculate each measure;

(b) the effects of any material differences between the methodology, parameters and assumptions used to calculate the measure for the reporting period and those used in the preceding reporting period; and

(c) an indication as to whether the measure disclosed at the reporting date is typical of similar measures during the reporting period.

[See Application Supplement paragraphs 409-411]

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

181. ***If an enterprise separately discloses amounts of gains or losses in the reporting period on financial instruments identified as managing risks associated with transactions expected to occur in future reporting periods, it should describe (a) the financial instruments involved; (b) the risk(s) that are being managed; and (c) the expected timing of the future transactions involved. An enterprise should continue to disclose this information, including the gains and losses in respect of that activity, until the future transactions occur or are no longer anticipated to occur.***

182. An enterprise may wish to provide additional disclosures of its financial risk management activities associated with transactions expected in future reporting periods. It might, for example, disclose the fair value at the reporting date of financial instruments identified as being used to manage future risks, or disclose information about the extent and effectiveness of its use of financial instruments during the reporting period to manage risks related to transactions that were expected to occur during the reporting period. Such disclosures would be explained in the context of the enterprise's financial risk management objectives and policies disclosed in accordance with paragraphs 156-163.

Methods Used to Estimate Fair Value

183. ***An enterprise should describe, for each significant class of financial asset and financial liability, the methods used to estimate fair values, including:***

    (a) identifying which financial instruments were valued using observable market exit prices (in accordance with paragraphs 77-103) and which were valued using valuation techniques (in accordance with paragraphs 104-117);

    (b) for financial instruments valued using a valuation technique, describing the valuation technique used, including describing the methodology and significant assumptions used;

    (c) describing significant changes made during the reporting period to methods and assumptions used to estimate fair value;

    (d) identifying the factors taken into account in determining the effect of the enterprise's own credit risk on the fair value of its financial liabilities;

    (e) if fair values of financial instruments are sensitive to key valuation assumptions, stating this fact, describing alternative assumptions, and indicating the most likely range of reasonably possible estimates; and

(f) identifying any large blocks of financial assets that may not be capable of immediate realisation at their recorded fair value, their fair value and an explanation of this fact.

184. In some instances, the choice of key valuation assumptions could result in a range of reasonably possible estimates for the fair value of a financial instrument or class of financial instruments. When that range is sufficiently great that it is reasonably possible that the choice of another appropriate valuation assumption could have a material effect on the financial statements, the disclosures required by sub-paragraph 183(e) would be made. An indication of the most likely range of reasonably possible amounts within which fair value could fall might be provided by indicating a range of amounts or by disclosing the effect of a change in the significant underlying assumptions used to estimate the fair value. Past experiences with regard to differences between estimated fair values and cash flows from the sale or settlement of financial instruments shortly after the measurement date might be indicative that measurement is sensitive to key valuation assumptions.

185. ***In the circumstances described in paragraph 122, when an enterprise determines that it is not practicable to make a reliable estimate of the fair value of a private equity investment, it should disclose the total carrying amount of the equity investment involved and the policy that it has adopted for determining the carrying amount of the equity investment. If the enterprise uses such a financial instrument in fulfilling its objectives and policies for managing significant financial risks, it should disclose that fact.***

186. ***If an enterprise sells, or determines that it becomes practicable to make a reliable fair value estimate for, equity investments for which it had previously determined it was not practicable to make a reliable fair value estimate in accordance with paragraph 122, the enterprise should disclose the carrying amount of such equity investments at the previous reporting date and either (a) the proceeds from sale of the investments or (b) the fair value at the date it determines a reliable estimate of fair value can be made.***

Derecognition Disclosures

Sale and Repurchase Transactions and Stock Lending Transactions

187. ***An enterprise (the transferor) should disclose the following information if it transfers and derecognises a financial asset in accordance with paragraphs 49-68 and concurrently enters into an agreement to repurchase substantially the same financial asset at a future date:***

(a) the nature of the transfer;

(b) the fair value and class of the financial assets derecognised as a result of the transfer; and

(c) ***the fair value and class of the financial assets and any liabilities recognised as a result of the transfer.***

The transferor should continue to provide this disclosure until it ceases to have the rights and obligations arising from its repurchase agreement.

Retained Interests in Transferred Assets

188. ***An enterprise (the transferor) that transfers some of a financial asset should disclose the following information if some components of the asset are derecognised and the components of the asset that the transferor continues to recognise have greater risk of variability in value than the derecognised components:***

(a) ***the fair value and balance sheet classification of the components that continue to be recognised; and***

(b) ***information about the risks inherent in those assets that will significantly affect the performance of the components that continue to be recognised.***

189. ***The enterprise should continue to provide the disclosure described in paragraph 188 until either the components referred to in sub-paragraph 188(a) are derecognised or the risk of variability in value of those components is no more than the risk of variability inherent in the components that were derecognised.***

Effective Date and Transition

190. ***This Draft Standard becomes operative for financial statements covering financial years beginning on or after _________, 200X. Earlier application is encouraged, but this Draft Standard should be applied only from the beginning of a financial year that begins after its issuance. If an enterprise applies this Draft Standard for periods beginning before ________, 200X, it should disclose that fact.***

191. An enterprise that chooses to adopt the Draft Standard before the effective date would be expected to apply all aspects of the Draft Standard at the same time, unless the parts of the Draft Standard adopted do not contravene accounting standards existing at the date of adoption.

192. ***An enterprise should adopt the following transitional requirements.***

(a) Except as required by sub-paragraph (d), at the beginning of the financial year in which this Draft Standard is initially applied, an enterprise should recognise in its balance sheet all financial instruments and should measure them at fair value in accordance with the provisions of this Draft Standard. Any difference between the previous carrying amount (which may have been zero) and fair value determined in accordance with this Draft Standard should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which this Draft Standard is initially applied.

(b) An enterprise should not adjust the carrying amount of non-financial items to exclude gains and losses arising from hedging arrangements that were included in that carrying amount before the beginning of the financial year in which this Draft Standard is initially applied.

(c) Except as required by sub-paragraph (b), an enterprise should recognise any gain or loss applicable to periods before the beginning of the reporting period in which this Draft Standard is initially applied, that this Draft Standard would require to be recognised in the income statement, as an adjustment of the balance of retained earnings at the beginning of the financial year in which this Draft Standard is initially applied. This adjustment should include those gains and losses first recognised as a result of applying this Draft Standard and those gains and losses previously excluded from the income statement but which this Draft Standard would require to be recognised in the income statement.

(d) On initial application of this Draft Standard, an enterprise should not recognise financial assets or financial liabilities that it had derecognised prior to

implementation of this Draft Standard, nor should it derecognise financial assets or financial liabilities that it had recognised prior to implementation of this Draft Standard. However:

- ***(i)*** ***if application of the Draft Standard would have required recognition of an item that was derecognised under previous accounting, the enterprise should describe the financial asset or financial liability involved until such time as it would have been derecognised in accordance with the Draft Standard; and***

- ***(ii)*** ***an enterprise should identify any contractual rights or contractual obligations that, although acquired, assumed or retained in connection with a transfer or settlement, were not recognised (either separately or as part of a financial asset or financial liability incorporating other rights or obligations) under the accounting previously applied. If those rights and obligations meet the criteria for recognition in paragraph 31, they should be recognised, measured at their fair value and accounted for in accordance with this Draft Standard. An enterprise need not change the manner in which those rights and obligations are presented in the financial statements.***

(e) ***An enterprise should classify components of a <u>hybrid contract</u> existing at the beginning of the financial year in which this Draft Standard is initially applied by applying the requirements of this Draft Standard at that date.***

193. As an example of the accounting in accordance with sub-paragraph 192(d), prior to the initial application of the Draft Standard an enterprise that transferred receivables but retained a subordinated interest in those receivables might, under previous accounting, have derecognised the receivables but not have recognised its retained interest. Sub-paragraph 192(d) requires the enterprise to recognise the retained interest as an asset and measure it at its fair value on initial application of the Draft Standard. Similarly, an enterprise might have transferred, prior to the date of initial application of the Draft Standard, receivables and assumed a liability by guaranteeing the collectability of a certain amount of those receivables. Under previous accounting, the enterprise might have derecognised the receivables, but not have recognised the financial guarantee. Sub-paragraph 192(d) requires the enterprise, on application of the Draft Standard, to recognise the financial guarantee as a liability if it meets the criteria for recognition in paragraph 31 and to measure it at its fair value. However, the enterprise would not change the previous accounting for the transfer of the receivables, even if the transfer would not have qualified for derecognition in accordance with the requirements of this Draft Standard.

194. Another example of sub-paragraph 192(d) would be where, prior to the initial application of the Draft Standard, an enterprise has transferred traded securities in exchange for cash

and at the same time agreed to repurchase those securities (on a date that is after the initial application of the Draft Standard) at a slightly higher fixed price. If the transfer had taken place after the implementation of the Draft Standard, the transferor would have derecognised the securities and recognised the forward agreement to repurchase them. However, under previous accounting the enterprise might have continued to recognise the securities and accounted for the cash it received in that "repo" agreement as the proceeds of a secured loan. Applying sub-paragraph 192(d) to this circumstance, the enterprise would not recognise the rights and obligations under the forward repurchase agreement because it has already recognised them, not separately but rather as part of a larger financial asset (the securities the enterprise continues to recognise). It would also not derecognise the securities.

195. ***When this Draft Standard is first adopted, an enterprise should not restate comparative information for recognition, derecognition and measurement and should disclose the fact that such information has not been restated. An enterprise need not present other information required by this Draft Standard for comparative periods.***