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.