FRED 30 THIRD SUPPLEMENT

FURTHER AMENDMENTS TO THE PROPOSED STANDARDS ON FINANCIAL INSTRUMENTS

ACCOUNTING STANDARDS BOARD

EXPOSURE DRAFT

THIRD SUPPLEMENT TO FRED 30

For the convenience of respondents in compiling their responses, the text of the questions in the Invitation to Comment (see pages 13 to 16) can be downloaded (in Word format) from the 'Financial Instruments' page in the Current Projects section of the ASB Website (www.frc.org.uk/asb).

For ease of handling, we prefer comments to be sent by email (in Word format) to:

fred30thirdsupplement@frc-asb.org.uk

Comments may also be sent in hard copy form to:

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Comments should be despatched so as to be received no later than 8 October 2004, although the ASB is also requesting comments on the fair value option proposals by the 21 July 2004. All replies will be regarded as on the public record and may be copied to the IASB and other standard-setters, unless confidentiality is requested by the commentator.

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ISBN 1 84140 547 7

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PREFACE

Introduction

1 In June 2002 the Accounting Standards Board (the ASB) issued FRED 30 'Financial Instruments: Disclosure and Presentation & Recognition and Measurement'. In August 2003 and April 2004, it issued two supplements to that FRED. Together the three documents propose that:

(a) a UK standard based on IAS 32 'Financial Instruments: Disclosure and Presentation' should be implemented for all entities, other than those that apply the FRSSE, for accounting periods beginning on or after 1 January 2005; and

(b) a UK standard based on the measurement and hedge accounting requirements of IAS 39 'Financial Instruments: Recognition and Measurement' (but not its recognition and derecognition requirements) should be implemented from the same date for all listed entities and for any unlisted entity that chooses to apply fair value accounting in its financial statements (so-called 'fair value volunteers').

2 The ASB is still consulting on those proposals and therefore has not issued either standard in final form.

3 The International Accounting Standards Board (IASB) has recently issued four exposure drafts (one in April, three this month) proposing amendments to the revised versions of IASs 32 and 39 it issued in December 2003 (and revised in April 2004). Because the ASB intends that the text of the UK standards based on IASs 32 and 39 should be as close as possible to the final international text, it is issuing this Third Supplement to FRED 30 in order to set out the IASB's proposed amendments and to invite comment on them.

4 The IASB will shortly be issuing a further exposure draft on financial instrument disclosures. That exposure draft is the result of the review that the IASB has been carrying out of IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions' and of the disclosure requirements of IAS 32. The ASB intends to issue those proposals as a UK exposure draft.

Structure of this Supplement

5 The IASB has issued its latest proposed amendments to IASs 32 and 39 in the form of four exposure drafts. The first three of those exposure drafts, which are set out in full in parts 1-3 of this Supplement, address:

(a) IAS 39's fair value option,

(b) transition and initial recognition of financial assets and financial liabilities, and

(c) cash flow hedge accounting of forecast intragroup transactions.

6 One important issue that the IASB has been working on recently is the border between its financial instruments standards (IASs 32 and 39) and its insurance standard (IFRS 4 'Insurance Contracts'); in other words, which contracts should be accounted for as financial instruments and which as insurance contracts. The fourth IASB exposure draft dealt with in this Supplement sets out the IASB's latest proposals on this subject.

(a) The proposals take as their starting point the texts of IASs 32 and 39 as amended by IFRS 4. The texts that the ASB last issued (in the Second Supplement to FRED 30) were before the IFRS 4's amendments so, to help those wishing to understand the evolution of the IASB's thinking, part 4 of this Supplement sets out the amendments IFRS 4 made to the two standards.

(b) Part 5 sets out the IASB's proposals ('Financial Guarantee Contracts and Credit Insurance') in full.

(c) The ASB intends the borders of its financial instruments standards to be drawn in exactly the same place as the IASB's borders. The IASB's border is the result of material set out in IAS 32, IAS 39 and IFRS 4. Although the ASB intends to issue UK standards based on IASs 32 and 39, it is not presently proposing to implement IFRS 4 as a UK standard. It therefore needs to incorporate the relevant material from IFRS 4 in other UK standards. Part 6 of the Supplement contains latest proposals as to how this should be done.

7 The paragraphs that follow briefly discuss the proposals in the Supplement. They are followed by the Invitation to Comment, and then by the detailed proposals themselves.

Part 1—The Fair fair value option

8 Prior to the 2003 version of IAS 39, entities complying with the standard were required to categorise their financial assets and financial liabilities and then apply a different, specified accounting treatment for each category. Thus:

(a) all items that meet the definition of a financial asset or financial liability that is held for trading are to be measured at fair value, with all changes in those fair values being recognised immediately in the profit and loss account (P&L). Derivatives are to be treated in the same way unless they are held as a cash flow hedging instrument in a hedging relationship that meets IAS 39's hedge accounting requirements, in which case changes in the fair value could be taken to (what in the UK would be) the statement of total recognised gains and losses (STRGL) and recycled from there to the P&L;

(b) all items that meet the 'held-to-maturity investments' definition and criteria and all items that meet the 'loans and receivables originated by the enterprise' definition are to be measured at cost-based amounts; and

(c) all other items (available-for-sale financial assets) were to be measured at fair value, and the changes in those fair values were either all to be recognised immediately in the P&L or all to be recognised in the STRGL and recycled from there to the P&L in accordance with the detailed provisions of the standard.

9 The December 2003 revision of IAS 39 changed this by introducing the fair value option. Under the option, an entity is permitted to designate irrevocably a financial instrument as one to be measured at fair value with fair value changes recognised immediately in the P&L; in other words, to apply the accounting treatment described in paragraph 1(a) above even though the instrument is not one of the types described in that paragraph. (The reasons for introducing this option are explained more fully in paragraphs BC5-BC7 of the Basis for Conclusions in part 1 of the Supplement.)

10 Currently the fair value option is available for any financial instrument.* The IASB is proposing however to impose some restrictions on its use. In particular, the proposal is that the option should be available only if both:

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* *The existing legal requirements in Great Britain and Ireland for companies that are not banks or insurance entities do not permit financial instruments to be measured at fair value with changes in those fair values being taken directly to the profit and loss account, unless the true and fair override is applied. Those requirements will shortly be amended to permit certain financial instruments to be accounted for at fair value through P&L; however under the amended legal requirements it would still be possible to take full advantage of the fair value option set out in the December 2003 version of IAS 39 only by applying the true and fair override. That would also be the case under the IASB's latest proposals because the proposed legal changes permit 'fair value through P&L' treatment in a narrower range of circumstances than the IASB's proposals.*

(a) the asset or liability involved is one of the types specified in the amendments; and

(b) the fair value of the asset or liability involved is 'verifiable'. Whether a fair value is verifiable would depend on the degree of subjectivity involved. The way the proposed amendment is drafted means that a fair value could be reliable but not necessarily verifiable.

(The reasons for proposing such restrictions are set out in part 1 of this Supplement, in paragraph 3 of the Background section and paragraphs BC9–BC13 of the Basis for Conclusions.)

11 The ASB has considerable reservations about this proposal.

(a) One of the main advantages of introducing the fair value option was that it makes implementation of the standard easier. Therefore, restricting the option's availability will make implementation more onerous unless the proposed restrictions permit the option to be used in all the circumstances in which the option would make implementation easier. The ASB is not convinced that this is so, and would encourage those entities that were planning to rely on the option to consider the matter carefully.

(b) The ASB notes that the effect of the proposed restrictions will be to require entities using the fair value option to maintain systems and procedures (in order to demonstrate compliance with the conditions set out in the proposals) that they would not need to maintain under the current standard.

(c) The proposal that fair value measures should be not only reliable but also verifiable seems to lead to some inconsistencies that the ASB thinks are unfortunate.

(i) One effect of the proposal is that the criteria that need to be met if a change in fair value is to be recognised immediately in the P&L now vary depending on whether the item is required to be accounted for at fair value through profit or loss or whether the entity has chosen to account for the item in that way. The ASB does not believe that a convincing case has been made in the exposure draft for this difference in approach.

(ii) Another effect of the proposal is that for some types of financial instrument the criteria for recognising an amount in the balance sheet will be less onerous than the criteria for recognising amounts in the P&L. In other words, henceforth what is good enough for the balance sheet will not always be good enough for the P&L. In the ASB's view, a more convincing case needs to be made than is currently made in the exposure draft if such a fundamental principle is to be introduced into the accounting literature.

The Board also shares the views expressed by those IASB Board members whose views are summarised in AV1 through AV7 of the exposure draft set out in part 1.

Part 2—Transition and initial recognition of financial assets and financial liabilities

12 The second set of proposals address two related issues concerning the determination of fair value measures on initial recognition and subsequently.

13 The first issue relates to measurement on initial recognition. The previous version of IAS 39 did not contain much guidance on the fair value measurement process. As a result, there was no specific guidance that limited an entity's ability to conclude that the fair value

of a financial instrument at initial recognition was different from its transaction price—even if that fair value was estimated using a valuation technique whose variables included data not derived from observable markets.

14 This was thought to create an opportunity for earnings management through the inappropriate recognition of 'day one' profits (or losses). Therefore, when the IASB revised IAS 39, it expanded the guidance on estimating fair value and, in doing so, made it clear that the transaction price will represent fair value on initial recognition unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets. It follows from this that a 'day one' profit or loss can be recognised only if evidenced in this way. This new guidance was to be applied retrospectively.

15 After the revised standard containing this new guidance was issued, commentators raised two concerns:

(a) In their view, full retrospective application of the guidance would not always be practicable.

(b) Although the IASB had noted in its revised standard that the new guidance would achieve convergence with US requirements, convergence had not in fact been achieved. This is because US entities do not have to apply the approach described in the IASB guidance to transactions occurring on or before 25 October 2002.

16 The IASB is therefore proposing to amend the guidance in its standard to bring it fully into line with the US requirements. Such an amendment would, the IASB believes, address both of the concerns raised.

17 The second issue concerns 'day two' profits. Although

the guidance limits an entity's ability to recognise day one gains and losses, the IASB is equally concerned about the inappropriate recognition of day two gains and losses and has doubts as to whether the guidance in the standard is clear enough on that point. It is therefore proposing to add guidance to make it clear that the principles to be applied on 'day one' should be applied subsequently as well.

18 Whilst the ASB would not have wanted to see the IASB making detailed amendments of this kind to IAS 39 at this stage in the process, it recognises the IASB's desire to control possible earnings management abuses. It understands, however, that, although the US has similar provisions, they are not proving easy to implement in practice.

Part 3—Cash flow hedge accounting of forecast intragroup transactions

19 IAS 39 contains detailed provisions on how and when hedge accounting can be used. Part 3 of this Supplement addresses one aspect of those requirements.

20 One of the principles on which the IASB's hedge accounting provisions are based is that, if hedge accounting is to be used, the hedged risk has to arise from transactions that involve a party external to the reporting entity. In other words, hedge accounting cannot be used to hedge intragroup transactions.

21 Currently it is common practice for entities to designate forecast intragroup transactions as hedged items and commentators have suggested that:

(a) the narrow exception that IAS 39 currently allows to its principle about hedging needing to involve external transactions should be widened to make it possible for forecast intragroup transactions to continue to be designated as hedged items;

(b) the implementation guidance that specifically permitted forecast intragroup transactions to be designated as hedged items, which was withdrawn by the IASB when it issued the December 2003 revisions to IAS 39, should be reinstated; and

(c) the IASB converge its requirements in this area with the US standard, which permits the use of hedge accounting for forecast intragroup transactions.

22 The IASB has decided not to pursue any of these suggestions. Instead, it has noted that, provided an external transaction is designated as the highly probable forecast transaction, forecast intragroup transactions can be used as part of the tracking mechanism (or 'audit trail') for associating the hedging instruments with external transactions. It is also proposing to clarify the application guidance to make it clear that "in its consolidated financial statements a group may designate as the hedged item, in a foreign currency cash flow hedge, a highly probable forecast transaction with a party external to the group provided that the highly probable forecast transaction is denominated in a currency other than the group's presentation currency."

23 The last part of this proposed clarification—the proviso that it is necessary that "the highly probable forecast transaction is denominated in a currency other than the group's presentation currency"—concerns the ASB. In its view, the fundamental principle of IAS 21 is that gains and losses from exposures to foreign currencies arise wherever the group has an exposure in a business unit to a currency that is not that business unit's functional currency; the presentation currency therefore plays no part in determining whether a foreign currency exposure exists and should not, the ASB believes, be a factor in determining whether a hedgeable risk exists.

Part 4—The implications of IFRS 4 for FRED 30

24 When the ASB issued the Second Supplement to FRED 30, it included in the Supplement the latest draft text of the two UK standards being discussed by the Supplement (the proposed UK standards based on IASs 32 and 39). IFRS 4 has amended those IASs 32 and 39 texts. Part 4 sets out those amendments in order to help commentators understand the amendments being proposed in part 5.

Part 5—Financial guarantee contracts and credit insurance

25 Differentiating between those items that should be accounted for under the IASB's financial instruments standards (IASs 32 and 39) and those that should be accounted for under the IASB's insurance contracts standard (IFRS 4 'Insurance contracts') has not proved a straight-forward matter for the IASB to resolve. The most difficult issue seems to have been the treatment of financial guarantee contracts, and the proposals in part 5 relate primarily to the treatment of financial guarantee contracts that meet IFRS 4's definition of an insurance contract.

26 A financial guarantee meets the insurance contract definition if the issuer is required to make payments to reimburse the holder if a specified debtor fails to make payment when due under the terms of a debt instrument. Such contracts are currently within the scope of IAS 39 where they are incurred or retained in transferring to another party financial assets or financial liabilities that are within the scope of IAS 39; all other such contracts are currently within the scope of IFRS 4.

27 The IASB is now proposing that these contracts be included in the scope of IAS 39, and should initially be measured at fair value. It is also proposing that subsequently they would be measured at the higher of

(a) the amount recognised under IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' and (b) the amount initially recognised less cumulative amortisation where appropriate.

28 The exposure draft also clarifies the drafting of the scope exclusion relating to certain loan commitments, and transfers to the measurement section the measurement requirements for loan commitments that are currently in the scope section of the standard.

Part 6—Material from IFRS 4 to be incorporated in UK standards

29 As already mentioned, if the borders for the UK's proposed standards on financial instruments are to be in the same place as the IASB's borders, some of the definitions and other material in IFRS 4 needs to be incorporated into UK standards. Part 6 of the Supplement discusses which IFRS 4 material is involved—in the main the material relates to definitions and to explanations of those definitions—and how it should be incorporated into UK standards—the proposal is that it should included in a special ASB appendix added to the UK standards based on IASs 32 and 39.

Invitation to Comment

30 The ASB is issuing this Supplement to request comments on the IASB's proposals and on the ASB's proposals for implementing them, via the draft standards set out in FRED 30 and its first two supplements, in the UK. The ASB is not seeking comments on other aspects of FRED 30's proposals.

31 Each of the IASB's exposure drafts has its own Invitation to Comment, and those are set out in full in parts 1-3 and 5. The ASB would in addition particularly welcome comments on the following issues:

The fair value option

Q1 The ASB is concerned (see paragraph 11 of the Preface) that the effect of the IASB's proposals on the fair value option might be to prevent the option from being used in circumstances where its use would be appropriate and would make implementation of IAS 39 easier. Do you believe that will be the case? If so, please give examples of the types of circumstances involved.

Q2 The ASB is proposing, in implementing the IASB's proposals on the fair value option, to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2005 with earlier adoption permitted in certain circumstances). Do you agree with this proposal? If not, why not?

Transition and initial recognition of financial assets and financial liabilities

Q3 The ASB is proposing, in implementing the IASB's proposals on the transition and initial recognition of financial assets and financial liabilities, to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2005 with earlier adoption permitted). Do you agree with this proposal? If not, why not?

Q4 The ASB has concluded that it is not necessary to incorporate the IASB's proposed amendment to IFRS 1 in UK standards. Do you agree with this conclusion? If not, why not?

Cash flow hedge accounting of forecast intragroup transactions

Q5 The ASB has expressed some concerns about the proposals on cash flow hedge accounting of forecast intragroup transactions (see paragraph 23 of this Preface). Do you share those concerns? If not, why not?

Q6 The ASB is proposing, in implementing the IASB's proposals, to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2006 with earlier adoption permitted). Do you agree with this proposal? If not, why not?

The border between financial instruments and insurance contracts

Q7 The ASB is proposing, in implementing the IASB's proposals on financial guarantee contracts and credit insurance, to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2006 with earlier adoption permitted). Do you agree with this proposal? If not, why not?

Q8 Part 6 of the Supplement sets out the material from IFRS 4 that the ASB believes needs to be incorporated into UK standards if the ASB's border between financial instruments and insurance contracts is to be in the same place as the IASB's.

(a) Do you agree that this should be the ASB's objective? If not, why not and what should the objective be?

(b) Do you agree that all the material identified in part 6 needs to be included in UK standards? If not, which material do you believe can be omitted?

(c) Do you believe that there is some other material (either from IFRS 4 or from other international standards) that needs to be incorporated into UK standards to achieve the stated objective?

(d) The ASB's proposal is that the material set out in part 6 will be implemented in the UK in 2005 and the material in part 5 in 2006, with earlier adoption permitted. Do you support this proposal or do you, for example, believe that all the proposals should be implemented at the same time?

32 The IASB has asked for comments on its fair value option by 21 July 2004 and on its other proposals by 8 October 2004. The ASB is also requesting comments on the technical content of the proposals by those dates, although it is happy to receive comments on the proposals for the UK implementation of the IASB's fair value option proposals by 8 October 2004.

PART 1—THE FAIR VALUE OPTION

Contents

Background*

1. In July 2001 the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002 the Board published its proposed improvements as an Exposure Draft and in December 2003 it issued a revised version of the two Standards.†

2. Among the revisions to IAS 39 was the introduction of an option that permits entities to designate irrevocably on initial recognition any financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the 'fair value option'). The reason for introducing this option was to simplify the practical application of IAS 39, as is explained further in paragraphs BC5-BC8 of the Basis for Conclusions on this Exposure Draft.

3. A substantial majority of the respondents to the June 2002 Exposure Draft who commented on the proposed fair value option agreed with it. However, some, including prudential supervisors of banks, securities companies and insurers, expressed concerns that the fair value option might be used inappropriately. The dialogue with these constituents about their concerns continued after the revised version of IAS 39 was issued. In particular, they were concerned that:

   (a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities

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* *ASB footnote:* This background note has been prepared by the IASB and is included in this Supplement in full and unamended, except that some footnotes have been added to provide a UK context for some of the comments made. References in the note to "the Board" are references to the IASB.

† *ASB footnote:* A UK exposure draft based on the IASB's Exposure Draft was published as FRED 30. UK standards based on the revised versions of IASs 32 and 39 that were issued by the IASB in December 2003 have not yet been issued in the UK. Therefore, when considering the implications for UK standards of what is said here, the references to IASs 32 and 39 should be taken to be references to the draft FRS • (IAS 32) and draft FRS • (Part of IAS 39) respectively, which are set out in FRED 30 and its Supplements.

might determine their fair value in a way that inappropriately affects profit or loss.

(b) use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.

(c) if an entity applied the fair value option to financial liabilities, it might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness.

4. The Board decided to propose that the fair value option be amended so as to limit its use while preserving the key benefits of the option (these benefits are noted in paragraphs BC5-BC8 of the Basis for Conclusions on this Exposure Draft). The Board decided to achieve this by:

(a) limiting the types of financial assets and financial liabilities to which the option may be applied (see proposed amendments to paragraph 9), and

(b) requiring that the option may be applied only to financial assets and financial liabilities whose fair value is verifiable (see proposed new paragraph 48B). The proposal that fair value must be verifiable would apply only when the fair value option is used. It is a stricter test than that of 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39.

5. This Exposure Draft sets out the resulting proposed amendments to IAS 39.

Invitation to Comment*

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

The Board is not requesting comments on matters other than those set out in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than 21 July 2004.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Question 2

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it (they) would not be eligible.

(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

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* *ASB footnote:* This is the IASB's Invitation to Comment. References in it to "the Board" are references to the IASB.

Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

Question 6

Do you have any other comments on the proposals?

Proposed Amendments to [draft] FRS • (Part of IAS 39)

In the Introduction to ~~IAS 39~~the Standard, paragraph IN16 is amended (new text is underlined; deleted text is struck through).

IN16. The Standard permits an entity to designate ~~any financial asset or financial liability~~ specified financial assets or financial liabilities, on initial recognition, as ones to be measured at fair value, with changes in fair value recognised in profit or loss. To impose discipline on this categorisation, an entity is precluded from reclassifying financial instruments into or out of this category.

In the Standard, paragraphs 9 and 103 are amended (new text is underlined; deleted text is struck through) and paragraphs 48A, 48B and 103A are added. For ease of reference, paragraph 50 is also included, although no changes are proposed to it.

Definitions of Four Categories of Financial Instruments (paragraph 9)

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

- ***(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:***
  - ***(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;***
  - ***(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profittaking; or***
  - ***(iii) a derivative (except for a derivative that is a designated and effective hedging instrument).***

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. ~~***Any financial asset or financial liability within the scope of this Standard may be designated when initially recognised as a financial asset or financial liability at fair value through profit or loss except for investments in***~~ ***If elected, such designation shall be used only for a financial asset or financial liability that meets one of the following conditions.***

> ***(i) The item is a financial asset or financial liability that contains one or more embedded derivatives as described in paragraph 10, whether or not paragraph 11 requires the embedded derivative(s) to be separated.***
>
> ***(ii) The item is a financial liability whose cash flows are contractually linked to the performance of assets that are measured at fair value. This condition is met only if the contract specifies the assets to whose performance the cash flows on the liability are linked.***
>
> ***(iii) The exposure to changes in the fair value of the financial asset or financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability (or portfolio of financial assets or financial liabilities), including a derivative (or portfolio of derivatives).***
>
> ***(iv) The item is a financial asset other than one that meets the definition of loans and receivables.***
>
> ***(v) The item is one that this or another Standard allows or requires to be designated as at fair value through profit or loss.***

In the case of (ii) and (iii), the designation of a financial asset or financial liability as at fair value through profit or loss requires the identification of the offsetting exposure. In these two cases, if either the financial asset or the financial liability is to be designated as at fair value through profit or loss, the identified related financial liability or financial asset shall also be measured at fair value through profit or loss, either by designation or, when the definition is met, by classification as held for trading.

Because designation as at fair value through profit or loss is at the entity's election,

such designation shall be used only if the fair value of the financial asset or financial liability to be so designated is verifiable (see paragraph 48B). ~~e~~Equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured shall not be designated as at fair value through profit or loss (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81).

Paragraphs 48, 48A, 48B and 49 and Appendix A paragraphs AG69-AG82 contain requirements for determining the fair value of a financial asset or financial liability. For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policies.

Definitions Relating to Recognition and Measurement (also in paragraph 9)

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. ~~*~~

~~* Paragraphs 48, 49 and AG69-AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.~~

Fair Value Measurement Considerations

48A. The best evidence of fair value is published price quotations in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data.

48B. Paragraph 9 requires that a financial asset or financial liability may be designated as at fair value through profit or loss only if its fair value is verifiable. For the purposes of this requirement, the fair value of a financial asset or financial liability is verifiable if and only if the variability in the range of reasonable fair value estimates made in accordance with paragraphs 48, 48A and 49 and Appendix A paragraphs AG69-AG82 is low. This requirement is met if, for example, the fair value estimate is based on:

(a) observable current market transactions in the same instrument (ie without modification or repackaging);

(b) a valuation technique whose variables include primarily observable market data and that is calibrated periodically to observable current market transactions in the same instrument (ie without modification or repackaging) or to other observable current market data; or

(c) a valuation technique that is commonly used by market participants to price the instrument and has been demonstrated to provide realistic estimates of prices obtained in actual market transactions.

Reclassifications

50. An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.

Effective Date and Transition

103A. An entity shall apply the [draft] amendments in paragraphs 9, 48A and 48B for ~~annual~~accounting* periods beginning on or after 1 January 2005. An entity that applies this Standard to earlier periods as permitted by paragraph 103

* *ASB footnote:* ASB amendment.

may change which financial assets and financial liabilities are designated as at fair value through profit or loss from the beginning of the first period for which it applies the [draft] amendments in paragraphs 9, 48A and 48B. In the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

> ***(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.***
>
> ***(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.***

In the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements. The entity shall also disclose:

> ***(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.***
>
> ***(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.***

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

ASB note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. It should be noted though that some of the discussion it contains concerns IASB requirements that have no equivalent in the UK or Republic of Ireland. Footnotes have been used to highlight those parts of the discussion.

All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Background

BC1. In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*.* The objectives of the Improvements project were to reduce the complexity in the Standards by clarifying and adding guidance, eliminating internal inconsistencies and incorporating into the Standards elements of Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance. In June 2002 the Board published its proposals in an Exposure Draft of Proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*.

BC2. Among the proposals in the June 2002 Exposure Draft was a proposal to permit entities to designate irrevocably on initial recognition any financial

* *ASB footnote:* Currently, there are no equivalent UK standards to IASs 32 and 39, although the issues that some parts of those standards address are also addressed in UK standards. However, in June 2002 when the IASB published its proposals to amend IASs 32 and 39, the ASB proposed that UK standards based on those international standards should be issued. Since then, the IASB has issued final standards based on those proposals and a subsequent amendment to the revised IAS 39; the ASB has not yet though finalised the UK standards based on those international standards.

asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the 'fair value option'). The Board proposed the fair value option in order to simplify the application of IAS 39, as explained further in paragraphs BC5-BC8, for example by helping entities to avoid some of the anomalies that can arise in IAS 39's 'mixed measurement model' (in which some financial instruments are measured at fair value and others at cost). The proposed fair value option was exactly that—an option—and did not require entities to measure more financial instruments at fair value.

BC3. Of the respondents to the June 2002 Exposure Draft who commented on the fair value option, a substantial majority agreed with it. This included a majority of each type of respondent except for banking, securities and insurance regulators. However, respondents made a number of comments on the proposed fair value option that the Board considered when finalising the Exposure Draft's proposals. These comments and the Board's conclusions on them are discussed in the Basis for Conclusions on IAS 39, paragraphs BC79-BC94.

BC4. After considering these comments, the Board decided to retain the fair value option in the revised IAS 39, but to require an additional disclosure when the option is used for a financial liability. (This disclosure is of the amount of the change in the fair value of the financial liability that is not attributable to changes in a benchmark interest rate.)

Reasons why the Board introduced the fair value option

BC5. As noted above, the Board introduced the fair value option to simplify the practical application of IAS 39, in particular in those situations in which, without the option, IAS 39's mixed measurement model could result in an entity reporting volatility on positions that are economically matched.

BC6. More specifically, the Board had in mind three situations in which the option might be used:

(a) Financial instruments that contain embedded derivatives. IAS 39 requires embedded derivatives that are not closely related to their 'host' contract to be separated and measured at fair value. Such separation and measurement can be both difficult and subjective, and valuation of the entire instrument may be both easier and less prone to measurement error. In this case the fair value option can be used to measure the entire instrument, rather than separately measuring the embedded derivative, and without having to demonstrate that the embedded derivative cannot be reliably measured.

(b) When IAS 39 requires financial assets to be measured at fair value, but liabilities that are contractually related to them to be measured at amortised cost. An example is 'unit-linked' liabilities issued by insurers (in which the amount paid on the liability directly reflects the performance of a pool of specified assets). In this case, use of the option avoids reporting the volatility that would arise if the assets were measured at fair value but the offsetting liabilities were at amortised cost.

(c) Other 'natural offsets', ie when the entity's exposure to the change in the fair value of a financial asset is offset by its exposure to the change in the fair value of a financial liability (or vice versa). These are of two types:

   (i) 'Natural offsets'—in particular those in which one of the items is a derivative—that could qualify for fair value hedge accounting in accordance with IAS 39. However, to obtain hedge accounting, the entity would have to meet various conditions, including detailed designation and documentation of the hedging relationship, and tracking the hedge to show that it is highly effective. This can require significant time, effort and systems, and therefore considerable expense. Because a similar accounting effect can be obtained by measuring both the hedged item and the hedging instrument at fair value through profit or loss, the fair value option can be used as an alternative to hedge accounting. It achieves a similar accounting result whilst avoiding the designation, tracking and assessing of hedge effectiveness that hedge accounting entails.

   (ii) 'Natural offsets' that do not qualify for fair value hedge accounting because of IAS 39's restrictive conditions. Like US GAAP, IAS 39 permits hedge accounting to be used only when the hedge is undertaken using a *derivative*.[*] Accordingly, this category includes nonderivative financial assets that naturally offset—or 'hedge'—non-derivative financial liabilities. It also includes hedges that provide some protection against fair value exposure, but not enough to qualify for hedge accounting given IAS 39's stringent hedge effectiveness tests. Lastly, this category includes liabilities that fund, and whose risks match, assets that are classified as held for trading—for example, liabilities that fund the activities of a broker/dealer. In all of these cases, entities can use the fair value option to avoid reporting the volatility that arises if the asset is measured at fair value (eg because it is not a loan or receivable and the entity does not have the positive intention and ability to hold it to maturity) but the related liability is measured at amortised cost. Furthermore, to the extent the asset and liability do not perfectly offset one another (ie the hedge is ineffective), their fair values will differ, resulting in a gain or loss.

BC7. There are two other situations in which IFRSs permit use of the fair value option. These are:

(a) Loan commitments, other than those that can be settled net in cash or another financial instrument. Such loan commitments meet the definitions of both a financial instrument and a derivative. However, the Board excluded them from the scope of IAS 39 (and thereby from IAS 39's requirement to measure derivative financial instruments at fair value through profit or loss) to simplify the accounting treatment for both the holder and the issuer. Nevertheless, the Board was informed of cases when entities would want to measure such loan commitments at fair value through profit or loss, for example when they manage the risk exposures related to them on a fair value basis or hedge those exposures with credit derivatives (that are within the scope of IAS 39). Accordingly, the Board permitted entities to apply IAS 39 to such loan commitments provided they applied the fair value option to them.

(b) Investments in associates and joint ventures held by venture capital organisations or mutual funds, unit trusts and similar entities. IAS 28

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[*] other than in a hedge of currency risk

Investments in Associates and IAS 31 *Interests in Joint Ventures* allow such investments to be excluded from their scope provided the fair value option is used (or they meet the IAS 39 definition of held for trading).* The Board's reasons for this decision were that measuring such investments at fair value through profit or loss would produce more relevant information than using equity accounting, and that fair value information is often readily available because fair value measurement is a well-established practice in these industries.

BC8. Some have questioned why the Board introduced the fair value option despite there not being an equivalent option in US GAAP. Two main points are worthy of note:

(a) Derivatives markets in the United States are significantly more developed than in other parts of the world. As a result, US entities are more able to hedge risk positions with derivatives. Conversely, entities located outside the US are more likely to offset risk positions using non-derivatives. Because IAS 39 permits hedge accounting only for hedges carried out with derivatives,† without the fair value option, such entities may be forced to buy derivatives to achieve hedge accounting. The only available derivatives may be those traded in US markets, which may be a poorer economic hedge of the underlying risk positions than a hedge using a non-derivative, eg because of differences between domestic and US interest rates. In addition, derivatives traded in US markets are commonly denominated in US dollars, with the result that entities located outside the US will also need to hedge the exchange rate risk with an additional derivative, thereby incurring additional transaction costs.

(b) IAS 39 contains a tighter definition of held for trading than US GAAP, with the result that fewer financial assets and financial liabilities can be measured at fair value through profit or loss by being classified as held for trading.

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* *ASB footnote:* Paragraph 9 of FRS 9 *Associates and Joint Ventures* requires investment funds, such as those in the venture capital and investment trust industry, to include all investments that are held as part of their investment portfolio either all at cost or all at market value, even if they are investments over which the investor has significant influence or joint control.

† other than in a hedge of currency risk

The rationale for the proposed amendments

BC9. As a result of continuing discussions with some constituents on the fair value option, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. In particular these constituents were concerned that:

(a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.

(b) use of the option might increase, rather than decrease volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.

(c) if an entity applied the fair value option to financial liabilities, it might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness.

BC10. The Board decided to propose that the fair value option be amended so as to limit its use whilst preserving the key benefits of the option noted above. The Board proposes to do this by explicitly limiting the option to the three situations outlined in paragraph BC6 and by the proposals described in the next four paragraphs.

BC11. The Board decided to meet the concern set out in paragraph BC9(a) in two ways:

(a) The Board decided to emphasise that the fair value option can be used only for items whose fair value is verifiable and to give guidance on this (see paragraph 48B). The Board notes that the proposed requirement that fair value must be verifiable would apply only for the fair value option and not to financial assets or financial liabilities (including derivatives) that are classified as held for trading, or to available-for-sale financial assets. Also, 'verifiable' is a stricter test than that of 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39.

(b) The Board decided to note that, for entities subject to prudential supervision, such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of the requirements in IAS 39 on how to determine fair value and of relevant risk management systems and policies. The aim of making this statement is to alert entities subject to prudential supervision to the possibility that their supervisor may be concerned to ensure that they do not use inappropriate estimates of fair value. The statement merely notes powers that supervisors may already have and does not confer any additional powers on them. In particular, it does not give supervisors the power to amend or overrule the requirements of IAS 39.

BC12. To meet the concern set out in paragraph BC9(b), the Board decided to propose that if an entity measures one side of a matched position at fair value by using the fair value option, it must also measure the other side at fair value through profit or loss. This is to ensure that all of a matched position is recognised in the same way and that the option, in this case, is used to overcome rather than to exacerbate the limitations of a mixed measurement model.

BC13. Regarding the concern described in paragraph BC9(c), the Board decided when finalising the improvements to IAS 39 that the fair value of a financial liability is affected by the credit risk of that liability. The reasons for this decision are set out in paragraphs BC87-BC92 of the Basis for Conclusions on IAS 39. As noted in paragraph BC4 above, the Board also responded to this concern when finalising the improvements to IAS 39 by requiring an additional disclosure to be provided when the option is used for a financial liability. (This disclosure is of the amount of the change in the fair value of the financial liability that is not attributable to changes in a benchmark interest rate.)

BC14. In addition, the proposals to restrict the application of the fair value option to (a) the three situations described in paragraph BC6 and (b) items whose fair value is verifiable would further meet this concern whilst preserving the key benefits of the option. This is because these proposals would restrict the financial liabilities to which the option may be applied.

BC15. The Board also noted two other cases, in addition to those set out in paragraph BC6 in which entities may want to use the fair value option:

(a) Entities such as investment trusts and venture capital entities for which established industry practice in some jurisdictions is to measure all financial assets at fair value through profit or loss.

(b) Entities that hold financial assets whose fair value exposure offsets to some extent the fair value exposure of *non*-financial liabilities. An example is financial assets held by insurers whose fair value exposure offsets that of insurance liabilities that are measured using techniques that incorporate some market-consistent data but are not measured at fair value.

The Board noted that such entities may want to use the fair value option to measure the financial assets at fair value with changes in their fair value recognised in profit or loss. To preserve such uses of the option, the Board decided to propose that the option may be used for financial assets other than those that meet IAS 39's definition of loans and receivables.

BC16. The Board considered the following two ways to implement this decision (ie to permit use of the option for financial assets other than loans or receivables):

(a) to allow the fair value option to be applied, by designation on initial recognition, to any financial asset other than a loan or receivable, on an *asset-by-asset* basis.

(b) to restore the permission in the original IAS 39 for an entity to elect, as an accounting policy choice, to recognise gains and losses on *all* available-for-sale assets in profit or loss, but to require that loans and receivables cannot be classified as available for sale.

BC17. The Board noted that some entities may not want to recognise in profit or loss gains and losses on *all* available-for-sale assets other than loans and receivables. For example:

(a) a bank-assurance company may want to apply the option to assets held to back insurance liabilities, but not to available-for-sale assets held in its banking business.

(b) a bank with a venture capital subsidiary may want to apply the option to the assets held by the venture capital subsidiary, but not to available-for-sale assets held in its banking business.

(c) an insurer may want to apply the option to assets that fund insurance liabilities (such as with-profits contracts) on which the chosen accounting model recognises changes in profit or loss, but not to assets that fund insurance liabilities (such as non-participating fixed annuity contracts) that are often measured using a cost model.

BC18. Accordingly, the Board decided to propose the first approach in paragraph BC16, namely to allow the fair value option to be applied, by irrevocable designation on initial recognition, to any financial asset other than a loan or receivable, on an asset-by-asset basis. The Board noted that this proposal would continue to allow entities to account differently for different holdings of the same type of asset (ie to account for some using the fair value option and others not).

BC19. Lastly, the Board decided to clarify that the fair value option could continue to be used in cases when IAS 39 or another Standard explicitly permits or requires its use. Two examples of this are described in paragraph BC7.

Other matters considered by the Board

The proposed category for financial assets and financial liabilities containing embedded derivatives

BC20. In developing the proposals in this Exposure Draft, the Board considered whether the first proposed category for which the fair value option may be used (financial instruments containing embedded derivatives) should apply only when IAS 39 requires the embedded derivative(s) to be separated or whether it should apply to all instruments containing embedded derivatives, regardless of whether IAS 39 requires the derivative(s) to be separated.

BC21. The Board decided to propose that this first category should be for all financial assets and financial liabilities that contain embedded derivatives, regardless of whether IAS 39 requires the derivative(s) to be separated for the following reasons:

(a) Informal discussions with constituents have indicated that one of the most common uses of the option is likely to be for structured products that contain embedded derivatives. IAS 39 requires some such embedded derivatives to be separated, whereas it requires other embedded derivatives not to be separated. It may take time and effort to identify all of the derivatives embedded in a structured product and to determine whether they have to be separated. Furthermore, the structured product will typically be hedged with derivatives that offset all (or nearly all) of the risks contained in it, regardless of whether the embedded derivatives that give rise to those risks are separated. Hence, the simplest way to account for such products is to apply the fair value option so that the entire product (and the derivatives that hedge it) is measured at fair value through profit or loss.

(b) Some investment contracts issued by insurers contain embedded derivatives, but these may be of a type that IAS 39 requires not to be separated. In some jurisdictions, insurers want to measure both investment contracts and related assets at fair value through profit or loss. This may enable some insurers to eliminate the mismatch in measurement attributes between the investment contract liabilities and the related assets (the latter being mainly measured at fair value).

BC22. However, the Board noted that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal. It decided to ask respondents for their views on this matter and, in particular, on whether the proposal described in the previous paragraph would allow the fair value option to be used too broadly.

The proposal that the fair value option may be used only for items whose fair value is verifiable

BC23. The Board acknowledged the concern of some prudential supervisors that if the fair value option were to be used for items whose fair value is subjective, entities may determine fair value in a way that inappropriately affects profit or loss.

BC24. The Board discussed whether it should propose that the fair value option may be used only for items whose fair value is 'reliably measurable'.

However, it decided not to make such a proposal for the following reasons:*

(a) The *Framework*† uses the term 'reliability' to mean that information "is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could be reasonably expected to represent." In the *Framework*, reliability includes notions of faithful representation, substance over form, prudence and completeness. In the context of the fair value option, the Board wanted to convey a narrower meaning, namely that the variability in the range of reasonable fair value estimates made in accordance with IAS 39 is low. Hence, to use the term 'reliably measurable' could have been misleading.

(b) IAS 39‡ specifies that only unquoted equity instruments and derivatives that are linked to and must be settled in such unquoted equity instruments can fail to be measured at fair value on the grounds that fair value is not 'reliably measurable'. IAS 32 paragraph 90 contains the same very limited exemption from the disclosure of fair value. The Board decided that a wider range of instruments could fail to qualify for the fair value option.

(c) Because the *Framework*§ uses the test of "can be measured with reliability" as a general recognition test for all items, the Board decided to use another term to avoid any implication that items covered by other Standards (eg share options) need not be measured at fair value if they do not meet the test proposed for the fair value option.

BC25. For these reasons, the Board decided to propose that the term 'verifiable' be used and that this be explained as meaning that the variability in the range of reasonable fair value estimates made in accordance with IAS 39 is low. Put another way, if several independent and knowledgeable observers were asked to estimate the fair value of a particular instrument in

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* *ASB footnote:* The subparagraphs that follow refer to the '*Framework'*, which is an IASB document. Its UK equivalent is the ASB's *Statement of Principles for Financial Reporting*. It describes 'reliability' in similar terms to the *Framework*.

† paragraph 31

‡ paragraphs 46(c) and 47(a)

§ paragraph 83(b)

accordance with IAS 39, they would all arrive at approximately the same amount. The Board noted that this term is used with a similar meaning in the conceptual frameworks of other standard-setters.* The Board also noted that the proposed test of 'verifiable' is a stricter test than that of 'reliably measured' contained in paragraphs 46(c) and 47(a) of IAS 39. Accordingly, if this proposal is adopted, fewer items will qualify for the fair value option than are measured at fair value if classified as held for trading or available for sale in accordance with IAS 39's requirements.

BC26. The Board also decided to add examples of when fair value is verifiable. Whilst these examples are not exhaustive, the Board decided that their inclusion would help entities to interpret the term 'verifiable'.

Effective Date and Transition

BC27. This Exposure Draft proposes to amend the revised IAS 39 that was issued in December 2003 and is effective for financial years beginning on or after 1 January 2005, with earlier application permitted.

BC28. When considering what the proposed effective date should be for the amendments proposed in this Exposure Draft, the Board noted the following points:

(a) Anecdotal evidence suggests that most first-time adopters of IFRSs (which is the largest group of entities applying the revised IAS 39) will not apply IAS 39 early (ie they will apply it only for financial years beginning on or after 1 January 2005) and will use the exemption in IFRS 1 *First-time Adoption of International Financial Reporting Standards* from applying IAS 39 to comparative amounts in the first year of adoption. The Board expects that the amendments proposed in this Exposure Draft will be finalised in late 2004.† Accordingly,

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* For example, the Concepts Statements issued by the US standard-setter, the Financial Accounting Standards Board, define verifiability as "The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias."

† *ASB footnote:* The ASB's current intention is to issue a UK standard incorporating these amendments in late 2004. The Second Supplement to FRED 30 proposes that the IFRS 1 exemption mentioned should be incorporated into UK standards.

these entities will have time to plan for the amended version of the option before they apply IAS 39.

(b) For entities that are planning to adopt early the revised IAS 39 for an accounting period ending in late 2004, the amendments proposed in this Exposure Draft are likely to be finalised very close to the time when the financial statements to which IAS 39 is first applied are published and may be finalised after interim financial statements for those periods have been published.

(c) Those few entities that choose to adopt early the revised IAS 39 for an accounting period ending before mid-2004 might have applied the existing version of the fair value option before the proposals in this Exposure Draft are finalised.

BC29. In the light of these points, the Board decided that the amendments proposed in this Exposure Draft should apply for financial periods beginning on or after 1 January 2005. The Board decided that this proposal strikes an appropriate balance between giving entities sufficient time to prepare for the amendments and ensuring that as many entities as possible do not adopt the current version of the option and then change shortly afterwards.

BC30. The Board also considered whether those entities that had adopted the existing version of the fair value option should have the opportunity to change the financial assets and financial liabilities to which the option is applied when they adopt the amendments proposed in this Exposure Draft. For example, should an entity that had applied the existing version of the option to a financial liability that does not qualify for the amended option be given the opportunity to cease applying the option to any related financial assets? As another example, should an entity that had applied the existing version of the option to only one side of a substantially offsetting position be given the opportunity to apply the amended option to all of the position? The Board decided that because entities may want to apply the fair value option to related assets and liabilities, entities that had adopted the existing version of the fair value option should have the opportunity to change the financial assets and financial liabilities to which the option is applied when they adopt the amendments proposed in this Exposure Draft.

BC31. Under this proposal the issue arises of whether any change in the measurement basis of a financial asset or financial liability should be applied retrospectively, so that assets and liabilities would be measured in the comparative financial statements on the same basis as in the current year financial statements. The Board noted the following arguments in favour of retrospective application:

(a) the Board's general approach is to require retrospective application unless impracticable, because retrospective application provides the most comparable information to users of financial statements, and

(b) the revised version of IAS 39 issued in December 2003 requires retrospective application when an entity adopts the existing version of the fair value option.

BC32. However, the Board noted that the following arguments against retrospective application, in particular for assets and liabilities to which the existing version of the option has been applied but to which the amended version of the option is not applied:

(a) entities may have used the existing version of the option as a simplification to fair value hedge accounting. Had the option not been available, such entities might, instead, have gone to the effort of meeting the hedge accounting requirements. Hedge accounting cannot be applied retrospectively because of the need to designate the hedge at inception.

(b) requiring comparative amounts to be restated would permit entities to decide, with the benefit of hindsight, whether to cease designating an item as one to which the option is applied, so as to achieve a desired effect on profit or loss.

BC33. Bearing in mind the points in the previous two paragraphs, the Board decided to propose that:

(a) when the amended version of the option *is* applied to a financial asset or financial liability that was *not* previously designated as at fair value through profit or loss, the change should be applied retrospectively (ie the comparative financial statements should be restated).

(b) if the amended version of the option is *not* to be applied to a financial asset or financial liability that *was* previously designated as at fair value through profit or loss, the change should be applied only to subsequent accounting periods (ie the comparative financial statements should not be restated).

BC34. The Board also decided to ask respondents for their views on this proposal and, in particular, whether all changes to the measurement basis of a financial asset or financial liability that result from adopting the amended version of the option should be applied retrospectively by restating the comparative financial statements.

Alternative Views

ASB note: The Alternative Views material that the IASB prepared to accompany its exposure draft is set out below in full. All references in the material to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

AV1. Three Board members voted against the publication of the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement—The Fair Value Option*. Their alternative views are set out below.

AV2. First, these Board members note that the concerns expressed by prudential supervisors (see paragraph BC9 of the Basis for Conclusions on this Exposure Draft) were considered by the Board when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion.

AV3. These Board members also note that the amendments are likely to have little effect on what instruments the option is applied to in practice. They understand that there are very few transactions to which entities could have applied the fair value option set out in the December 2003 version of IAS 39 that would not also qualify under the proposed amendments set out in this Exposure Draft. They believe that the Exposure Draft introduces a series of complex rules, with consequential costs to preparers of financial statements, in order to obtain substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39.

AV4. These Board members also note that one of the proposals in the Exposure Draft is to prohibit the fair value option being applied to items whose fair value is not verifiable. They believe that this gives rise to an undesirable dual standard, by adding a second tier threshold for fair value measurement, since IAS 39 requires available-for-sale assets and items that are held for trading to be measured at fair value without a verifiability test.

AV5. The Exposure Draft also proposes to prohibit the fair value option being applied to loans, receivables and financial liabilities, unless they qualify under one of the first three categories proposed in paragraph 9(b). These Board members note that the proposed requirements for category (iii) are very restrictive on initial recognition because they would require the identification of an existing substantially offsetting exposure to changes in fair value between the designated financial instruments similar to that required for hedge accounting. In addition, subsequently the proposed requirements fail to meet their stated objective of decreasing volatility in profit or loss because the fair value designation would be required to be continued even after one of the offsetting instruments has been derecognised. They note that category (ii) also requires that the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions still hold.

AV6. The proposals to revise the fair value option will have another important consequence, namely to delay the finalisation of IAS 39. These Board members believe that such a delay is unhelpful to preparers and users of financial statements. In particular, the proposals will not be finalised until late 2004, which is very close to when entities that are required to apply IFRSs from 2005 will have to adopt them. Moreover, entities that are already using IAS 39 will currently be preparing to implement, or have already implemented, the fair value option that was included in the December 2003 version of IAS 39.

AV7. Lastly, two of the three Board members believe that financial reporting standards should deal only with the requirements of financial reporting and should not describe or endorse the powers of prudential supervisors or other regulators. They note that the IASB has no authority to endorse the powers of other regulators and any reference to such powers (such as is made in the Exposure Draft) may create a false impression that it does have such authority, even though the Board clearly states in paragraph BC11(b) of the Basis for Conclusions on this Exposure Draft that it does not give supervisors the power to amend or overrule the requirements of IAS 39.

PART 2—TRANSITION AND INITIAL RECOGNITION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Contents

Background*

1. In July 2001, the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002 the Board published its proposed improvements as an Exposure Draft and in December 2003 it issued a revised version of the two Standards.†

2. Among the revisions to IAS 39 was expanded guidance on how to measure the fair value of financial instruments. The Board decided to include such guidance to help achieve reliable and comparable estimates when financial instruments are measured at fair value.

3. Specifically, the Board decided to include guidance on when an entity can recognise gains or losses on initial recognition of financial instruments. In the revised version of IAS 39, paragraph AG76 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets. It follows that a 'day 1' gain or loss can be recognised only if evidenced in this way. When developing this requirement, the Board noted that it converged with US GAAP.

* *ASB footnote:* This introductory note has been prepared by the IASB and is included in this Supplement in full and unamended, except that some footnotes have been added to provide a UK context for some of the comments made. References in the note to "the Board" are references to the IASB.

† *ASB footnote:* A UK exposure draft based on the IASB's Exposure Draft was published as FRED 30. UK standards based on the revised versions of IASs 32 and 39 that were issued by the IASB in December 2003 have not yet been issued in the UK. Therefore, when considering the implications for UK standards of what is said here, the references to IASs 32 and 39 should be taken to be references to the draft FRS • (IAS 32) and draft FRS • (Part of IAS 39) respectively, which are set out in FRED 30 and its Supplements.

4. The transition provisions in the revised IAS 39 and IFRS 1 *First-time Adoption of International Financial Reporting Standards* require retrospective application of the guidance described in paragraph 3.*

5. Respondents to the June 2002 Exposure Draft who commented on the proposed transition provisions did not raise any specific concern about the retrospective application of the fair value measurement guidance in IAS 39. However, after the revised IAS 39 was issued, constituents raised the following concerns:

   (a) retrospective application of the 'day 1' gain or loss recognition requirements will be difficult and expensive, and may require subjective assumptions about what was observable and what was not. For example, because the average contractual term of the investments could be as long as ten years, it may be difficult to identify all transactions on which 'day 1' profit has been recognised.

   (b) retrospective application diverges from the requirements of US GAAP. Very similar requirements in US GAAP are applicable only to transactions entered into after 25 October 2002.

6. The Board is committed to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many entities will adopt IFRSs for the first time. However, because the issue concerns transition and because retrospective application of the requirements in paragraph AG76 can be difficult and give rise to reconciling differences with US GAAP for a number of years, the Board decided, as a special case, to propose an amendment to the transition requirements in the revised IAS 39. This amendment would apply when entities first adopt that Standard. It would allow, but not require, entities to adopt an approach to transition that is easier to implement than that in the revised IAS 39 and also enable entities to eliminate any reconciling differences with US GAAP. More specifically, it decided to give entities a choice of applying the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76 either:

   (a) prospectively to transactions entered into after 25 October 2002, or

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* *ASB footnote:* There is no UK standard equivalent to IFRS 1.

(b) retrospectively as required by paragraph 104 of IAS 39.

7. The Board also noted that confusion had arisen over how any gain or loss not recognised on 'day 1' should be recognised subsequently. In particular, some suggested that the entire gain or loss might be recognised on 'day 2'. The Board decided to clarify that:

(a) the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements in IAS 39; and

(b) accordingly, a gain or loss should be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

8. The Board also decided not to provide any additional guidance on fair value measurement at this time.

Invitation to Comment*

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Question 2

Do the proposals contained in this Exposure Draft appropriately address the concerns set out in paragraph 5 of the Background on this Exposure Draft? If not, why not and how would you address those concerns?

Question 3

Do you have any other comments on the proposals?

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* *ASB footnote:* This is the IASB's Invitation to Comment. References in it to "the Board" are references to the IASB.

Proposed Amendments to [draft] FRS • (Part of IAS 39)

In the Standard, [draft] paragraphs 107A and 109 are added. For ease of reference, paragraphs 103 and 104 are reproduced below, although no changes are proposed to them.

Effective Date and Transition*

103. ***An entity shall apply this Standard for ~~annual~~ accounting periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for ~~annual~~ accounting periods beginning before 1 January 2005 unless it also applies [draft] FRS • (IAS 32) ~~(issued December 2003)~~. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.***

104. ***This Standard shall be applied retrospectively except as specified in paragraphs 105-108. The opening balance of retained earnings for the earliest prior period presented and all other comparative amounts shall be adjusted as if this Standard had always been in use unless restating the information would be impracticable. If restatement is impracticable, the entity shall disclose that fact and indicate the extent to which the information was restated.***

107A. ***Notwithstanding paragraph 104, an entity may apply the requirements in the last sentence of paragraph AG76 prospectively to transactions entered into after 25 October 2002.***

109. ***An entity shall apply [draft] paragraph AG76A for ~~annual~~ accounting periods beginning on or after 1 January 2005. Earlier application is permitted.***

In the Application Guidance in Appendix A [draft] paragraph AG76A is added. For ease of reference, paragraph AG76 is reproduced below, although no change is proposed to it.

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* *ASB footnote:* The highlighted amendments made to paragraphs 103, 104 and 109 are amendments that the ASB is proposing to make, and were first proposed in the Second Supplement to FRED 30.

Appendix A
Application Guidance

Measurement (paragraphs 43-70)

No Active Market: Valuation Technique

AG76. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

AG76A. The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. Accordingly, a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

~~Proposed Consequential Amendments to IFRS 1~~*

~~In the Standard, paragraph 13 is amended (new text is underlined) and [draft] paragraph 25E is added.~~

~~13 An entity may elect to use one or more of the following exemptions:~~

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* *ASB footnote:* IFRS 1 has no UK equivalent.

~~(a)~~ ~~....~~

~~(j)~~ ~~fair value measurement of financial assets or financial liabilities at initial recognition (paragraph 25E).~~

~~...~~

~~Fair value measurement of financial assets or financial liabilities~~

~~25E~~ ~~A first-time adopter may have measured financial assets or financial liabilities at fair value in accordance with previous GAAP. If it determined fair value at initial recognition on a basis that does not comply with the last sentence of paragraph AG76 of IAS 39, it may elect not to apply that sentence to transactions entered into before 25 October 2002.~~

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

ASB note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. It should be noted though that some of the discussion it contains concerns IASB requirements that have no equivalent in the UK or Republic of Ireland. Footnotes have been used to highlight those parts of the discussion.

All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Background

BC1. The revised IAS 39[*] paragraph AG76 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets. It follows that a 'day 1' gain or loss can be recognised only if evidenced in this way. When developing this requirement, the Board noted that it converges with US GAAP.

BC2. IAS 39 and IFRS 1 *First-time Adoption of International Financial Reporting Standards*[†] in most cases require retrospective application so that assets and liabilities are measured in the comparative financial statements on the same basis as in the current year financial statements. The Board's view is that retrospective application provides the most comparable information to users of financial statements. In particular, IAS 39 and IFRS 1 require retrospective application of the fair value measurement guidance in IAS 39 paragraph AG76.

[*] *ASB footnote:* The ASB has proposed issuing a UK standard based on the measurement and hedge accounting requirements of the revised IAS 39, but has not yet done so.
[†] *ASB footnote:* There is no equivalent standard in the UK to IFRS 1.

The rationale for the proposed amendments

BC3. Respondents to the June 2002 Exposure Draft who commented on the transition provisions did not raise any specific concern on the retrospective application of the fair value measurement guidance in IAS 39. However, after the revised IAS 39 was issued constituents raised the following concerns:

(a) retrospective application of the 'day 1' gain or loss recognition requirements may be difficult and expensive, and may require subjective assumptions about what was observable and what was not. For example, because the average contractual term of the investments could be as long as ten years, it may be difficult to identify all transactions on which 'day 1' profit has been recognised.

(b) retrospective application diverges from US GAAP. Very similar requirements in US GAAP are applicable only to transactions occurring after 25 October 2002.

BC4. The Board considered the following ways to address these concerns:

(a) deem retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 to be impracticable.

(b) extend the transition exception for derecognition transactions in IAS 39 to the recognition of 'day 1' gains or losses.

(c) permit prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 to transactions entered into after 25 October 2002.

Deem retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 to be impracticable

BC5. The Board considered whether retrospective application could be deemed to be impracticable. IAS 39 exempts retrospective application if such application is impracticable.

BC6. The Board noted that IAS 8 *Accounting Policies, Changes in Accounting*

Estimates and Errors defines and explains what is impracticable.* In particular:

(a) paragraphs 52 and 53 state that retrospective application is impracticable if such an application would require the use of hindsight. In the case of 'day 1' gain or loss recognition, hindsight is not required. Entities would not need to re-estimate the fair value of financial instruments. Rather they would recognise them at the transaction price.

(b) paragraph 5 states that retrospective application is impracticable "if the effects of retrospective application ... are not determinable". The Board concluded that whether this test is met is a subjective issue that depends upon entity-specific circumstances (eg what data an entity has) and, hence, will vary from one entity to another. Also, the Board was informed that many of the entities most affected by this issue are large investment banks for whom this test would probably not be met.

BC7. Furthermore, the Board concluded that this approach would provide relief only to existing users of IFRSs. It would not ease the implementation burden for first-time adopters, who cannot claim such an exemption (IFRS 1 does not contain an impracticability exemption). This could lead to incomparability between existing users of IFRSs and first-time adopters.

BC8. Accordingly, the Board decided not to propose this approach.

Extend the transition exception for derecognition transactions in IAS 39 to those involving recognition of 'day 1' gains or losses

BC9. The second approach the Board considered was to extend the transition exception for derecognition transactions in IAS 39 to those involving recognition of 'day 1' gains or losses. Under this exception entities would apply the 'day 1' gain or loss recognition requirements in paragraph AG76 prospectively to transactions occurring after 1 January 2004 or an earlier date of the entity's choosing, provided that the information needed to

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* *ASB footnote:* UK standards do not contain material equivalent to that described in (a) and (b) of this paragraph.

apply the 'day 1' gain or loss recognition requirements in paragraph AG76 was obtained at the time of initial recognition of the transaction. However, the Board noted that this could result in lack of comparability between entities because different entities could choose different dates from which to apply the guidance in paragraph AG76.

BC10. Therefore the Board decided not to propose this approach.

Permit prospective application of the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76 to transactions entered into after 25 October 2002

BC11. Lastly, the Board considered whether to permit prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 to transactions entered into after 25 October 2002. This would enable entities to eliminate any difference with US GAAP, because EITF 02-03 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* requires prospective application from 25 October 2002.

BC12. The Board noted that one of its reasons, as stated in the Basis for Conclusions on IAS 39, for its decision on the recognition of 'day 1' gains or losses was to converge with US GAAP. It achieved such convergence on measurement, but not on transition. The Board observed that as a general principle it requires retrospective application because this provides the most comparable information to users of financial statements. However, it acknowledged that the choice between retrospective and prospective application is influenced by practicality considerations and, in this case, by the desire to converge with US GAAP. Hence, to enable entities to converge completely with US GAAP, the Board decided to permit prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 for transactions entered into after 25 October 2002.

BC13. The Board also noted that this approach would be less onerous than full retrospective application. Entities that reconcile their results to US GAAP could comply with this requirement because they would have the relevant data. For entities that do not reconcile to US GAAP, collecting the necessary information for the eighteen months prior to 1 January 2004 will be less onerous than full retrospective application.

BC14. The Board acknowledged that the amendments proposed in this Exposure Draft are likely to be finalised very close to the time when the financial statements to which IAS 39 is first applied are published, and may be finalised after interim financial statements for those periods have been published. As a result, some entities might already have compiled all the data necessary for retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76. In view of this, the Board decided that it would also permit entities to apply that requirement with full retrospective effect (as currently required by IAS 39).

BC15. Because the concerns regarding retrospective application of the provisions in paragraph AG76 are equally applicable to first-time adopters, the Board decided to amend IFRS 1 to make the proposals in this Exposure Draft applicable to first-time adopters, as well as existing users of IFRSs.

Other matters considered by the Board

BC16. The Board also noted that confusion had arisen over how any gain or loss not recognised on 'day 1' should be recognised subsequently. In particular, some suggested that the entire gain or loss might be recognised on 'day 2'. The Board decided to clarify that:

(a) the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements in IAS 39; and

(b) accordingly, a gain or loss should be recognised after initial recognition only to the extent it arises from a change in a factor (including time) that market participants would consider in setting a price.

BC17. The Board also decided not to add any additional guidance on fair value measurement at this time. It concluded that because the guidance recently provided on fair value measurement in the revision to IAS 39 is extensive, seemingly minor changes could have unforeseen consequences. It also decided to monitor developments in US GAAP and seek convergence where possible.

PART 3—CASH FLOW HEDGE ACCOUNTING OF FORECAST INTRA-GROUP TRANSACTIONS

Contents

Background*

1. In July 2001, the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002, the Board published its proposed improvements as an Exposure Draft and, in December 2003, it issued a revised version of the two Standards.†

2. A principle in IAS 39 is that entities can obtain hedge accounting only for transactions that involve a party external to the entity. Among the revisions to IAS 39 made in 2003 was the inclusion of an exception to this principle. This exception, previously contained in Guidance on Implementation (IGC) 137-13 *Intra-group monetary item that will affect consolidated net income*, allows the foreign currency risk in an intragroup monetary item to be designated as the hedged item in consolidated financial statements as long as the intragroup item results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*.‡ However, the revised IAS 39 does not allow a forecast intragroup transaction to be designated as the hedged item in a foreign currency cash flow hedge in consolidated financial statements. This was allowed by the previous version of IAS 39 as

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* *ASB footnote:* This background note has been prepared by the IASB and is included in this Supplement in full and unamended, except that some footnotes have been added to provide a UK context for some of the comments made. References in the note to "the Board" are references to the IASB.

† *ASB footnote:* A UK exposure draft based on the IASB's Exposure Draft was published as FRED 30. UK standards based on the revised versions of IASs 32 and 39 that were issued by the IASB in December 2003 have not yet been issued in the UK. Therefore, when considering the implications for UK standards of what is said here, the references to IASs 32 and 39 should be taken to be references to the draft FRS • (IAS 32) and draft FRS • (Part of IAS 39) respectively, which are set out in FRED 30 and its Supplements.

‡ *ASB footnote:* The equivalent UK standard to IAS 21 is SSAP 20 *Foreign currency translation*. SSAP 20 is not however the same as IAS 21 in all respects.

interpreted by IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income.*[★]

3. After the revised IAS 39 was issued, constituents raised the following concerns:

   (a) it is common practice for entities to designate a forecast intragroup transaction as the hedged item. Also, previously, IGC 137-14 (now deleted) permitted the designation of the forecast intragroup transaction as the hedged item in a foreign currency cash flow hedge, provided the conditions prescribed in the IGC were met.

   (b) some entities using IFRSs and entities that are planning to adopt IFRSs in 2005 have established a practice of designating forecast intragroup transactions as hedged items and have entered into derivative instruments to hedge the resulting exposures.

   (c) the revised IAS 39 creates a difference from US GAAP because SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* explicitly permits hedge accounting for foreign currency risk on forecast intragroup transactions.

4. The Board noted that the revised IAS 39 permits entities that had designated a forecast intragroup transaction as the hedged item to obtain hedge accounting by designating a highly probable forecast external transaction as the hedged item. The Board noted that if the hedge is designated in this way, entities can use the forecast intragroup transaction as part of the tracking mechanism (or 'audit trail') for associating the hedging instrument with an external transaction. Also if, as is often the case, the external transaction is for a higher amount than the intragroup transaction, the entity could designate a part of the highly probable forecast external transaction as the hedged item.

5. However, the Board also noted that there was confusion among constituents

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[★] *ASB footnote:* IGCs were implementation guidance issued by the IAS 39 Implementation Guidance Committee. All extant IGCs have now been subsumed into the implementation guidance set out in the revised version of IAS 39. The ASB has proposed that this implementation guidance should be issued in the UK when it issues FRS • (Part of IAS 39).

about whether the designation outlined in paragraph 4 is permitted by the revised IAS 39. Accordingly, the Board decided to clarify that in consolidated financial statements an entity can designate as the hedged item in a foreign currency cash flow hedge a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) concerned, provided that the transaction gives rise to an exposure that has an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency).

6. The Board also decided to propose that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006, with earlier application permitted.

Invitation to Comment*

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Question 2

Do the proposals contained in this Exposure Draft appropriately address the concerns set out in paragraph 3 of the Background on this Exposure Draft? If not, why not, and how would you address these concerns?

Question 3

Do you have any other comments on the proposals?

* *ASB footnote:* This is the IASB's Invitation to Comment. References in it to "the Board" are references to the IASB.

Proposed Amendments to [draft] FRS • (Part of IAS 39)

In the Standard, [draft] paragraph 110 is added.

Effective Date and Transition

110. An entity shall apply [draft] paragraph AG99A for ~~annual~~accounting★ periods beginning on or after 1 January 2006. Earlier application is permitted.

In the Application Guidance paragraphs AG99A and AG99B are renumbered AG99B and AG99C respectively, and [draft] new paragraph AG99A is added, as below.

Appendix A

Application Guidance

Hedged Items (paragraphs 78–84)

Qualifying Items (paragraphs 78-80)

AG99A. In consolidated financial statements a group can designate as the hedged item, in foreign currency cash flow hedge, a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, provided the transaction gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency).

In the Basis for Conclusions, in the heading above paragraph BC135A "AG99A and AG99B" is replaced by "AG99B and AG99C".

★ *ASB footnote:* ASB amendment.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

> ASB note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. It should be noted though that some of the discussion it contains concerns IASB requirements that have no equivalent in the UK or Republic of Ireland. Footnotes have been used to highlight those parts of the discussion.
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> All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Background

BC1. A principle in IAS 39 is that entities can obtain hedge accounting only for transactions that involve a party external to the entity. Among the revisions to IAS 39 made in 2003 was the inclusion of an exception to this principle. This exception, previously contained in IGC 137-13 *Intra-group monetary item that will affect consolidated net income*, allows the foreign currency risk in an intragroup monetary item to be designated as the hedged item in consolidated financial statements as long as the intragroup item results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*.* However, the revised IAS 39 does not allow a forecast intragroup transaction to be designated as the hedged item in a foreign currency cash flow hedge in consolidated financial statements. This was allowed by the previous version of IAS 39 as interpreted by IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*.

BC2. These requirements can be illustrated by the following example. Group A comprises Company B, a manufacturing subsidiary whose functional

* *ASB footnote:* The equivalent UK standard to IAS 21 is SSAP 20 *Foreign currency translation*. SSAP 20 is not however the same as IAS 21 in all respects. In particular, SSAP 20 does not deal specifically with the choice of presentation currency.

currency is the euro, and Company C, a selling subsidiary whose functional currency is the US dollar. Company B incurs most of its production costs in euro. It sells most of the product it makes, in US dollars, to Company C, which sells the product to external customers, also in US dollars. Consequently, Group A has a foreign currency exposure between its external purchases (in euro) and its external sales (in US dollars). On consolidation, if Group A selects the euro as its presentation currency, this exposure will be reflected by consolidated sales revenue varying with movements in the US dollar/euro exchange rate* while consolidated cost of sales will not.

BC3. Continuing the example in paragraph BC2, assume that on 1 January, Company B forecasts it will sell goods to Company C for US$100, with delivery on 31 March and payment on 30 June in order to meet a sale that Company C forecasts it will make to external customers for US$120, with deliveries in early April and payment in early July. Assume the transactions are highly probable. The revised IAS 39 does not permit Group A at 1 January to designate the forecast intragroup sale from Company B to Company C as the hedged item in a foreign currency cash flow hedge.

The Rationale for the Proposed Amendments

BC4. After the revised IAS 39 was issued, constituents raised the following concerns:

(a) it is common practice for entities to designate a forecast intragroup transaction as the hedged item. Also, previously, IGC 137-14 (now deleted) permitted the designation of the forecast intragroup transaction as the hedged item in a foreign currency cash flow hedge, provided the conditions prescribed in the IGC were met.

(b) some entities using IFRSs and entities that are planning to adopt IFRSs in 2005 have established a practice of designating forecast intragroup transactions as hedged items and have entered into derivatives to hedge the resulting exposures.

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* This is because IAS 21 requires the US dollar sales recognised in the income statement of Company C to be translated into euro (ie the group presentation currency) at actual or average rates.

(c) the revised IAS 39 creates a difference from US GAAP because SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* explicitly permits hedge accounting for foreign currency risk on forecast intragroup transactions.

BC5. The Board considered the following ways to address these concerns:

(a) Permit a highly probable forecast intragroup transaction to be the hedged item provided that the transaction will result in the recognition of an intragroup monetary item for which exchange differences are not fully eliminated on consolidation.

(b) Permit a highly probable forecast external transaction to be the hedged item.

Permit a highly probable forecast intragroup transaction to be the hedged item provided that the transaction will result in the recognition of an intragroup monetary item for which exchange differences are not fully eliminated on consolidation

BC6. The Board noted that a simple solution would be to extend the current exception in paragraph 80 of IAS 39* to highly probable forecast intragroup transactions without the requirement for a corresponding external exposure. In the example in paragraphs BC2 and BC3, this would have the effect that the forecast intragroup sale from Company B to Company C could be designated as the hedged item. This would essentially reinstate the guidance previously in IGC 137-14.

BC7. The rationale for the exception in IAS 39 (from the general principle that entities can obtain hedge accounting only for transactions involving a party external to the entity) is that the hedged intragroup item is not fully eliminated on consolidation under IAS 21. This rationale does not hold for a forecast transaction—such a transaction is not recognised in the financial statements and, hence, does not result in amounts that are not fully eliminated on consolidation under IAS 21. In addition, the Board could not see another valid conceptual rationale for permitting a highly probable

* Paragraph 80 permits, in consolidated financial statements, an intragroup monetary item that results in an exposure to foreign exchange gains or losses that are not fully eliminated on consolidation to be designated as the hedged item.

forecast intragroup transaction to be designated as the hedged item. Consequently, in revising IAS 39, the Board decided not to allow the designation of a highly probable forecast intragroup transaction as the hedged item in consolidated financial statements. Also, the Board noted that the exclusion from the revised IAS 39 of a specific exemption for forecast intragroup transactions was not a mistake. Rather, it was a deliberate change made in the light of comments received from constituents questioning the conceptual rationale for such an exception.

BC8. Consequently, the Board decided not to extend the current exception in IAS 39 to highly probable forecast intragroup transactions.

Permit a highly probable forecast external transaction to be the hedged item

BC9. For cash flow hedge accounting to be used, IAS 39 paragraph 86(b) requires that the hedge is of "the exposure to variability in cash flows that (i) is attributable to a particular risk associated with ... a forecast transaction and (ii) could affect profit or loss". The Board noted that, from the perspective of the group, such an exposure arises from the forecast external transaction. Using the example in paragraphs BC2 and BC3, from the perspective of the group whose presentation currency is the euro, such an exposure arises from the forecast sales denominated in US dollars by Company C to external customers. Accordingly, in consolidated financial statements the group could obtain hedge accounting by designating the hedge as a hedge of this highly probable forecast external transaction rather than as a hedge of the forecast intragroup transaction.

BC10. With this approach, the forecast intragroup transaction could form part of the tracking mechanism (or 'audit trail') for associating the hedging instrument with an external transaction. Also if, as is often the case, the external transaction is higher in amount than the intragroup transaction, the entity could designate a portion of the external transaction as the hedged item. In the above example it could designate the first $100 of the $120 sale proceeds. This would broadly achieve the same accounting result as designating the intragroup transaction although the timing of the reclassification from equity to profit or loss of amounts initially recognised in equity might differ.

BC11. The Board noted that this interpretation is consistent with the definition of consolidated financial statements in IAS 27 *Consolidated and Separate*

Financial Statements. IAS 27 defines consolidated financial statements as the financial statements of a group presented as those of a single economic entity. Under this definition the group, being a single economic entity, has an exposure it can hedge.*

BC12. The Board also considered whether this interpretation is consistent with IAS 21. It noted that under IAS 21 the group does not have a functional currency. Rather, it comprises a number of entities each of which has a functional currency. Some constituents argued that this implies that the group has a hedgeable exposure only if that exposure is denominated in a currency other than the functional currency of the specific entity concerned. Accordingly, they argue that in the example in paragraphs BC2 and BC3, there is no hedgeable exposure because both the external sales and the external purchases are denominated in the functional currency of the entity that has the exposure (ie US dollars for Company C and euro for Company B).

BC13. Others argue that the group in the example has both an economic and an accounting exposure. They arise because the group's costs are denominated in a currency different from its sales. Furthermore, this exposure affects profit or loss whatever presentation currency the group chooses (ie in the above example, whether it is dollars, euro or a third currency).

BC14. In addition, if the group in the above example were to operate as a single economic entity, its functional currency would be either euro or US dollars depending upon the facts of the case. In these circumstances either the forecast purchase in euro or the forecast sale in US dollars could qualify for hedge accounting. IAS 27 defines consolidated financial statements as the financial statements of a group presented as those of a single economic entity, which implies that hedge accounting should similarly be permitted for the group in the above example.

BC15. The Board was persuaded by the arguments in paragraphs BC13 and BC14. Accordingly, it decided to clarify that in consolidated financial statements a group can designate as the hedged item a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) concerned, provided the transaction gives rise to an

* *ASB footnote:* This is also the view taken in UK standards.

exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency). The Board decided that it would be preferable to clarify the interpretation of IAS 39 in this manner rather than create an exception by reintroducing the guidance in IGC 137-14. Accordingly, it decided to include this clarification in the Application Guidance section of IAS 39. The Board noted that this clarification facilitates the use of cash flow hedge accounting at the group level without altering any of the hedge accounting requirements in IAS 39.

BC16. Finally, the Board considered what should be the effective date of the proposed clarification. The Board is committed to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many entities adopt IFRSs for the first time. Accordingly, it decided that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006. However, given the widespread and practical relevance of the issue, it also decided to permit earlier application.

Alternative View on Proposed Amendments to IAS 39—Cash Flow Hedge Accounting of Forecast Intragroup Transactions

AV1. One Board member voted against the publication of the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement—Cash Flow Hedge Accounting of Forecast Intragroup Transactions*. The member's alternative view is set out below.

AV2. The Board member disagrees that entities should be permitted to designate a forecast external transaction as the hedged item in the absence of an economic exposure. This situation arises when the forecast external transaction is denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, but not in the group's presentation currency. In such a case, this Board member believes that there is no economic exposure, but only an accounting exposure. Furthermore, this Board member believes that the Exposure Draft's proposals would treat the group's presentation currency as if it were a functional currency, which is contrary to IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The member also believes that it would be possible for an entity to obtain hedge accounting for forecast transactions in the absence of an economic exposure, by changing its presentation currency.

PART 4—THE IMPLICATIONS OF IFRS 4 FOR FRED 30

Contents

Background

1 One of the important issues that the IASB has been working on recently is the border between its financial instrument standards (IAS 32 and 39) and its insurance contracts standard (IFRS 4); in other words, which contracts should be accounted for as financial instruments and which should be accounted for as insurance contracts. Part 5 of this FRED sets out the IASB's latest proposals on this issue.

2 Those proposals as always take the form of a mark-up of an existing text to show the changes that are being proposed. The text being marked up is the text of IASs 32 and 39, as amended by IFRS 4.

3 Included in the Second Supplement to FRED 30, which was issued in April 2004, was the text of IASs 32 and 39, amended to reflect the changes the ASB was then proposing. It is not the same as the text being marked up in Part 5 because it does not reflect the amendments made to IASs 32 and 39 by IFRS 4.

4 As those amendments also relate to the border between the financial instruments standards and the insurance contracts standard, the ASB thought it might be helpful to those studying part 5 to see what the IFRS 4 changes were. The rest of this part of the Supplement sets out those amendments.

5 In line with the ASB's policy of ensuring that any UK standards it issues based on IAS 32 and 39 will as far as possible adopt exactly the same wording as the international standards, the intention is that these amendments (together with those set out elsewhere in this Supplement and in the Second Supplement) will be reflected in the final text of any standards developed from FRED 30.

Amendments made to IAS 32

IFRS 4 amended the Second Supplement's version of IAS 32 as follows:

4. This Standard shall be applied to all types of financial instrument except:

....

(~~c~~<u>d</u>) ~~rights and obligations arising under insurance contracts. However, entities shall apply this Standard to a financial instrument that takes the form of an insurance (or reinsurance) contract as described in paragraph 6, but principally involves the transfer of financial risks described in paragraph 52. In addition, entities shall apply~~ <u>insurance contracts as defined in IFRS 4</u> <u>**Insurance Contracts.**</u> ***<u>However,</u> this Standard <u>applies</u> to derivatives that are embedded in insurance contracts ~~and are accounted for as embedded derivatives under [draft] FRS • (Part of IAS 39) Financial Instruments: Measurement~~ <u>if IAS 39 requires the entity to account for them separately</u>.***[*]

~~(e) contracts that require a payment based on climatic, geological or other physical variables (see paragraph AG1 of [draft] FRS • (Part of IAS 39) Financial Instruments: Measurement). However, this Standard shall be applied to other types of derivatives that are embedded in such contracts and are accounted for as embedded derivatives under [draft] FRS • (Part of IAS 39) Financial Instruments: Measurement (for example, if an interest rate swap is contingent on a climatic variable such as heating degree days, the interest rate swap element is an embedded derivative that is within the scope of this Standard – see paragraphs 10-13 of [draft] FRS • (Part of IAS 39) Financial Instruments: Measurement).~~

<u>(e)</u> <u>financial instruments that are within the scope of IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15-32 and AG25-AG35 of this Standard regarding the distinction between</u>

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[*] *ASB footnote:* Part 5 of this FRED proposes amending the first sentence by adding the words underlined: "insurance contracts as defined in IFRS 4 *Insurance Contracts* <u>other than insurance contracts that are also financial guarantee contracts as defined in IAS 39</u>."

financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IAS 39).

...

...

~~6.~~ ~~For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (or in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. The provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks (see paragraph 52), for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other entities. Entities that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations.~~

Amendments made to IAS 39

7 IFRS 4 amended the version of IAS 39 included in the Second Supplement as follows:

2. This Standard shall be applied by all entities to all types of financial instruments except:

(~~e~~d) financial instruments issued by the entity that meet the definition of an equity instrument in [draft] FRS • (IAS 32) Financial Instruments: Disclosure and Presentation (including options and warrants). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.

(~~d~~e) rights and obligations arising under an insurance contract~~s~~ as defined in IFRS 4 Insurance Contracts or under a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, ~~entities shall apply this Standard to a financial instrument that takes the form of an insurance (or reinsurance) contract as described in paragraph 6 of [draft] FRS • (IAS 32) Financial Instruments: Disclosure and Presentation, but principally involves the transfer of financial risks described in paragraph 52 of that Standard. In addition,~~ this Standard applies to a derivative~~s~~ that ~~are~~ is embedded in ~~insurance~~ such a contract~~s are subject to the embedded derivatives provisions of this Standard~~ if the derivative is not itself a contract within the scope of IFRS 4 (see paragraphs 10-13 and Appendix A paragraphs AG~~27~~23AG33). Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer shall apply this Standard to the contract (see paragraph 3 and Appendix A paragraph AG4A).*

[*] *ASB footnote:* The proposal in Part 5 is that the following underlined words should be added to the first sentence: "rights and obligations arising under (i) an insurance contract as defined in IFRS 4 Insurance Contracts, other than an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract...".

~~***(f) financial guarantee contracts (including letters of credit and other credit default contracts) that provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (see paragraph 3). An issuer of such a financial guarantee contract shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under FRS 12 Provisions, Contingent Liabilities and Contingent Assets, and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised. Financial guarantees are subject to the derecognition provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63).***~~ ***...***

~~***(h) contracts that require a payment based on climatic, geological or other physical variables (see Appendix A paragraph AG1). However, other types of derivatives that are embedded in such contracts are subject to the embedded derivatives provisions of this Standard (for example, if an interest rate swap is contingent on a climatic variable such as heating degree days, the interest rate swap element is an embedded derivative that is within the scope of this Standard—see paragraphs 10-13 and Appendix A paragraphs AG27-AG33).***~~

...

3. ~~***Financial guarantee contracts are subject to this Standard if they provide for payments to be made in response to changes in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'). For example, a financial guarantee contract that provides for payments to be made if the credit rating of a debtor falls below a particular level is within the scope of this Standard.***~~ ***Some financial guarantee contracts require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. If that requirement transfers significant risk to the issuer, the contract is an insurance contract as defined in IFRS 4 (see paragraphs 2(e) and AG4A). Other financial guarantee contracts require payments to be made in response to changes in a specified interest***

rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. Such contracts are within the scope of this Standard. *

...

9. ***The following terms are used in this Standard with the meanings specified:***

Definition of a Derivative

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-7) with all three of the following characteristics:

(a) ***its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');***

(b) ***it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and***

(c) ***it is settled at a future date.***

.....

10. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes

* *ASB footnote:* The IASB is proposing that this paragraph should be deleted (see Part 5).

some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

Rationale behind IFRS 4's amendments

1 IFRS 4 explained these amendments in the following terms:

BC62 Some contracts require specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. If the resulting risk transfer is significant, these contracts meet the definition of an insurance contract. Some of these contracts have the legal form of an insurance contract and others have the legal form of a financial guarantee or letter of credit. In the Board's view, although this difference in legal form may be associated in some cases with differences in substance, the same accounting requirements should, in principle, apply to all contracts with similar substance.

BC63 Some took the view that the scope of IAS 39 should include all contracts that provide cover against credit risk, on the following grounds:

(a) Although credit insurers manage credit risk by pooling individual risk within a portfolio, banks also do this in managing the credit risk in a portfolio of financial guarantees. Although banks may rely more on collateral, this is no reason to require a different accounting treatment.

(b) Banks manage credit risk embedded in their financial assets, and there is no reason to require them to apply a different standard to credit risk embedded in financial guarantees.

(c) Credit risk is commonly traded in capital markets, even if the specific forms of credit risk embedded in some forms of credit insurance are not traded.

(d) As noted above, some financial guarantees were already within the scope of IAS 39. To ensure consistent reporting, the scope of IAS 39 should include all contracts that provide protection against similar exposures.

BC64 Some argued that insurance against credit risk is different from a financial guarantee and should be within the scope of IFRS 4, on the following grounds:

(a) Insurance against credit risk is often arranged by the seller of goods and protects the seller against default by the buyer. The fact that default is generally outside the control of the seller, and so is fortuitous, allows the use of stochastic methods to estimate future cash flows arising from the contract, because they are random and not subject to moral hazard. By contrast, some financial guarantees, such as some letters of credit, are arranged at the request of the party whose obligation is being guaranteed. Default on such guarantees is partly under the control of that party.

(b) Insurance against credit risk is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities.

(c) A credit insurer may refuse to pay a claim if the policyholder did not give full disclosure and may delay payment while a claim is investigated, whereas a guarantor is often required to pay on first notice of a default.

(d) A credit insurer faces risks similar to those arising in some other insurance contracts. For example, a contract may require payments (either to the debtor or to the creditor) if a debtor's income is reduced by specified adverse events such as unemployment or illness, regardless of whether the debtor continues to pay off the loan when due. The issuer of this contract may face risks similar to those faced by a guarantor of the loan.

(e) Including these contracts within the scope of IAS 39 would compel credit insurers to change their accounting immediately, unlike issuers of other types of insurance contract. Furthermore, some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not resolve until phase II.

BC65 When the Board developed ED 5, the following contracts were already within the scope of IAS 39 and the Board concluded that they should remain so:

(a) a financial guarantee given or retained by a transferor when it derecognises financial assets or financial liabilities. In general, IAS 39 prevents the derecognition of the transferred asset or liability when such a guarantee exists.

(b) a financial guarantee that does not meet the definition of an insurance contract.

BC66 Other financial guarantees were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In June 2002, an Exposure Draft of amendments to IAS 39 proposed that IAS 39 should deal with all financial guarantees at initial recognition, but that the subsequent measurement of some financial guarantees should remain within the scope of IAS 37. In finalising the revision of IAS 39, issued in December 2003, the Board decided that the issuer of the financial guarantees described in paragraph BC62 (ie those that meet the definition of an insurance contract) should initially recognise them at fair value, and subsequently measure them at the higher of (a) the amount recognised under IAS 37, and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

BC67 In finalising IFRS 4, the Board retained the approach it had adopted in revising IAS 39. Even those financial guarantees that meet the definition of an insurance contract are excluded from the scope of the IFRS. IAS 32 addresses disclosures about them and IAS 39 addresses their recognition and measurement. The Board noted that the fair value of a financial guarantee at initial recognition is likely to be equal to a guarantee fee (or premium for credit insurance) received at market rates, unless there is evidence to the contrary. The Board may review the treatment of these contracts in phase II.

BC68 The Board decided that phase I should not give specific guidance on accounting for financial guarantees received. For contracts classified as insurance contracts, the beneficiary of the guarantee is a policyholder; policyholder accounting is beyond the scope of IFRS 4. For contracts within the scope of IAS 39, the beneficiary applies IAS 39; the application of IAS 39 to other contracts is beyond the scope of this project.

PART 5—FINANCIAL GUARANTEE CONTRACTS AND CREDIT INSURANCE

Contents

Introduction*

IN1. Financial guarantee contracts (sometimes known as 'credit insurance') require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Some financial guarantee contracts result in the transfer of significant insurance risk and thus meet the definition of 'insurance contract' in IFRS 4 *Insurance Contracts*.†

IN2. This Exposure Draft contains proposals by the International Accounting Standards Board to amend IAS 39 *Financial Instruments: Recognition and Measurement* to define 'financial guarantee contracts' and amend the requirements for their treatment by the issuer. Under the proposals, the legal form of such contracts would not affect their accounting treatment.

IN3. The proposals would require the issuer of a financial guarantee contract (other than those contracts described in paragraph IN6) to measure the contract:

(a) initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(b) subsequently at the higher of (i) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

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* *ASB footnote:* This background note has been prepared by the IASB and is included in this Supplement in full and unamended, except that some footnotes have been added to provide a UK context for some of the comments made. References in the note to "the Board" are references to the IASB.

† *ASB footnote:* The ASB has stated that it is not presently proposing to implement IFRS 4 as a UK standard. However, as explained more fully in Part 6 of this Supplement it is proposing to incorporate some of IFRS 4's definitions, including its definition of 'insurance contracts', into UK standards. As the proposed UK standards based on IASs 32 and 39 have not yet been issued, when considering the implications for UK standards of what is said here, the references to IASs 32 and 39 should be taken to be references to the draft FRS • (IAS 32) and draft FRS • (Part of IAS 39) respectively, which are set out in FRED 30 and its Supplements.

and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.*

These requirements would apply even if the contract meets the definition of an insurance contract in IFRS 4.

IN4. For a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party, the main practical effect of the proposals is the requirement to use IAS 37 to determine whether an additional liability should be recognised. Without the requirements proposed in this Exposure Draft, if the issuer carries out a liability adequacy test meeting minimum requirements described in paragraph 16 of IFRS 4, the issuer need not use IAS 37 to determine whether an additional liability should be recognised.

IN5. The proposals could have a more significant effect for financial guarantee contracts that are not issued in an arm's length transaction to an unrelated party and for financial guarantee contracts embedded in other contracts.

IN6. Financial guarantee contracts that were entered into or retained on transferring financial assets or financial liabilities to another party would be measured:

(a) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

(b) as a derivative in all other cases.

IN7. The substance of the proposals is consistent with requirements included in the revised version of IAS 39 issued in December 2003. In finalising IFRS 4 in early 2004, the Board acknowledged the need to expose its conclusions in this area for comment. Pending completion of amendments resulting from this Exposure Draft, these financial guarantee contracts are within the scope of IFRS 4.

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* *ASB footnote:* The equivalent UK standards to IAS 37 and IAS 18 are FRS 12 *Provisions, Contingent Liabilities and Contingent Assets* and Application Note G to FRS 5 *Reporting the Substance of Transactions*.

IN8. Although the scope section of IAS 39 excluded financial guarantee contracts from the scope of IAS 39, it specified their measurement. For clarity, the Exposure Draft proposes to address the measurement of these contracts in the measurement section of IAS 39, not in its scope section.

IN9. Similarly, the proposals in the Exposure Draft would transfer the requirements for measuring some loan commitments from the scope section of IAS 39 to its measurement section. However, the measurement basis for these loan commitments remains unchanged.

IN10. If confirmed in a Standard, the proposals in this Exposure Draft would apply for annual periods beginning on or after 1 January 2006. Earlier application would be encouraged.

IN11. This Exposure Draft does not address accounting by the holder of financial guarantee contracts. This subject is outside the scope of IFRS 4.

Invitation to Comment*

The International Accounting Standards Board invites comments on the changes proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

Question 1 – Form of contract

The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).

Do you agree that the legal form of such contracts should not affect their accounting treatment?

If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.

Question 2 – Scope

The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of

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* *ASB footnote:* This is the IASB's Invitation to Comment. References in it to "the Board" are references to the IASB.

IFRS 4)*, and defines a financial guarantee contract as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument" (see paragraph 9 of IAS 39).

Is the proposed scope appropriate?

If not, what changes do you propose, and why?

Question 3 – Subsequent measurement

The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:

(a) the amount recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and

(b) the amount initially recognised (ie fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue* (see paragraph 47(c) of IAS 39).

Is this proposal appropriate? If not, what changes do you propose, and why?

Question 4 – Effective date and transition

The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.

Are the proposed effective date and transition appropriate? If not, what do you propose, and why?

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* *ASB footnote:* The relevant part of paragraph 2 of IAS 39 is set out in the 'Proposed Amendments' section; the IASB's proposal is that paragraph 4 of IFRS 4 would state simply that IFRS 4 does not apply to "financial guarantee contracts as defined in IAS 39".

Question 5 – Other comments

Do you have any other comments on the proposals?

Proposed Amendments ~~to IAS 39 and IFRS 4~~

In this Exposure Draft, the proposed amendments are shown with new text underlined and deleted text struck through.

Proposed amendments to [draft] FRS • (Part of IAS 39) ~~(as previously amended by IFRS 4)~~

In the Introduction to ~~IAS 39~~the Standard, paragraphs IN5 and IN6 are amended and paragraph IN5A is added.

IN5. The scope of the Standard includes financial guarantee contracts that were previously within the scope of IFRS 4 *Insurance Contracts*. A financial guarantee contract is defined as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. Financial guarantee contracts are initially recognised at fair value. Other than those described in paragraph IN5A, financial guarantee contracts are subsequently measured at the higher of (a) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.* ~~The treatment of financial guarantee contracts has been reviewed. Such a contract is within the scope of this Standard if it is not an insurance contract, as defined in IFRS 4 *Insurance Contracts*. Furthermore, if an entity entered into, or retained, a financial guarantee on transferring to another party financial assets or financial liabilities within the scope of the Standard, the entity applies the Standard to that contract, even if the contract meets the definition of an insurance contract. The Board expects to issue in the near future an Exposure Draft proposing amendments to the treatment of financial guarantees within the scope of IFRS 4.~~

IN5A. Financial guarantee contracts that were entered into or retained on

* *ASB footnote:* It is proposed that the UK standard would replace all references to IAS 37 with references to FRS 12, and would simply delete all references to IAS 18 and IFRS 4.

transferring to another party financial assets or financial liabilities within the scope of this Standard are subsequently measured:

(a) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

(b) as a derivative in all other cases.

IN6. A ~~second~~ scope exclusion has been ~~added~~ made for loan commitments that are not classified as at fair value through profit or loss and cannot be settled net. A commitment to provide a loan at a below-market interest rate is initially recognised at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, ~~where~~ when appropriate, cumulative amortisation recognised in accordance with IAS 18 ~~*Revenue*~~.

In the Standard, paragraphs 2(e), 2(h), 4, 47 and AG4A are amended and paragraph 3 is deleted. In paragraph 9, a new definition is added immediately after the definition of a derivative, and the definition of a financial liability at fair value through profit or loss is amended as set out below. Paragraph 43 is included here for reference, but is not amended.

The amendments to paragraphs 2(h) and 47(d) would transfer measurement requirements for some loan commitments from the scope section of the Standard to the measurement section, but would not change those requirements.

2. ***This Standard shall be applied by all entities to all types of financial instruments except:***

...

(e) rights and obligations arising under (i) an insurance contract as defined in IFRS 4 **Insurance Contracts***, other than an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or*

(ii) ***~~under~~ a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of IFRS 4 if the derivative is not itself a contract within the scope of IFRS 4 (see paragraphs 10-13 and Appendix A paragraphs AG23-AG33). ~~Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer shall apply this Standard to the contract (see paragraph 3 and Appendix A paragraph AG4A).~~***

...

(h) ***~~except as described in paragraph 4, loan commitments that cannot be settled net in cash or another financial instrument. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). An issuer of a commitment to provide a loan at a below-market interest rate shall initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under IAS 37 and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18.~~ loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IAS 37 to ~~other~~ loan commitments that are not within the scope of this Standard. ~~Loan~~ However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 1542 and Appendix A paragraphs AG36-AG63).***

3. ~~Some financial guarantee contracts require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. If that requirement transfers significant risk to the issuer, the contract is an insurance contract as defined in IFRS 4 (see paragraphs 2(e) and AG4A). Other financial guarantee contracts require payments to be made in response to changes in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. Such contracts are within the scope of this Standard.~~

[Deleted]

4. The following loan commitments are within the scope of this Standard:

(a) ~~Loan~~ loan commitments that the entity designates as financial liabilities at fair value through profit or loss ~~are within the scope of this Standard~~. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.

(b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).

(c) commitments to provide a loan at a below-market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.

9. ...

Definition of a Financial Guarantee Contract

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions of Four Categories of Financial Instruments

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

...

(iii) ***a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).***

...

Initial Measurement of Financial Assets and Financial Liabilities

43. When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Subsequent Measurement of Financial Liabilities

47. After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a financial guarantee contract (which shall be measured in accordance with (c)) or a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured (which shall be measured at cost).

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or is accounted for using the continuing involvement approach. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.

(c) financial guarantee contracts as defined in paragraph 9, other than those that were entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard (see also Appendix A paragraph AG4A). After initial recognition, an issuer of a financial guarantee contract that was not entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard shall measure it at the higher of:

(i) *the amount determined in accordance with IAS 37* **Provisions, Contingent Liabilities and Contingent Assets;** *and*

(ii) ***the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18*** **Revenue.**

(d) ***commitments to provide a loan at a below-market interest rate. After initial recognition, the issuer of such a commitment shall measure it at the higher of:***

(i) ***the amount determined in accordance with IAS 37; and***

(ii) ***the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.***

Financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89-102.

AG4A. Financial guarantee contracts may have various legal forms, such as a financial guarantee, letter of credit, credit default contract or insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraphs~~s~~ 2(e) ~~and 3~~):

(a) Although a financial guarantee contract meets the definition of ~~If the contract is not~~ an insurance contract~~, as defined~~ in IFRS 4, the issuer applies this Standard. ~~Thus, a financial guarantee contract that requires payments if the credit rating of a debtor falls below a particular level is within the scope of this Standard.~~ Paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently:

(i)~~(b)If the issuer incurred~~ unless the financial guarantee contract was entered into or retained ~~the financial guarantee~~ on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer ~~applies this Standard~~ measures it at the higher of:

- the amount determined in accordance with IAS 37; and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 (see paragraph 47(c)).

(ii) if the financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer measures it:

- in accordance with paragraphs 29-37 and AG47-AG52 of this Standard if the financial guarantee contract prevents derecognition or results in continuing involvement; and
- as a derivative in all other cases.

~~(c) If the contract is an insurance contract, as defined in IFRS 4, the issuer applies IFRS 4 unless (b) applies.~~

(~~d~~b) If ~~the issuer gave~~ a financial guarantee contract is issued in connection with the sale of goods, the issuer applies IAS 18 in determining when it recognises the ~~resulting~~ revenue from the guarantee and from the sale of goods.

(c) If a credit guarantee (eg a contract that requires payments if the credit rating of a debtor falls below a particular level) meets neither the definition of a financial guarantee contract in this Standard nor the definition of an insurance contract in IFRS 4, the issuer applies this Standard.* Such a contract is a derivative.

* *ASB footnote:* It is proposed that, in the UK standard, the final part of this sentence would be amended to read "...neither the definition of a financial guarantee contract nor the definition of an insurance contract, the issuer applies..."

Proposed amendments to IFRS 4*

> In the Introduction to IFRS 4, a reference to credit insurance contracts is inserted in paragraph IN3.

IN3 The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs <u>(eg credit insurance contracts that meet the definition of a financial guarantee contract in IAS 39 *Financial Instruments: Recognition and Measurement*)</u>. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39~~ *Financial Instruments: Recognition and Measurement*~~. Furthermore, it does not address accounting by policyholders.

> Paragraphs 4(d), B18(g) and B19(f) are amended as follows.

4 An entity shall not apply this IFRS to:

...

(d) financial guarantee~~s~~<u> contracts as defined in IAS 39</u>~~ that an entity enters into or retains on transferring to another party financial assets or financial liabilities within the scope of IAS 39, regardless of whether the financial guarantees are described as financial guarantees, letters of credit or insurance contracts (see IAS 39)~~.

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

...

* *ASB footnote:* As IFRS 4 is not a UK standard, the whole of this section is not relevant to UK requirements. It has not been struck through because that would have made it difficult for those wishing to respond to the IASB on its proposed amendment to identify the changes the IASB is proposing to make.

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default ~~product~~ contract or insurance contract. ~~However, these contracts are outside the scope of this IFRS if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of IAS 39 (see paragraph 4(d)).~~ However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in IAS 39 and are within the scope of IAS 32 and IAS 39, not this IFRS (see paragraph 4(d)).

B19 The following are examples of items that are not insurance contracts:

...

(f) a ~~financial~~ guarantee ~~contract~~ (or letter of credit, credit derivative default product or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see IAS 39).

In the Guidance on Implementing IFRS 4, IG Examples 1.11 and 1.12 are amended.

IG Example 1: Application of the definition of an insurance contract	
Contract type	*Treatment in phase I*
1.11 Contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. The contract may have various legal forms (eg insurance contract, ~~financial~~ guarantee or letter of credit).	Insurance contract, but within the scope of IAS 39, not this IFRS. ~~Within the scope of the IFRS, unless the contract was entered into or retained on the transfer of financial assets or financial liabilities within the scope of IAS 39.~~ ~~If the issuer's accounting policies do not require it to recognise a liability at inception, the liability adequacy test in paragraphs 15-19 of the IFRS may be particularly relevant.~~ The legal form of the contract does not affect its recognition and measurement.
1.12 A credit-related ~~financial~~ guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index.	Not an insurance contract. Within the scope of IAS 39.

Effective date and transition*

The Board proposes that an entity should apply the proposed requirements in this Exposure Draft (if confirmed in a Standard) for ~~annual~~ accounting periods beginning on or after 1 January 2006. Earlier application would be encouraged. If an entity applies these changes for an earlier period, it would be required to disclose that fact.

The proposed requirements would apply retrospectively~~, as described in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*~~.

Proposed consequential amendments

[Draft] FRS • (IAS 32) Financial Instruments: Disclosure and Presentation

Paragraphs 4(d) and 12 are amended as follows.

4. ***This Standard shall be applied by all entities to all types of financial instruments except:***

...

(d) insurance contracts as defined in IFRS 4* Insurance Contracts *other than insurance contracts that are also financial guarantee contracts as defined in IAS 39. However, this Standard applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately.

12. The following terms are defined in paragraph 9 of IAS 39 and are used in this Standard with the meaning specified in IAS 39.

- amortised cost of a financial asset or financial liability

* *ASB footnote:* The amendments highlighted in the box are proposed ASB amendments.

- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

*~~IAS 37~~Proposed amendments to FRS 12 Provisions, Contingent Liabilities and Contingent Assets**

In Appendix C, example 9, the second paragraph (inserted in 2004 by IFRS 4) is deleted, and a cross-reference to paragraph 2(f) of IAS 39 is changed so that it refers to paragraph 47(c) of IAS 39.

* *ASB footnote:* Originally, example 9 in Appendix C of IAS 37 was identical to example 9 in Appendix III of FRS 12. However, the IAS 39 example has subsequently been amended by IAS 39 and IFRS 4, and the IASB is proposing to amend it again. The proposals in this and other parts of the Supplement are intended to ensure that the UK standard based on IAS 39 has the same effect as IAS 39 itself. The ASB intends to amend example 9 in Appendix III of FRS 12 to ensure it is consistent with that.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

> ASB note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. It should be noted though that some of the discussion it contains concerns IASB requirements that have no equivalent in the UK or Republic of Ireland. Footnotes have been used to highlight those parts of the discussion.
>
> All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Introduction

BC1. This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of proposed *Amendments to* IAS 39 *Financial Instruments: Recognition and Measurement and* IFRS 4 *Insurance Contracts* relating to *Financial Guarantee Contracts and Credit Insurance*. Individual Board members gave greater weight to some factors than to others.

BC2. Financial guarantee contracts may take various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. This Exposure Draft proposes to define a 'financial guarantee contract' as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.

BC3. If the risk transfer resulting from a financial guarantee contract is significant, the contract meets the definition of an insurance contract in IFRS 4.* Nevertheless, this Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 and measured initially at fair value. Subsequently:

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* *ASB footnote:* Part 6 of the Supplement proposes that this and other IFRS 4 definitions are incorporated in the proposed UK standards based on IASs 32 and 39.

(a) financial guarantee contracts that were not entered into or retained on transferring to another party financial assets or financial liabilities would be measured at the higher of:

   (i) the amount determined in accordance with IAS 37; and

   (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

(b) financial guarantee contracts that were entered into or retained on transferring to another party financial assets or financial liabilities would be measured:

   (i) in accordance with paragraphs 29-37 and AG47-AG52 of IAS 39 if the financial guarantee contract prevents derecognition or results in continuing involvement; or

   (ii) as a derivative in all other cases.

BC4. This Exposure Draft deals with the treatment of financial guarantee contracts by the issuer. It does not address their treatment by the holder.

Background

BC5. The Board's discussions on financial guarantee contracts in the following documents are summarised below:*

(a) June 2002 Exposure Draft of amendments to IAS 39

(b) ED 5 *Insurance Contracts*

(c) December 2003 revisions to IAS 39

(d) IFRS 4 *Insurance Contracts*.

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* *ASB footnote:* The June 2002 Exposure Draft of amendments to IAS 39 was issued in the UK in FRED 30, and ED 5 was issued in the UK in July 2003 as an ASB Consultation paper *IASB Proposals on Insurance Contracts*. Neither the December 2003 version of IAS 39 nor IFRS 4 has been issued in the UK.

June 2002 Exposure Draft of amendments to IAS 39

BC6. The Board addressed financial guarantee and similar contracts in June 2002 when it published an Exposure Draft of amendments to IAS 39. At that time, the following contracts were already within the scope of IAS 39 and the Board concluded that they should remain so:

(a) a financial guarantee contract given or retained by a transferor when it derecognises financial assets or financial liabilities.

(b) a financial guarantee contract that does not meet the definition of an insurance contract.

BC7. Other financial guarantee contracts were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Exposure Draft of June 2002 proposed that IAS 39 should deal with all financial guarantees at initial recognition, but that the subsequent measurement of some financial guarantee contracts should remain within the scope of IAS 37. The objective of this amendment was to clarify that issuing a financial guarantee contract creates a liability that should be recognised. IAS 37 would require the contracts to be measured at the amount an entity would rationally be expected to pay to settle the obligation or to transfer it to a third party.

ED 5 *Insurance Contracts*

BC8. Subsequently, the Board began to develop ED 5 *Insurance Contracts*. Some took the view that the scope of IAS 39 should include all contracts that provide cover against credit risk, on the following grounds:

(a) Although credit insurers manage credit risk by pooling individual risk within a portfolio, banks also do this in managing the credit risk in a portfolio of financial guarantees. Although banks may rely more on collateral, this is no reason to require a different accounting treatment.

(b) Banks manage credit risk embedded in their financial assets, and there is no reason to require them to apply a different standard to credit risk embedded in financial guarantees.

(c) Credit risk is commonly traded in capital markets, even if the specific forms of credit risk embedded in some forms of credit insurance are not traded.

(d) As noted above, some financial guarantee contracts were already within the scope of IAS 39. To ensure consistent reporting, the scope of IAS 39 should include all contracts that provide protection against similar exposures.

BC9. Others argued that insurance against credit risk is different from a financial guarantee contract and should be within the scope of IFRS 4, on the following grounds:

(a) Insurance against credit risk is often arranged by the seller of goods and protects the seller against default by the buyer. The fact that default is generally outside the control of the seller, and so is fortuitous, allows the use of stochastic methods to estimate future cash flows arising from the contract, because they are random and not subject to moral hazard. By contrast, some financial guarantees, such as some letters of credit, are arranged at the request of the party whose obligation is being guaranteed. Default on such financial guarantee contracts is partly under the control of that party.

(b) Insurance against credit risk is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities.

(c) A credit insurer may refuse to pay a claim if the policyholder did not give full disclosure and may delay payment while a claim is investigated, whereas a guarantor is often required to pay on first notice of a default.

(d) A credit insurer faces risks similar to those arising in some other insurance contracts. For example, an insurance contract may require payments (either to the debtor or to the creditor) if a debtor's income is reduced by specified adverse events such as unemployment or illness, regardless of whether the debtor continues to make loan payments when due. The same adverse events may trigger payments on a financial guarantee contract.

(e) Including these contracts within the scope of IAS 39 would compel credit insurers to change their accounting immediately, unlike issuers of other types of insurance contracts. Furthermore, some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not resolve until phase II of its project on insurance contracts.

BC10. ED 5 proposed in July 2003 that the contracts described in paragraph BC2 should be subject to the same requirements as all other insurance contracts.

BC11. Insurers generally agreed with ED 5 in this area. However, bank respondents typically opposed the proposals in ED 5, arguing that financial guarantees should remain within the scope of IAS 39 or IAS 37, on the following grounds:

(a) Financial guarantee contracts that provide for specified payments to reimburse the holder for a loss because a specified debtor fails to make payment when due should not be viewed as insurance contracts or derivatives. Although there are similarities to insurance contracts, there are also similarities to the management of credit risk in banks (see paragraph BC8).

(b) ED 5 did not indicate precisely what the accounting treatment should be for issued financial guarantee contracts within its scope, except for the proposed loss recognition test (subsequently relabelled in IFRS 4 as the liability adequacy test). Consequently, it would not be clear whether issued financial guarantee contracts within the scope of ED 5 (rather than IAS 39) should be initially measured at fair value.

(c) If viewed as an insurance product, these financial guarantees may be measured at fair value in phase II of the project on insurance contracts, which bank respondents regarded as less appropriate than applying IAS 37.

BC12. ED 5 proposed that financial guarantees incurred or retained on derecognition of a non-financial asset or non-financial liability should be treated in the same way as financial guarantees incurred or retained on derecognition of a financial asset or financial liability (ie they would be within the scope of IAS 39). However, no respondents commented on the substance of this proposal, and entities responding to ED 5 were not the entities most likely to be affected by this proposal. Therefore, the Board deleted this proposal in finalising IFRS 4, so that such contracts are within the scope of IFRS 4, pending the outcome of this Exposure Draft.

December 2003 revisions to IAS 39

BC13. Some respondents to the June 2002 Exposure Draft of amendments to IAS 39 expressed concern that applying IAS 37 after initial recognition would result in individual financial guarantee contracts being measured at nil immediately after initial recognition if the probability threshold in IAS 37 was not met, and thus the entity would recognise an immediate gain.

BC14. To address this concern, the Board clarified in the revised IAS 39 that the issuer of the financial guarantees described in paragraph BC2 (in effect, those that meet the definition of an insurance contract) should recognise them initially at fair value, and measure them subsequently at the higher of (a) the amount determined in accordance with IAS 37 and (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. The Board issued the revised IAS 39 in December 2003.

BC15. The Board deferred detailed consideration of financial guarantee contracts to its deliberations on ED 5.

IFRS 4

Insurance Contracts

BC16. In finalising IFRS 4 in early 2004, the Board reached the following conclusions:

(a) Financial guarantee contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. However, although this difference in legal form may be associated in some cases with differences in substance, the accounting for these instruments should not depend on their legal form.

(b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39.

(c) If a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if the contract is an insurance contract, as defined in IFRS 4.

(d) Unless (c) applies, the measurement described in the revision of IAS 39 of December 2003 (see paragraph BC14) is appropriate for a financial guarantee contract that meets the definition of an insurance contract. However, the Board acknowledged the need to expose this conclusion for comment. Mindful of the need to develop a 'stable platform' of Standards for 2005, the Board decided to finalise IFRS 4 without specifying the accounting for these contracts and to develop this Exposure Draft. Pending amendments resulting from this Exposure Draft, IFRS 4 treats these contracts in the same way as other insurance contracts (as proposed in ED 5).

(e) If a guarantee was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(f) As noted in paragraph BC12, when the Board finalised IFRS 4, it deleted the proposal that guarantees incurred or retained on derecognition of a non-financial asset or non-financial liability should be treated in the same way as guarantees incurred or retained on derecognition of a financial asset or financial liability. Pending the outcome of this Exposure Draft, it follows that guarantees incurred or retained on the transfer of a nonfinancial asset are within the scope of IFRS 4 if they meet the definition of an insurance contract. Among other things, this means that the guarantee is subject to the liability adequacy test described in paragraphs 15-19 of IFRS 4.

BC17. The Board decided to publish this Exposure Draft for the reasons in paragraph BC16(d).

Arguments for not publishing the Exposure Draft

BC18. Some suggested two reasons for not making the changes proposed in this Exposure Draft, in addition to those reasons given in paragraph BC9:

(a) Some argue that IAS 37 requires entities to determine adjustments for risk for each contract individually and that this leads to excessive risk margins when a portfolio of similar contracts is considered as a whole. However, the Board sees no basis for the assertion that IAS 37 requires an assessment contract by contract.

(b) Some argue that the decision to apply this model to these contracts in phase I prejudges the outcome of phase II for other insurance contracts. However, the Board emphasises that this is not the case.

BC19. Additionally, some suggested that the Board should not change the requirements for credit insurance contracts at this stage because IFRS 4 permits insurers to continue most aspects of their existing accounting for all other types of insurance contract, pending further work on phase II of the project. Paragraphs BC20-BC22 set out the Board's response to this suggestion.

BC20. The Board noted that, before the amendments proposed in this Exposure Draft, IFRS 4 applies as follows to these contracts:

(a) The issuer may continue using its existing accounting policies for these contracts, unless they conflict with the requirements of paragraphs 14-20 of IFRS 4. One such conflict could be the recognition of catastrophe or equalisation provisions, which paragraph 14(a) prohibits. Paragraphs BC23 and BC24 below give more detail on existing practices.

(b) Unless the issuer applies a liability adequacy test that meets the minimum requirements in paragraph 16 of IFRS 4, it must perform a comparison with the amount determined by IAS 37 (in other words, a comparison similar to that proposed in this Exposure Draft). The liability adequacy test may be particularly relevant if the issuer's accounting policies would not otherwise require it to recognise a liability at the inception of the contract.

(c) The issuer could improve its accounting policies for such contracts if those improvements meet the criteria in paragraphs 21-30 of IFRS 4.

BC21. In addition, the Board noted that the main practical effects of the proposals in this Exposure Draft, if confirmed, are likely to be the following:

(a) All entities issuing financial guarantee contracts would recognise a liability at inception and measure it at that time at its fair value. For a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party, this requirement is unlikely to change existing practice significantly.

(b) For subsequent measurement, an arm's length fee received for a stand-alone financial guarantee contract would be recognised as income over the period of the underlying risk exposure. For such financial guarantee contracts, this is unlikely to change existing practice significantly.

(c) The issuer would use IAS 37 to determine whether an additional liability should be recognised. Without the requirements proposed in this Exposure Draft, the issuer would carry out a liability adequacy test to comply with paragraphs 15-19 of IFRS 4. If that test did not meet the minimum requirements in paragraph 16 of IFRS 4, the issuer would use IAS 37 to determine whether an additional liability should be recognised. The minimum requirements in paragraph 16 of IFRS 4 are the following:

(i) the test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

(ii) if the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

BC22. To counter the view that IFRSs (and specifically IAS 37) do not require an entity to recognise a liability when it issues a financial guarantee contract, the Board concluded that it should publish this Exposure Draft now and not wait for further work on phase II of the Insurance project.

Review of other accounting treatments

BC23. The treatment proposed in this Exposure Draft has some similarities with existing accounting models used by issuers of financial guarantees and credit insurance contracts, and some differences. Some credit insurers use an 'accident year' model, with the following features:

(a) *At inception, premiums received are recognised as deferred income (unearned premium)*. The proposals in the Exposure Draft would have a similar effect for a stand-alone financial guarantee contract issued in an arm's length transaction to an unrelated party.

(b) *Deferred premiums are recognised as revenue over the period of the underlying risk exposure*. The proposals in the Exposure Draft would have a similar effect.

(c) *Cost of originating the contract (often called 'acquisition costs') are deferred and amortised on a basis that reflects the underlying risk exposure*. The proposals in the Exposure Draft would require the issuer to deduct transaction costs, as defined in IAS 39, in determining the initial carrying amount of the liability. Instead of being recognised as an expense, those transaction costs would result in additional interest expense over the life of the contract. That interest expense would be determined using the effective interest method described in IAS 39. If acquisition costs do not meet the definition of transaction costs in IAS 39, they would be recognised as an expense when incurred.

(d) *If estimated payments under a contract (or, perhaps, a portfolio of contracts) exceed the deferred premiums, an additional liability is recognised.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 requires a measurement that reflects the time value of money (which some existing models do not) and includes an adjustment for risk and uncertainty (which may differ from the basis used, if any, by existing models).

(e) *If the period of the underlying risk exposure has passed, but payments are still foreseen, a liability is recognised.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 considers the time value of money and risk and uncertainty.

BC24. Some other credit insurers use an 'underwriting year' model, with the following features:

(a) *At inception, premiums received are recognised as revenue. At the same time, a liability is recognised to reflect the estimated payments under the contract.* The proposals in the Exposure Draft would have a similar effect for the measurement of a stand-alone financial guarantee issued in an arm's length transaction to an unrelated party. However, to comply with IAS 18, the premiums would be recognised as revenue over time as the liability recognised at inception is amortised.

(b) *The liability is adjusted as estimates of the payments change.* The proposals in the Exposure Draft would have a similar effect, although there could be some difference in application because IAS 37 considers the time value of money and risk and uncertainty.

Comparison with US GAAP

BC25. The US Financial Accounting Standards Board (FASB) has issued guidance that may be of interest to respondents to this Exposure Draft. The guidance is in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). Relevant features of FIN 45 include the following:

(a) One of the FASB's main reasons for developing FIN 45 was to counter the belief of some that SFAS 5 *Accounting for Contingencies* prohibited a guarantor from recognising a liability for a guarantee issued if it is not probable that payments will be required under that guarantee.

(b) FIN 45 clarifies that a guarantor is required to recognise, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee (or, if greater, the measurement required by SFAS 5). When a guarantee is issued in a stand-alone arm's length transaction with an unrelated party, the liability recognised at inception should be the premium received or receivable.

(c) FIN 45 does not prescribe the method for the subsequent measurement of the guarantor's liability for its obligations under the guarantee. In commenting on current practices, FIN 45 notes that the liability recognised (initially at fair value) would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee (i) only upon either expiration or settlement of the guarantee, (ii) by a systematic and rational amortisation method, or (iii) as the fair value of the guarantee changes (eg for guarantees accounted for as derivatives). However, FIN 45 does not provide the criteria for determining when each of those methods would be appropriate. In addition, SFAS 5 applies to the contingent liability related to the contingent loss for the guarantee.

(d) FIN 45 does not apply to guarantees issued by an insurance company or a reinsurance company and accounted for in accordance with FASB statements specific to the insurance sector (SFASs 60, 97, 113 and 120).

(e) The recognition and measurement requirements of FIN 45 do not apply to guarantees issued either between parents and their subsidiaries, between corporations under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent.

(f) The transitional provisions in FIN 45 require prospective application, to guarantees issued or modified after 31 December 2002.

(g) FIN 45 requires specific disclosures about guarantees to be given.

BC26. The proposals in this Exposure Draft are consistent with FIN 45 in some areas, but differ in others:

(a) Like FIN 45, this Exposure Draft proposes initial recognition at fair value. The IASB agrees with the conclusion in FIN 45 that the fair value, at inception, of a financial guarantee contract issued in a stand-alone arm's length transaction with an unrelated party is likely to be equal to the premium received.

(b) The Exposure Draft proposes systematic amortisation, in accordance with IAS 18, of the liability recognised initially. This is compatible with FIN 45. Both the Exposure Draft and FIN 45 include a liability adequacy (or loss recognition) test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and SFAS 5).

(c) Unlike FIN 45, the Exposure Draft does not propose a different treatment for financial guarantee contracts issued by insurers. In the Board's view, distinctions based on the nature of the parties issuing a financial guarantee contract would make financial statements less relevant and reliable than distinctions (if any are required) based on the nature of the transaction.

(d) Unlike FIN 45, the Exposure Draft does not propose exemptions for parents, subsidiaries or other entities under common control. However, the Board noted that differences, if any, would be reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities, and that the amount recognised in consolidated financial statements would be the same under both FIN 45 and the proposals in the Exposure Draft.

(e) The Exposure Draft does not propose specific disclosure requirements about financial guarantee contracts, but relies on existing disclosure requirements in IAS 32. A proposed consequential amendment would bring these contracts within the scope of IAS 32.

Effective date and transition

BC27. The Board concluded that no specific transitional requirements should be proposed. The Board noted that the steps required for entities to apply the proposals would be (a) to establish the initial carrying amount, (b) to amortise the initial carrying amount and (c) to measure the liability in accordance with IAS 37 (if the liability is higher than the amortised initial carrying amount).

BC28. Although step (c) may involve the use of hindsight if a timely assessment had not previously been made, none of these requirements is likely to be onerous because:

(a) entities already applying IFRSs should have applied IAS 37 in accounting for the liability and should be accounting for the fee received in accordance with IAS 18.

(b) first-time adopters that begin planning on a timely basis for the transition to IFRSs would not need to apply an unacceptable level of hindsight.

Therefore, the Board concluded that the proposed amendments should be applied retrospectively. Similarly, the Board concluded that there was no reason to provide an extended transition period.

PART 6—MATERIAL FROM IFRS 4 TO BE INCORPORATED IN UK STANDARDS

Contents

Introduction

1 This part of the Supplement comprises an ASB exposure draft of amendments it is proposing to make to the draft standards set out in FRED 30 and its First and Second Supplements.

2 The objective of the amendments being proposed is to ensure that the border between financial instruments and insurance contracts is in exactly the same place in the UK as it is internationally.

3 The IASB has drawn its border by including material both in its financial instrument standards (IASs 32 and 39) and in its insurance contracts standard (IFRS 4). (For example, although all three standards rely on the term 'insurance contracts', it is IFRS 4 that defines the term.) However, the ASB has to adopt a different approach because it is not presently proposing to implement IFRS 4 as a UK standard.

4 The proposal in this part of the Supplement is therefore that certain IFRS 4 definitions, and the other border-related material that the IASB has included in IFRS 4, should be included in the proposed UK standards based on IASs 32 and 39. The next section of this part of the Supplement sets out the extracts from IFRS 4 that the ASB is proposing should be included in those UK standards, and the final section explains the reasoning behind the proposal.

5 If this material is incorporated in the UK standard based on IAS 39, the relevant cross-reference to other standards will be amended appropriately or footnotes will be provided signalling the relevant UK standard, according to the Board's usual practice for incorporating International Financial Reporting Standards into UK material.

Extracts from IFRS 4 that it is proposed should be included in the UK standards based on IASs 32 and 39

From the Standard section

Embedded derivatives

7 IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in profit or loss. IAS 39 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.

8 As an exception to the requirement in IAS 39, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirement in IAS 39 does apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, that requirement also applies if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

9 Paragraph 8 applies equally to options to surrender a financial instrument containing a discretionary participation feature.

From Appendix A 'Defined Terms'

This appendix is an integral part of the IFRS.

Discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
Financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
Guaranteed benefits	Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.
Insurance contract	A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix B for guidance on this definition.)
Insurance liability	An insurer's net contractual obligations under an insurance contract.
Insurance risk	Risk, other than financial risk, transferred from the holder of a contract to the issuer.
Insured event	An uncertain future event that is covered by an insurance contract and creates insurance risk.

Insurer	The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.
Policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs.

From Appendix B 'Definition of an insurance contract'

This appendix is an integral part of the IFRS.

B1 This appendix gives guidance on the definition of an insurance contract in Appendix A. It addresses the following issues:

(a) the term 'uncertain future event' (paragraphs B2-B4);

(b) payments in kind (paragraphs B5-B7);

(c) insurance risk and other risks (paragraphs B8-B17);

(d) examples of insurance contracts (paragraphs B18-B21);

(e) significant insurance risk (paragraphs B22-B28); and

(f) changes in the level of insurance risk (paragraphs B29 and B30).

Uncertain future event

B2 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

(a) whether an *insured event* will occur;

(b) when it will occur; or

(c) how much the insurer will need to pay if it occurs.

B3 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

B4 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

Payments in kind

B5 Some insurance contracts require or permit payments to be made in kind. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.

B6 Some fixed-fee service contracts in which the level of service depends on an uncertain event meet the definition of an insurance contract in this IFRS but are not regulated as insurance contracts in some countries. One example is a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash). Another example is a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage. The latter contract could meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts.

B7 Applying the IFRS to the contracts described in paragraph B6 is likely to be no more burdensome than applying the IFRSs that would be applicable if such contracts were outside the scope of this IFRS:

(a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.

(b) If IAS 18 *Revenue* applied, the service provider would recognise revenue by reference to the stage of completion (and subject to other specified criteria). That approach is also acceptable under this IFRS, which permits the service provider (i) to continue its existing accounting policies for these contracts unless they involve practices prohibited by paragraph 14 and (ii) to improve its accounting policies if so permitted by paragraphs 22-30.

(c) The service provider considers whether the cost of meeting its contractual obligation to provide services exceeds the revenue received in advance. To do this, it applies the liability adequacy test described in paragraphs 15-19 of this IFRS. If this IFRS did not apply to these contracts, the service provider would apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether the contracts are onerous.

(d) For these contracts, the disclosure requirements in this IFRS are unlikely to add significantly to disclosures required by other IFRSs.

Distinction between insurance risk and other risks

B8 The definition of an insurance contract refers to insurance risk, which this IFRS defines as risk, other than *financial risk*, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or nonoccurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.

B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided the payment that is contingent on the insured event can be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it need not be separated and measured at fair value (see paragraph 7 of this IFRS).

B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.

B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a damaged old asset by a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.

B14 Some contracts require a payment if a specified uncertain event occurs, but do not require an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses the contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset.

Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

B15 Lapse or persistency risk (ie the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (ie the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

B16 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the issuer to insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.

B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract.

Examples of insurance contracts

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

(a) insurance against theft or damage to property.

(b) insurance against product liability, professional liability, civil liability or legal expenses.

(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) disability and medical cover.

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default product or insurance contract. However, these contracts are outside the scope of this IFRS if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of IAS 39 (see paragraph 4(d)).

(h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(i) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(j) travel assistance (ie compensation in cash or in kind to policyholders for losses suffered while they are travelling). Paragraphs B6 and B7 discuss some contracts of this kind.

(k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).

(l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.

(m) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

(a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, for example life insurance contracts in which the insurer bears no significant mortality risk (such contracts are noninsurance financial instruments or service contracts, see paragraphs B20 and B21).

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts (such contracts are normally non-insurance financial instruments or service contracts, see paragraphs B20 and B21).

(c) self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party).

(d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see also paragraph B13).

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see IAS 39).

(f) a financial guarantee contract (or letter of credit, credit derivative default product or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see IAS 39).

(g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue.

(b) the other party recognises the consideration paid as a financial asset, rather than as an expense.

B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, IAS 18 applies. Under IAS 18, revenue associated with a transaction involving the rendering of services is recognised by reference to the stage of completion of the transaction if the outcome of the transaction can be estimated reliably.

Significant insurance risk

B22 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8-B21 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.

B23 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (ie probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

B24 The additional benefits described in paragraph B23 refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:

(a) the loss of the ability to charge the policyholder for future services. For example, in an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of the client. Therefore, the potential loss of future investment management fees is not relevant in assessing how much insurance risk is transferred by a contract.

(b) waiver on death of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, the waiver of these charges does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in assessing how much insurance risk is transferred by a contract.

(c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay one million currency units if an asset suffers physical damage causing an insignificant economic loss of one currency unit to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing one currency unit. At the same time, the contract creates non-insurance risk that the issuer will need to pay 999,999 currency units if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.

(d) possible reinsurance recoveries. The insurer accounts for these separately.

B25 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements.* Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.

B26 It follows from paragraphs B23-B25 that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). As noted in paragraph B24(b), the waiver on death of cancellation or surrender charges is not included in this assessment if this waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate lifecontingent payments are insignificant.

B27 Paragraph B23 refers to additional benefits. These additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (in other words, insurance

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

B28 If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

Changes in the level of insurance risk

B29 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the current annuity rates charged by the insurer to other new annuitants when the policyholder exercises the option. The contract transfers no insurance risk to the issuer until the option is exercised, because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.

B30 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.

Rationale behind proposal

1 IAS 39.2(e), as amended by IFRS 4, exempts from IAS 39 rights and obligations arising under "an insurance contract as defined in IFRS 4". That IFRS 4 definition therefore needs to be included in UK standards.

(a) IFRS 4 contains an appendix on the interpretation and implementation of this definition. If the definition is to be used in the UK in the same way as it is used internationally, it would seem sensible to include that material in UK standards as well.

(b) The definition of an insurance contract relies on four other IFRS 4 definitions—insurer, insurance risk, policyholder and insured event—and one of those definitions relies on a further IFRS 4 definition—financial risk—those five IFRS 4 definitions need also to be incorporated in UK standards.

2 IAS 39.2(e), as amended by IFRS 4, exempts from IAS 39 rights and obligations arising under "a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature." (IFRS 4 specifies that it (rather than IAS 39) applies to financial instruments it issues that contain discretionary participation features.)

(a) The IFRS 4 definition of a discretionary participation feature therefore needs to be included in UK standards. That definition itself relies on a further IFRS 4 definition (of guaranteed benefits), which would also need to be included.

(b) IFRS 4.34 states that, if an insurance contract containing a discretionary participation feature also contains a guaranteed element, either that guaranteed element should be recognised as a liability or the whole contract should be treated as a liability. If just the guaranteed element is treated as a liability, it would be accounted for under IAS 39. Therefore, it could be argued that those parts of IFRS 4.34 that deal with the guaranteed element need to be incorporated in

UK standards.* However, the ASB has concluded that, whether the material is included or omitted, the accounting would be the same† so the material does not need to be included in a UK standard.

3 IAS 39.2(e), as amended by IFRS 4, makes it clear that, even though IAS 39 does not apply to a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature, it does apply to a derivative that is not within the scope of IFRS 4 but is embedded in such a contract. The ASB believes that it is not necessary to include additional material in UK standards to achieve that effect.

4 IFRS 4.8 contains what appears to be an exception to IAS 39's requirements on embedded derivatives. That paragraph and its surround (ie IFRS 4.7-9) therefore need to be included in UK standards. That material relies on one IFRS 4 definition (of insurance liabilities), which would also have to be included.

5 IFRS 4.10 explains that some insurance contracts contain both an insurance component and a deposit component. It goes on to explain that in the circumstances set out in that paragraph the insurer is required or permitted to unbundle those components, in which case the deposit component should be accounted for in accordance with IAS 39. Consideration was given to including this material in UK standards, but it was eventually concluded that it should not be included. It was recognised that, if the ASB's objective is to ensure that all those items that would be accounted for in accordance with IAS 39 internationally are accounted for in accordance with the UK standard based on IAS 39, the material *should* be included; however, that would involve requiring some unbundling of insurance contracts—in other words, a partial implementation of IFRS 4—and the ASB has made it clear that it is not presently proposing to implement IFRS 4 as a UK standard.

* And just those parts because the rest deals in effect with the classification of the FFA. We would also need to include the definition of 'guaranteed element', and the definition on which that definition relies (of guaranteed benefits).

† If the material were omitted, unless the guaranteed element meets the definition of a derivative (in which case it would have to be measured at fair value), the law as it stands (and as it would be amended by the Fair Value Directive) would require it to be carried at cost, which is what IAS 39 would require as well.

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For ease of handling, we prefer comments to be sent by email (in Word format) to:

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Comments may also be sent in hard copy form to:

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Comments should be despatched so as to be received no later than 8 October 2004, although the ASB is also requesting comments on the fair value option proposals by the 21 July 2004. All replies will be regarded as on the public record and may be copied to the IASB and other standard-setters, unless confidentiality is requested by the commentator.