

13

DERIVATIVES AND OTHER
FINANCIAL INSTRUMENTS:
DISCLOSURES

FINANCIAL REPORTING
STANDARD



ACCOUNTING
STANDARDS
BOARD

*Financial Reporting Standard 13
'Derivatives and other Financial
Instruments: Disclosures' is issued by
the Accounting Standards Board in respect
of its application in the United Kingdom
and by the Institute of Chartered
Accountants in Ireland in respect of its
application in the Republic of Ireland.*

13

DERIVATIVES AND OTHER
FINANCIAL INSTRUMENTS:
DISCLOSURES



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Financial Reporting Standard 13 is set out in paragraphs 1-135.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2, 81 and 119 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix VII 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.

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ADOPTION OF FRS 13 BY THE BOARD

APPENDICES

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SUMMARY

General

- a Financial Reporting Standard 13 applies to all entities, other than insurance companies, that have one or more of their capital instruments listed or publicly traded on a stock exchange or market and to all banks and similar institutions.
- b Such entities are required by the FRS to disclose in their financial statements certain information on their financial instruments. The objective of these disclosures is to provide information about the impact of financial instruments on the entity's risk profile, how the risks arising from financial instruments might affect the entity's performance and financial condition, and how these risks are being managed.

The approach adopted in the FRS

- c The FRS requires both narrative and numerical disclosures. The narrative disclosures describe the role that financial instruments have in creating or changing the risks that the entity faces, including its objectives and policies in using financial instruments to manage these risks. The numerical disclosures show how these objectives and policies were implemented in the period and provide supplementary information for evaluating significant or potentially significant exposures. Together these disclosures provide a broad overview of the entity's financial instruments and of the risk positions created by them, focusing on those risks and instruments that are of greatest significance.

Narrative disclosures

- d The FRS requires an explanation to be provided of the role that financial instruments play in creating or changing the risks that the entity faces in its activities. The entity should also explain the directors' approach to managing each of those risks, including a description of the objectives, policies and strategies for holding and issuing financial instruments. Where the directors decide, before the balance sheet date, to change these objectives, policies or strategies, that change should also be explained.
- e The narrative disclosures are mandatory, although the FRS permits them to be given in a statement accompanying the financial statements (such as the operating and financial review or the directors' report) provided that they are incorporated into the financial statements by a suitable cross-reference.

Numerical disclosures

- f Although all entities within the scope of the FRS are required to provide the same type of narrative disclosures, the FRS requires different numerical disclosures for each of:
- entities that are not financial institutions
 - banks and similar institutions
 - other types of financial institution.

These different disclosures reflect differences in the significance of the main risks that arise from financial instruments.

- g The FRS requires specified numerical disclosures to be provided about:
- interest rate risk
 - currency risk
 - liquidity risk (except for banks and similar institutions, which are covered by existing requirements)
 - fair values
 - financial instruments used for trading (including, for banks and some other financial institutions, information on the market price risk of their trading book)
 - financial instruments used for hedging
 - certain commodity contracts.
- h To avoid the numerical disclosures becoming so detailed that their message is obscured, the FRS encourages, and in some cases requires, a high degree of aggregation.

Illustrations

- i Appendix III contains three illustrations of the required disclosures. The first shows the sort of information that the vast majority of companies to which the FRS applies will need to provide and the second the sort of information to be provided by companies that are more complex. The third illustration focuses on the disclosures that banks and certain other financial institutions will need to provide.

Insurance companies

- j Insurance companies are at present excluded from the scope of the FRS. This is to allow the Accounting Standards Board to consider the disclosures to be provided by insurance companies in the context of developments in insurance company accounting generally.

GUIDE TO THE FRS

The disclosures required by this FRS depend on the type of reporting entity involved. The FRS distinguishes three types of reporting entity and, for ease of reference, the requirements (and related definitions) are set out in separate parts. The three types of reporting entity, and the part of the FRS that is relevant to each, are as follows:

- | | |
|---|--------|
| • Reporting entities other than financial institutions and financial institution groups | Part A |
| • Banks and similar institutions and banking and similar groups | Part B |
| • Other financial institutions and financial institution groups. | Part C |

For convenience, Parts B and C have been printed on pink pages.

FINANCIAL REPORTING STANDARD 13

Objective

- 1 The objective of this FRS is to ensure that reporting entities within its scope provide in their financial statements disclosures that enable users to assess the entity's objectives, policies and strategies for holding or issuing financial instruments. In particular, such information should enable users to assess:
 - (a) the risk profile of the entity for each of the main financial risks that arise in connection with financial instruments and commodity contracts with similar characteristics; and
 - (b) the significance of such instruments and contracts to the entity's reported financial position, performance and cash flows, regardless of whether the instruments and contracts are on balance sheet (recognised) or off balance sheet (unrecognised).

PART A - REPORTING ENTITIES OTHER THAN FINANCIAL INSTITUTIONS AND FINANCIAL INSTITUTION GROUPS

Definitions

- 2 The following definitions shall apply in Part A of the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Capital instruments:-

All instruments that are issued by reporting entities as a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments. In the case of consolidated financial statements the term includes capital instruments issued by subsidiaries except those that are held by another member of the group included in the consolidation.

The definition set out above is taken from FRS 4 ‘Capital Instruments’.

Commodity contract and cash-settled commodity contract:-

A *commodity contract* is a contract that provides for settlement by receipt or delivery of a commodity.

A *cash-settled commodity contract* is a commodity contract (including a contract for the delivery of gold) which, though having contract terms that require settlement by physical delivery, is of a type that is normally extinguished other than by physical delivery in accordance with general market practice.

‘Commodities’ in this context means hard commodities (such as metals) and soft commodities (such as oils, grains, cocoa, coffee, cotton, soya beans

and sugar). It is not intended that cash or government securities should be treated as commodities for the purposes of the FRS.

Derivative financial instrument:-

A financial instrument that derives its value from the price or rate of some underlying item.

Underlying items include equities, bonds, commodities, interest rates, exchange rates and stock market and other indices.

Derivative financial instruments include futures, options, forward contracts, interest rate and currency swaps, interest rate caps, collars and floors, forward interest rate agreements, commitments to purchase shares or bonds, note issuance facilities and letters of credit.

Equity instrument:-

See 'Financial instrument, financial asset, financial liability and equity instrument'.

Equity shares:-

Shares other than non-equity shares.

Fair value:-

The amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Financial institution and financial institution group:-

These terms are defined in paragraph 119 of Part C.

Financial instrument, financial asset, financial liability and equity instrument:–

A *financial instrument* is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial instruments include both primary financial instruments—such as bonds, debtors, creditors and shares—and derivative financial instruments. Types of financial instruments are discussed further in Appendix II.

A *financial asset* is any asset that is:

- (a) cash;
- (b) a contractual right to receive cash or another financial asset from another entity;
- (c) a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
- (d) an equity instrument of another entity.

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

- (a) to deliver cash or another financial asset to another entity; or
- (b) to exchange financial instruments with another entity under conditions that are potentially unfavourable.

An *equity instrument* is an instrument that evidences an ownership interest in an entity, ie a residual interest in the assets of the entity after deducting all of its liabilities.

‘Equity instrument’ has a wider meaning than equity shares because it includes some non-equity shares, as well as warrants and options to subscribe for or purchase equity shares in the issuing entity.

Floating rate financial assets and financial liabilities:-

Financial assets and financial liabilities that attract an interest charge and have their interest rate reset at least once a year.

For the purposes of the FRS, financial assets and financial liabilities that have their interest rate reset less frequently than once a year are to be treated as fixed rate financial assets and financial liabilities.

Functional currency:-

The currency of the primary economic environment in which an entity operates and generates net cash flows.

SSAP 20 ‘Foreign currency translation’ uses the term ‘local currency’ rather than the term ‘functional currency’, although the definitions of the two terms are identical.

Insurance company or group:-

A company that carries on an insurance business and is regulated accordingly or an insurance group as defined in the relevant legislation.*

Non-equity shares:-

Shares possessing any of the following characteristics:

- (a) any of the rights of the shares to receive payments (whether in respect of dividends, in respect of redemption or otherwise) are for a limited amount that is not calculated by reference to the company's assets or profits or the dividends on any class of equity share.
- (b) any of their rights to participate in a surplus in a winding up are limited to a specific amount that is not calculated by reference to the company's assets or profits and such limitation had a commercial effect in practice at the time the shares were issued or, if later, at the time the limitation was introduced.
- (c) the shares are redeemable either according to their terms, or because the holder, or any party other than the issuer, can require their redemption.

* In the UK an insurance company is one to which Part II of the Insurance Companies Act 1982 applies. The equivalent reference in the Republic of Ireland is the Companies (Amendment) Act 1986 section 2(3). An insurance group is defined in Great Britain in section 255A of the Companies Act 1985 and in Northern Ireland in Article 263A of the Companies (Northern Ireland) Order 1986. In the Republic of Ireland an insurance company or group is one to which Regulation 3 of the European Community (Insurance Undertakings: Accounts) Regulations 1996 applies.

Short-term debtors and creditors:-

Financial assets and financial liabilities that meet all of the following criteria:

- (a) they would be included under one of the following balance sheet headings if the entity was preparing its financial statements in accordance with Schedule 4 to the Companies Act 1985:^{*}
 - (i) debtors;
 - (ii) prepayments and accrued income;
 - (iii) creditors: amounts falling due within one year, other than items that would be included under the 'debenture loans' and 'bank loans and overdrafts' subheadings;
 - (iv) provisions for liabilities and charges; or
 - (v) accruals and deferred income;
- (b) they mature or become payable within 12 months of the balance sheet date; and
- (c) they are not a derivative financial instrument.

^{*} in Great Britain. The equivalent legislation in Northern Ireland is Schedule 4 to the Companies (Northern Ireland) Order 1986 and in the Republic of Ireland the Schedule to the Companies (Amendment) Act 1986.

Trading in financial assets and financial liabilities:-

Buying, selling, issuing or holding financial assets and financial liabilities in order to take advantage of short-term changes in market prices or rates or, in the case of financial institutions and financial institution groups, in order to facilitate customer transactions.

Financial assets and financial liabilities bought, sold, issued or held in order to hedge the risks associated with another transaction or position are deemed to be trading in financial assets and financial liabilities only if that other transaction or position involves such trading.

Entities required to provide the disclosures set out in this part of the FRS

- 3 Part A of the FRS applies to all financial statements that are intended to give a true and fair view of the reporting entity’s financial position and profit or loss (or income and expenditure) for a period and are prepared by a reporting entity that has any of its capital instruments listed or publicly traded on a stock exchange or market, except that it does not apply:**
- (a) if the entity is:**
- (i) a financial institution or financial institution group;**
 - (ii) an entity that is applying the Financial Reporting Standard for Smaller Entities (FRSSE); or**
 - (iii) an insurance company or group.**

(b) to a parent's own financial statements when those statements are presented together with the parent's consolidated financial statements.

- 4 The term 'stock exchange or market' includes domestic and foreign exchanges and markets and it also includes markets other than the main market. It therefore includes markets such as the London and Irish Stock Exchanges, EASDAQ, NASDAQ and the Alternative Investment Market.

Instruments to be dealt with in the disclosures

Financial assets and financial liabilities to be dealt with in the disclosures

- 5 **The FRS applies to all financial assets and financial liabilities, except that those listed below are to be excluded from the disclosures (other than the currency disclosures set out in paragraphs 34-37):**

(a) interests in subsidiary, quasi-sub subsidiary and associated undertakings, partnerships and joint ventures that fall within the relevant FRS concerned with such interests, other than an interest in such entities that is held exclusively with a view to subsequent resale;*

* *Subsidiary undertakings are dealt with in FRS 2 'Accounting for Subsidiary Undertakings', quasi-sub subsidiary undertakings are dealt with in FRS 5 'Reporting the Substance of Transactions', and associated undertakings, partnerships and joint ventures are dealt with in FRS 9 'Associates and Joint Ventures'. Equity minority interests in subsidiaries and quasi-sub subsidiaries are not financial instruments and therefore also do not need to be dealt with in the disclosures.*

- (b) **employers’ obligations to employees under employee share option and employee share schemes, and any shares held in order to fulfil such obligations;**
- (c) **pension and other post-retirement benefit assets and liabilities that fall within the scope of SSAP 24 ‘Accounting for pension costs’ and UITF Abstract 6 ‘Accounting for post-retirement benefits other than pensions’;**
- (d) **rights and obligations arising under operating leases, as defined by SSAP 21 ‘Accounting for leases and hire purchase contracts’;**
- (e) **equity shares issued by the reporting entity and warrants and options on such shares issued by the reporting entity, other than those that are held exclusively with a view to subsequent resale;**
- (f) **financial assets, financial liabilities and cash-settled commodity contracts of an insurance company or group.**

Short-term debtors and creditors

- 6 An entity should exclude from all the disclosures (other than the currency disclosures set out in paragraphs 34-37) either all or none of its short-term debtors and creditors. An explanation of how such items have been dealt with should be provided.**

- 7 The main focus of the FRS is on financial instruments that are complex or play a significant medium- to long-term role in the financial risk profile of the entity. Such financial instruments do not generally include short-term debtors and creditors. The FRS therefore does not require such items to be included in the disclosures. On the other hand, some entities may regard it as useful to include such items or may find it easier to do so. Paragraph 6 therefore permits entities either to include or to exclude such items. However, in order to achieve a degree of consistency and comparability, either all such items should be excluded from all the disclosures (other than the currency disclosures) or none of the items should be excluded from any of the disclosures.

Non-equity shares issued by the reporting entity

- 8 **All non-equity shares issued by the reporting entity should be dealt with in the disclosures in the same way as its financial liabilities, except that they should be disclosed separately.**
- 9 Although all non-equity shares issued by the reporting entity are financial instruments, only some of them are financial liabilities of that entity; the rest are equity instruments. However, rather than introduce complexity into the FRS by requiring entities to categorise non-equity shares into equity instruments and financial liabilities, paragraph 8 adopts a pragmatic approach.

Commodity contracts

- 10 Similarly, although commodity contracts requiring settlement by physical delivery are not financial instruments, paragraph 64 requires some such contracts to be included in certain of the disclosures as if they were.

Disclosure of objectives, policies and strategies

- 11 The disclosures required by the FRS focus primarily on the risks that arise in connection with financial instruments (and certain similar contracts) and how they have been managed. These risks will typically include credit risk, liquidity risk, cash flow risk, interest rate risk, currency risk and other types of market price risk—all of which are discussed in greater detail in Appendix I—although the risks may be categorised in some other way.
- 12 It is envisaged, but not required, that the information provided about these risks—in other words, the disclosures required by the FRS—will usually be presented in the context of a discussion, in a statement such as the operating and financial review, of the entity’s activities, structure and financing. This discussion will typically also consider the financial risk profile of the entity as a whole, before focusing specifically on financial instruments. Such an approach enables the disclosures required by the FRS to be put into their proper context and it ensures that the disclosures required focus on the risks of greatest significance to the entity.
- 13 **An explanation should be provided of the role that financial instruments have had during the period in creating or changing the risks the entity faces in its activities. This should include an explanation of the objectives and policies for holding or issuing financial instruments and similar contracts, and the strategies for achieving those objectives—in both cases as agreed by the directors—that have been followed during the period.**

- 14 This disclosure would usually include a discussion of the nature of, and purposes for which, the main types of financial instruments and similar contracts are held or issued. Instruments used for financing, for risk management or hedging and for trading or speculation would all need to be covered, though separately from each other.
- 15 The disclosure would also typically include a description of the main financial risk management and treasury policies agreed by the directors, including the policies, quantified where appropriate, on:
- (a) the fixed/floating split, maturity profile and currency profile of financial assets and liabilities;
 - (b) the extent to which foreign currency financial assets and financial liabilities are hedged to the functional currency of the business unit concerned;
 - (c) the extent to which foreign currency borrowings and other financial instruments are used to hedge foreign currency net investments; and
 - (d) any other hedging.
- 16 If the disclosure described in paragraph 13 reflects a significant change from the explanations provided for the previous accounting period, this should be disclosed and the reasons for the change explained.**
- 17 This disclosure would include changes resulting from changes in the entity's main market price risks and from changes in the way that its exposures are managed.

- 18 If the directors agreed, before the date of approval of the financial statements, to make a significant change to the role that financial instruments will have in creating or changing the risks of the entity, that change should be explained.**
- 19 The disclosures described in paragraphs 11–17 focus on the position during and at the end of the reporting period. However, to help users in making assessments about the entity, it is also important that details are provided of any changes the directors have agreed to make during the course of the next accounting period to the role that financial instruments will have. Paragraph 18 requires such information. This disclosure is supplemented by the requirements of SSAP 17 ‘Accounting for post balance sheet events’ concerning the disclosure of certain events that occur after the balance sheet date.
- 20 An explanation should be provided of how the period-end numerical disclosures shown in the financial statements reflect the objectives, policies and strategies disclosed under paragraph 13. If the period-end position is regarded as materially unrepresentative of the entity’s position during the period or of its agreed objectives, policies and strategies, an explanation of the extent to which it is regarded as unrepresentative should be provided.**
- 21 **If an entity uses financial instruments as hedges, it should describe:**
- (a) **the transactions and risks that have been hedged, including the period of time until they are expected to occur; and**

(b) the instruments used for hedging purposes, distinguishing between those that have been accounted for using hedge accounting and those that have not.

- 22 In this context a ‘hedge’ is an instrument that individually, or with other instruments, has a value or cash flow that is expected, wholly or partly, to move inversely with changes in the value or cash flows of the position being hedged.
- 23 **The required disclosures described in paragraphs 11-22 should be given either in the financial statements or in some other statement, such as the operating and financial review, that is made available with the financial statements, provided that, if the disclosures are not included in the financial statements, they are incorporated therein by means of a cross-reference in the notes to the financial statements to the exact location of the disclosures.**

Numerical disclosures—general matters

- 24 The disclosures required by the FRS are intended to be highly summarised, which is why the FRS prescribes in some detail the offsetting and aggregation to be used. It needs to be recognised, however, that the disclosures will involve a greater degree of aggregation and more offsetting than would be appropriate for recognition purposes. For example, the currency risk disclosures require various derivative financial instruments to be offset or aggregated with other financial assets and financial liabilities and the resulting, combined figure to be analysed. Whilst such a treatment is appropriate for the purposes of that particular disclosure, it does not follow that it would be appropriate for recognition purposes.

- 25 One effect of the high degree of aggregation and offsetting required, or encouraged, by the FRS is that it may not be possible to trace the components of the disclosures back to their respective balance sheet captions. Where this is the case, it will often be helpful to provide additional detail to enable the figures to be traced back unless that additional detail would unduly complicate the disclosure.

Interest rate risk disclosures

Financial liabilities

- 26 **The aggregate carrying amount of financial liabilities should be analysed, by principal currency, to show separately those liabilities at fixed interest rates, those at floating interest rates and those on which no interest is paid. In preparing the analysis:**
- (a) **interest rate swaps, currency swaps, forward contracts and other derivative financial instruments whose effect is to alter the interest or currency basis of the financial liabilities should, as far as possible, be taken into account;**
 - (b) **any financial liabilities and derivative financial instruments that cannot be adequately reflected in the analysis should be excluded and a summary of their main effects provided instead.**
- 27 Finance lease obligations, and deep discounted bonds and similar liabilities whose finance costs are allocated in accordance with FRS 4, are not ‘financial liabilities on which no interest is paid’. Financial assets accounted for in a similar way are similarly not ‘financial assets on which no interest is earned’.

- 28 The requirement that derivative financial instruments should be taken into account in preparing the analysis means, for example, that, if the reporting entity has taken out a floating rate borrowing and has also entered into an interest rate swap that has the economic effect of replacing that floating rate borrowing with a fixed rate borrowing, the borrowing should be shown as a fixed rate borrowing in the disclosure.
- 29 The information to be provided about instruments excluded from the main analysis will need to be sufficient to enable the reader to understand their significance for the entity's interest rate risk profile, without providing excessive detail. Amongst other things, this might include disclosing, on a summarised basis:
- (a) the notional amounts of principal involved;
 - (b) the rates of interest;
 - (c) the period for which the contracts are operative; and
 - (d) the terms of any options contained within the instrument.
- 30 **The following should also be disclosed by reference to principal currency:**
- (a) **the weighted average interest rate of the fixed rate financial liabilities;**
 - (b) **the weighted average period for which interest rates on the fixed rate financial liabilities are fixed;**

(c) the weighted average period until maturity for financial liabilities on which no interest is paid; and

(d) the benchmark rate for determining interest payments for the floating rate financial liabilities.

- 31 Some entities manage the interest rate risk on their borrowings on a gross basis (in other words, without netting off cash, other liquid resources and perhaps similar items), while others manage it on a net basis. The FRS requires the interest rate risk disclosures to be prepared on a gross basis, although this does not prevent entities from showing the figures on a net basis if the difference is not material. If the difference is material but an entity still wishes to show the position on a net basis, additional information showing the net position may be included in the analysis so long as the gross position is also shown.

Financial assets

- 32 If an entity has material holdings of financial assets, the same required information as is described by paragraphs 26-31 should be provided about them.**

- 33 An entity's holdings of financial assets may include investments in equity shares and in other instruments that neither pay interest nor have a maturity date. The disclosures to be provided under paragraph 32 for such instruments will typically be limited to information about any currency exposures involved.

Currency risk disclosures

- 34 An analysis should be provided of the net amount of monetary assets and liabilities* at the balance sheet date showing the amount denominated in each currency, analysed by reference to the functional currencies of the operations involved. In preparing this analysis:**
- (a) to avoid excessive detail, the focus should be on the principal functional currencies and on the principal currencies in which the monetary items are denominated.**
 - (b) monetary assets and liabilities denominated in the same currency as the functional currency of the operations involved should not be included in the analysis.**
 - (c) if an entity has used foreign currency borrowings to finance, or provide a hedge against, foreign net investments† and the exchange gains or losses on those borrowings are included in the statement of total recognised gains and losses in accordance with SSAP 20, those borrowings should not be included in the analysis.**

* *As the currency disclosure required by the FRS is intended to reflect the reporting entity's application of SSAP 20, the terminology of SSAP 20 (ie 'monetary assets' and 'monetary liabilities') has been used instead of the FRS's usual references to financial assets and financial liabilities.*

† *Although the FRS uses the term 'foreign net investment', SSAP 20 uses two different terms to describe the same item: 'foreign equity investments' and 'net investments'.*

- (d) account should as far as possible be taken of the effect of currency swaps, forward contracts and other derivative financial instruments that contribute to the matching of foreign currency exposures and a summary should be provided of the main effect of any such financial instruments that have not been taken into account.**
- 35 The purpose of the disclosure required by paragraph 34 is to show an analysis of the currency exposures that give rise to the net currency gains and losses recognised in the profit and loss account.
- 36 The analysis will therefore need to be constructed to reflect the entity’s application of SSAP 20. SSAP 20 requires financial statements to reflect the financial results and relationships as measured in the functional currency of each operation’s financial statements before translation. This means that:
- (a) assets and liabilities denominated in the same currency as the functional currency of the entity that utilises them will not need to be remeasured using the entity’s functional currency, which is why paragraph 34(b) requires such assets and liabilities to be excluded from the analysis.
 - (b) assets and liabilities that are not denominated in the same currency as the functional currency of the entity that utilises them will need to be remeasured using the entity’s functional currency and will therefore result in translation gains and losses. Under SSAP 20, all such gains and losses, other than those referred to in paragraph 37 below, will be included in the profit and loss account. The disclosure set out in paragraph 34 focuses on the currency exposures giving rise to these gains and losses.

- (c) assets and liabilities, once expressed in the functional currency of the entity that utilises them, give rise to further differences on translation of the net investment in that currency to the reporting currency of the reporting entity. For the reasons explained in SSAP 20, this translation difference is required to be included in the statement of total recognised gains and losses, rather than the profit and loss account, and is therefore not dealt with in the analysis set out above.
- 37 Under SSAP 20, if a foreign currency borrowing qualifies as a hedge against a foreign net investment, the translation gains and losses on the foreign currency borrowing may be excluded from the profit and loss account and, instead, reported in the statement of total recognised gains and losses where they offset those on the foreign net investment. Paragraph 34(c) requires the currency exposures giving rise to such gains and losses to be excluded from the disclosure required by the FRS.

Liquidity disclosures

- 38 **A maturity profile of the carrying amount of financial liabilities should be presented, showing amounts falling due:**
- (a) **in one year or less, or on demand;**
 - (b) **in more than one year but not more than two years;**
 - (c) **in more than two years but not more than five years; and**
 - (d) **in more than five years.**

The maturity profile should be determined by reference to the earliest date on which payment can be required or on which the liability falls due.

39 In order to provide the disclosure required by paragraph 38, the maturity analyses of debt and finance lease obligations required by FRS 4 and SSAP 21 respectively could be brought together and extended. If this approach is adopted, the analyses of debt and finance lease obligations will need to be based on the carrying amounts and not, for example, on the amounts to be paid on maturity or, in the case of lease obligations, on the gross obligations before deduction of finance charges. In addition:

- (a) an analysis of the carrying amount of financial liabilities other than debt and finance lease obligations would need to be provided; and
- (b) those obligations under finance leases that are payable in the second to fifth years would need to be analysed into those that are payable in more than one year but not more than two years and those that are payable in more than two years but not more than five years.

40 An analysis of the maturity of any material undrawn committed borrowing facilities of the entity should also be provided, showing those amounts expiring:

- (a) in one year or less;**
- (b) in more than one year but not more than two years; and**
- (c) in more than two years.**

If conditions precedent are attached to a committed facility, it should be included in the analysis only if all the conditions were satisfied at the balance sheet date.

- 41 The maturity analysis of debt required by paragraphs 33-36 of FRS 4 takes into account certain committed borrowing facilities. To avoid double-counting, such facilities should not also be included in the disclosure set out in paragraph 40 above.
- 42 The adequacy of undrawn committed borrowing facilities will usually depend on a number of factors. In order to help the reader to assess the significance of the facilities, it will often be useful to provide details of the purpose and the period for which material facilities are committed and the extent to which the facilities are subject to annual review by the provider of the finance.
- 43 Although the FRS does not require a maturity analysis of financial assets, some entities may find it helpful to provide one in order to show the maturity analyses of financial liabilities and borrowing facilities in their proper context.

Fair value disclosures

- 44 **An entity should group its financial assets and financial liabilities (whether recognised or unrecognised) into appropriate categories and for each category should disclose either:**
- (a) **the aggregate fair value as at the balance sheet date together with the aggregate carrying amount; or**
 - (b) **the aggregate fair value of items with a positive fair value and, separately, the aggregate fair value of items with a negative fair value, in both cases as at the balance sheet date and in each case accompanied by the relevant aggregate carrying amount.**

- 45 Entities can choose whether to disclose a single net figure for each category of financial asset and financial liability or to disclose two ‘gross’ figures. Entities developing systems to meet this requirement need to be aware, however, that, if a subsequent FRS requires most or all financial assets and financial liabilities to be carried on the balance sheet at fair value, gross figures would then be required.
- 46 Financial assets and financial liabilities are to be grouped into appropriate categories for the purpose of disclosing fair values. It will usually help users’ understanding if those categories take into account the purpose for which each asset or liability is held or issued and the type of asset or liability involved. The categories will typically follow the same structure as—but be in more detail than—that used in discussing the objectives, policies and strategies for holding or issuing financial instruments. For example, interest rate derivatives would usually be shown separately from currency derivatives and interest rate derivatives would usually be split between interest rate swaps and instruments such as caps and collars. As it will generally be helpful to categorise like with like, financial assets would not usually be included in a category that also included financial liabilities. However, an exception to this might be that similar derivative financial instruments held or issued for the same purpose would be grouped together, regardless of whether their fair value was positive or negative.
- 47 Fair values are to be disclosed regardless of whether the financial asset or financial liability involved is held as a hedge. However, if the item is a hedge, it may be useful, in providing the fair value information, to indicate the link between the hedge and the hedged item and to explain whether the fair value of the hedged item is also disclosed.

- 48 If the estimated difference between the carrying amount of a financial asset or financial liability (or of a category of them) and its fair value is not material, the carrying amount may be used as the fair value.**
- 49 For some financial assets and financial liabilities, the historical cost carrying amount will approximate to fair value. Examples of such assets and liabilities might include debtors and creditors subject to normal trade credit terms,* other short-term financial assets and liabilities and other financial instruments (such as floating rate debt) where payments are reset to market rates at frequent intervals.
- 50 However, not all debtors and creditors will have a historical cost carrying amount that approximates to fair value. For example, the fair value of the reporting entity's own long-term fixed rate debt may be materially greater or lower than its carrying amount depending on changes in interest rates since the debt was issued. Another example may be a long-term debtor where the delay in settlement is not compensated for by interest at current market rates.
- 51 The method(s) and any significant assumptions used in determining fair value should be disclosed.**
- 52 Guidance on procedures for estimating the fair value of financial assets and financial liabilities is set out in Appendix IV.

* Such items will usually be short-term debtors and creditors and therefore—depending on whether advantage is taken of paragraph 6 of the FRS—may not need to be dealt with in the disclosures.

- 53 No fair value need be disclosed if it is not practicable for the reporting entity to estimate with sufficient reliability the fair value of any financial asset or financial liability, or category of them, that is not traded on an organised market in a standard form. In such circumstances, the following should be provided instead:**
- (a) a description of the financial asset or financial liability (or category of them) and its carrying amount.**
 - (b) the reasons why it is not practicable for the reporting entity to estimate the fair value with sufficient reliability.**
 - (c) information about the principal characteristics of the underlying financial asset or financial liability (or category of them) that is pertinent to estimating its fair value—for example the factors that determine or affect the instrument’s cash flow—and the market for such instruments. Such information need not be provided if, at the level of aggregation and date at which the information would otherwise be disclosed, its disclosure is likely, in the opinion of the directors, to be seriously prejudicial to the entity’s interests. The fact that such information has not been disclosed and the reasons for the omission should be stated.**

- 54 Before this exemption can be invoked, the entity will need to have exhausted all viable methods of estimating and disclosing a sufficiently reliable fair value.
- (a) If it is possible to estimate the range of amounts within which the fair value may lie, the requirement in paragraph 44 can be met by disclosing that range.
 - (b) If it is impracticable to estimate the fair value of individual instruments, it may be practicable to estimate the fair value of a portfolio of them. In those cases the FRS requires the fair value of the portfolio to be used.
 - (c) If it is practicable for an entity to estimate the fair value of some, but not all, of a class of financial instruments, the FRS requires the fair value of that subset to be disclosed and the disclosures described in paragraph 53 to be provided for the rest of that class.
- 55 Factors that would generally be present for the exemption described in paragraph 53 to apply include:
- (a) the financial asset or financial liability is unique and no comparable instruments exist;
 - (b) the future cash flows of the financial asset or financial liability are difficult to predict reliably; and
 - (c) a reliable valuation model is not available from internal or external sources.

- 56 Whether the exemption will need to be applied will depend on the circumstances involved. These circumstances may vary over time and, as a result, what is not practicable in one year may be practicable in another.

Disclosures about financial assets and financial liabilities held or issued for trading

- 57 **If the reporting entity trades in financial assets and financial liabilities, the following information should be provided:**
- (a) **the net gain or loss from trading in financial assets and financial liabilities that has been included in the profit and loss account during the period, analysed by type of financial instrument, business activity, risk or in such other way as is consistent with the entity's management of this activity.**
 - (b) **if the analysis provided in accordance with subparagraph (a) is other than by type of financial instrument, a description, for each line of that analysis, of the types of financial instruments involved.**
 - (c) **the period-end fair value of financial assets and, separately, of financial liabilities, held or issued for trading.**
 - (d) **if the period-end position disclosed in accordance with subparagraph (c) is regarded as materially unrepresentative of the entity's typical position during the period, the average fair value over the period of financial assets and financial liabilities held or issued for trading. The**

average fair value should be calculated using daily figures or, if the figures are not calculated daily, using the most frequent interval that an entity's systems generate for management, regulatory or other reasons.

Disclosures about hedges

- 58 Some entities use financial assets and financial liabilities as hedges to manage their risk profile. When instruments are used in this way, they are usually accounted for using hedge accounting. Under hedge accounting, changes in fair values of the hedge (referred to hereafter as 'the gain or loss on the hedge')* are usually not recognised in the profit and loss account immediately they arise. Instead, they either are not recognised at all or are recognised and carried forward in the balance sheet; then, when the hedged transaction occurs, the gain or loss on the hedge is usually either used to adjust the amount at which the hedged item is dealt with in the financial statements or recognised in the profit and loss account at the same time as the hedged item.
- 59 **The following information should be provided about gains and losses on financial assets and financial liabilities for which hedge accounting has been used:**
- (a) **the cumulative aggregate gains and losses that are unrecognised at the balance sheet date. If the item's fair value is not disclosed under the FRS, any gain or loss on the item need not be dealt with in this disclosure.**

* For ease of reference, all changes in the fair value or cash flows of financial assets and financial liabilities used as hedges are referred to in the FRS as 'gains' and 'losses'.

- (b) the cumulative aggregate gains and losses carried forward in the balance sheet at the balance sheet date, pending their recognition in the profit and loss account.**
 - (c) the extent to which the gains and losses disclosed under (a) and (b) are expected to be recognised in the profit and loss account in the next accounting period.**
 - (d) the amount of gains and losses included in the reporting period's profit and loss account that arose in previous years and were either unrecognised or carried forward in the balance sheet at the start of the reporting period.**
- 60 The disclosures described in paragraph 59(b), (c) and (d) should not include gains or losses on hedges that have been accounted for by adjusting the carrying amount of a fixed asset recognised on the balance sheet.**
- 61 Paragraph 60 is intended as a pragmatic response to the practical difficulties involved in trying to keep a record of the gains and losses on hedges that have been accounted for by adjusting the carrying amount of a fixed asset and are now being recognised in the profit and loss account through the depreciation charge. Although similar problems can arise on gains and losses accounted for by adjusting the carrying amount of other assets and liabilities, the paragraph deals only with fixed assets because that is where the difficulties are greatest.

- 62 If financial assets or financial liabilities previously accounted for as hedges are reclassified during the period and no longer accounted for as hedges and, as a result, gains and losses that arose in previous years have been recognised in the reporting period's profit and loss account, the amount of those gains and losses should be disclosed.**
- 63 Although it will be rare for an entity to reclassify instruments previously accounted for (or designated) as hedges, it may happen. Such reclassifications are accounted for in a variety of ways and paragraph 62 requires disclosure only to the extent that gains and losses that arose in previous periods are recognised, on reclassification, in the profit and loss account.

Disclosures about commodity contracts

- 64 Subject to paragraph 65, entities within the scope of this part of the FRS should treat cash-settled commodity contracts as if they were financial assets or financial liabilities for the purposes of:**
- (a) the narrative disclosures described in paragraphs 11-23;
 - (b) the fair value disclosures described in paragraphs 44-56;
 - (c) the disclosures about financial assets and financial liabilities held or issued for trading described in paragraph 57; and
 - (d) the disclosures about hedges described in paragraphs 58-63.

65 Where an entity participates in an illiquid commodity market and it can demonstrate that:

- (a)** the market is dominated by very few participants; and
- (b)** disclosure of some of the information required by paragraph 64(b), (c) or (d) at the time that its financial statements become publicly available is likely to move the market significantly and, in the directors' opinion, would be seriously prejudicial to the interests of the entity,

that part of the disclosures need not be given. The fact that such information has not been disclosed and the reasons for the omission should be stated.

Additional disclosures about market price risk

66 Entities are encouraged, but not required, to provide numerical disclosures that show the magnitude of market price risk arising over the period for all financial instruments and cash-settled commodity contracts and, if significant, all other items carrying market price risk. This information should be provided using a technique or other basis that is consistent with the way the entity manages its risk exposures. Entities that use one approach to manage market price risk in one part of their business and a different approach in another part are encouraged to provide separate disclosures for each part.

67 Entities are also encouraged to provide a discussion of their approach to market price risk so as to set the numerical information in context and to assist in its interpretation.

68 It is important to choose a disclosure approach that gives meaningful information without oversimplifying the position or inundating the user with unmanageable amounts of data. Entities are encouraged to report in ways that reflect how the risk is managed. This could involve one of the methods described below, another method or a combination of approaches.

- (a) *More details about positions at the reporting date* and perhaps activity during the period. For example, an entity with a small number of swaps might disclose for each material swap the fixed rate, the benchmark used to determine the floating rate and the maturity. However, entities that use a large number of financial instruments may find such disclosures impractical.
- (b) *Sensitivity analysis*, ie the hypothetical effects on net assets or profits of various possible changes in market prices. This might involve disclosing, for example, the effects of one percentage point and two percentage point increases and decreases in all interest rates; flattening or steepening of the yield curve; a 10 per cent increase or decrease in all or selected exchange rates; and 20 per cent changes in prices of securities held. (These amounts of change are illustrative only.) Entities providing this disclosure would usually show some of the changes in market prices that they actually use in managing or adjusting risk.

One of the limitations of sensitivity analysis is that it shows the effect of only the chosen changes in market prices; a very different effect could arise from greater or smaller changes, particularly if the instruments involve options. Another limitation is that a market price change rarely occurs in isolation. For example, a change in inflation expectations may cause changes in all of interest rates, exchange rates and equity prices, perhaps with a time delay, yet sensitivity analysis will typically show the effect of one of these changes while assuming that all other prices and rates remain unchanged. Another limitation is that sensitivity analysis takes no account of the fact that some market price changes are more likely than others.

- (c) *‘Gap’ analysis* of interest rate repricing and/or maturity dates. This approach involves analysing assets and liabilities into time bands by reference to interest rate repricing dates or maturity dates. It should be noted that gap analysis reports on interest rate risk only, is not always able to capture the effect of all options and is less useful where instruments are not all denominated in the same currency (unless separate analyses are provided for each currency).
- (d) *‘Duration’ of instruments*. This approach, which also deals only with interest rate risk, is a method of measuring sensitivity to interest rate changes. Duration is the length (in years) of a hypothetical zero coupon bond whose value would change by the same amount as that of the instrument(s) in response to a change in interest rates. A shorter duration indicates a lower level of interest rate sensitivity. This approach suffers from the same drawbacks as gap analysis.

- (e) *Value at risk.* The value at risk of a group of assets and liabilities is the expected loss that will arise on those assets and liabilities from an adverse market movement with a specified probability over a specified period of time. For example, based on a simulation of a large number of possible scenarios, an entity might determine with 95 per cent probability that any adverse change in the fair value of its financial instruments over a ten-day holding period will not exceed £N, in which case £N will be the value at risk of that group of instruments.

69 If the disclosures described in paragraph 66 are provided, they should be supplemented by:

- (a) an explanation of the method used and of the main parameters and assumptions underlying the data provided;**
- (b) an explanation of the objective of the method used and of the limitations that may result in the information not fully reflecting the market price risk of the assets and liabilities involved; and**
- (c) reasons for any material changes in the amount of reported market price risk when compared with that reported for the previous period.**

- 70 Whilst many entities, particularly financial institutions, are very interested in value at risk as a way of monitoring and managing risk, there is, as yet, no consensus on the methodology or assumptions to be used. Different methodologies and assumptions produce very different value at risk numbers. This is also true of sensitivity analysis. Requiring the disclosure of the methodology and assumptions used will put the user on notice of this fact. In the case of value at risk, for example, the details to be disclosed will usually include the holding period and confidence limits, and might also include the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used. The FRS also requires the limitations and objectives of the method used to be disclosed. This disclosure is intended to ensure that users understand that the information provided is a relative estimate of risk and not a precise and accurate number.
- 71 **If material changes are made to the method, or key assumptions and parameters, used in providing the disclosure described in paragraph 66, the reasons for the change should be given and the previous period's information should be restated using the basis adopted in the current period.**
- 72 The purpose of the requirement set out in paragraph 71 is to provide a degree of comparability between the information provided for the reporting period and the previous period. The intention is that any material change in method, assumptions or parameters that has had a significant effect on the comparability of the information should be dealt with by restating the figures for the previous period; changes that do not have such an effect do not require restatement.

Disclosure of accounting policies

- 73 SSAP 2 'Disclosure of accounting policies' requires financial statements to include clear, fair and concise explanations of all material or critical accounting policies adopted. Disclosing the accounting policies used for financial instruments is of particular importance in view of the wide variety of accounting treatments that are adopted.
- 74 In order to comply with SSAP 2, the description of accounting policies will usually need to include (if the choice of policy applied has had a material effect) a description of:
- (a) the methods used to account for derivative financial instruments, the types of derivative financial instruments accounted for under each method and the criteria that determine the method used.
 - (b) the basis for recognising, measuring (both on initial recognition and subsequently), and ceasing to recognise financial assets and financial liabilities.
 - (c) how income and expenses (and other gains and losses) are recognised and measured.
 - (d) the treatment of financial assets and financial liabilities not recognised, including an explanation of how provisions for losses are recognised on financial assets and financial liabilities that have not been recognised.
 - (e) policies on offsetting.

- 75 Where financial instruments are carried on the historical cost basis, features covered by the description of accounting policies would typically include (where the choice of policy applied has had a material effect) the treatment of:
- (a) premiums and discounts on financial assets;
 - (b) changes in the estimated amount of determinable future cash flows associated with a financial instrument, such as a debenture indexed to a commodity price;
 - (c) a fall in the fair value of a financial asset to below the asset's carrying amount; and
 - (d) restructured financial liabilities.
- 76 Where financial instruments are used as hedges and accounted for using hedge accounting, the description of accounting policies will usually need to include (if the choice of policy has had a material effect) a description of:
- (a) the circumstances in which a financial instrument is accounted for as a hedge;
 - (b) the recognition and measurement treatment applied to an instrument used as a hedge;
 - (c) the method used to account for an instrument that ceases to be accounted for as a hedge;
 - (d) the method used to account for the hedge when the underlying item or position matures, is sold, extinguished, or terminated; and
 - (e) the method used to account for the hedge of a future transaction when that transaction is no longer likely to occur.

*Amendment to FRS 4***77 FRS 4 is amended by replacing paragraph 33 with the following paragraph:**

“An analysis of the maturity of debt should be provided showing amounts falling due:

- (a) in one year or less, or on demand;
- (b) in more than one year but not more than two years;
- (c) in more than two years but not more than five years; and
- (d) in more than five years.”

78 The effect of this amendment will be to change the band into which amounts that are due exactly five years after the balance sheet date will fall. Depending on the interpretation that has been used in the past, amounts that are due exactly two years after the balance sheet date may also now be dealt with in a different band.

Date from which effective

79 The accounting practices set out in the FRS should be regarded as standard in respect of accounting periods ending on or after 23 March 1999. Earlier adoption is encouraged but not required.

80 Corresponding amounts should be disclosed for each of the disclosures required by the FRS. However, this may not be practicable in all circumstances for the first accounting period in which the FRS comes into effect. Accordingly, such disclosure is not required for that period, although it is encouraged.

PART B - BANKS AND SIMILAR INSTITUTIONS AND BANKING AND SIMILAR GROUPS

Definitions

- 81 The following definitions, in addition to those set out in paragraph 2, shall apply in Part B of the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type** in Part B.

Bank or similar institution:-

An entity that:

- (a) is authorised under the Banking Act 1987 (in the UK) or the Central Bank Acts 1942-1989 (in the Republic of Ireland); or
- (b) whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.

The purpose of subparagraph (b), which repeats the definition of credit institution contained in the First Banking Coordination Directive (77/780/EEC), is to include within the term ‘bank or similar institution’ entities such as building societies and credit unions.

Banking or similar groups:-

Groups where:

- (a) the parent company is a bank or similar institution; or
- (b) the parent company:
 - (i) does not itself carry on any material business apart from the acquisition, management and disposal of interests in subsidiary undertakings; and
 - (ii) its principal subsidiary undertakings are wholly or mainly entities that are banks or similar institutions.

Trading book and non-trading book:-

The trading book comprises all the assets and liabilities held or issued as part of the entity's trading in financial assets and financial liabilities. The assets and liabilities that are not held in a trading book are non-trading book assets and liabilities.

The trading activities of banks and similar institutions, and many other financial institutions and groups, include:

- providing financial instruments to clients (other than through traditional lending and deposit-taking activities or by granting finance leases)—ie customer facilitation
- providing liquidity to the market—ie market-making

- acting as a connecting link between different markets—ie arbitrage
- taking proprietary positions
- related hedges.

The non-trading book comprises all the assets and liabilities that are not in the trading book, including structural and strategic positions. Non-trading activities include:

- traditional lending and deposit-taking
- granting of finance leases
- asset/liability and liquidity management
- investment activity, including activity of a strategic nature
- related hedges.

Although many financial institutions and groups are already required for capital adequacy purposes to categorise their assets and liabilities into trading book items and non-trading book items, the FRS does not require assets and liabilities to be categorised for its purposes in exactly the same way as for the purposes of the Capital Adequacy Directive (93/6/EEC).

Entities required to provide the disclosures set out in this part of the FRS

- 82 **Part B of the FRS applies to all financial statements that are intended to give a true and fair view of the reporting entity's financial position and profit or loss (or income and expenditure) for a period and are prepared by a reporting entity that is a bank or similar institution or a banking or similar group, except that it does not apply to a parent's own financial statements when those statements are presented together with the parent's consolidated financial statements.**

Instruments to be dealt with in the disclosures

- 83 **The instruments to be dealt with in the disclosures set out in this part of the FRS are those referred to in paragraphs 5-10, except that:**
- (a) in paragraphs 5 and 6 the references to paragraphs 34-37 shall be taken to refer to paragraphs 90-97; and**
 - (b) in paragraph 10 the reference to paragraph 64 shall be taken to refer to paragraphs 113 and 114; and**
 - (c) financial assets and financial liabilities arising from traditional lending and deposit-taking activities shall not be treated as falling within the meaning of the term 'short-term debtors and creditors'.**

Disclosure of objectives, policies and strategies

- 84 **Entities within the scope of this part of the FRS should provide the required disclosures, after taking into account the explanations, set out in paragraphs 11-23.**

Numerical disclosures—general matters

- 85 Paragraphs 24 and 25 are also relevant in the context of the numerical disclosures required in this part of the FRS.

Interest rate risk disclosures

- 86 Interest rate risk may arise both on the trading book and on the non-trading book. The disclosures set out in paragraphs 87-89 focus on the interest rate exposures arising from the non-trading book; interest rate risk arising from the trading book is dealt with in the trading book disclosures described in paragraphs 104-111.
- 87 **A table should be provided showing the aggregate carrying amounts of assets and liabilities in the non-trading book, analysed by category of asset and liability and, within those categories, into time bands. In this analysis:**
- (a) **items should be allocated to time bands by reference to the earlier of the next interest rate repricing date and the maturity date.**
 - (b) **the time bands used should include at least the following:**
 - (i) **three months or less;**

- (ii) more than three months but not more than six months;**
 - (iii) more than six months but not more than one year;**
 - (iv) more than one year but not more than five years; and**
 - (v) more than five years.**
- (c) the analysis should show the net position for each time band.**
- (d) account should as far as possible be taken of derivative financial instruments whose effect is to alter the interest basis of non-trading book assets and liabilities. Those that cannot be adequately reflected in the analysis should be excluded and a summary of their main effect provided instead.**

88 A significant dimension of interest rate risk is the currency in which assets and liabilities are denominated. For example, a floating rate asset and a floating rate liability denominated in different currencies will not appear, from the table required by paragraph 87, to create an interest rate sensitivity gap if their current sterling equivalent and repricing dates are the same. There may, however, be substantial interest rate risk exposure if one item is denominated in the currency of a country with high and fluctuating interest rates while the other is denominated in the currency of a country with low and stable interest rates. In such circumstances, entities are encouraged to incorporate details of the currency of denomination in the table.

- 89 The information provided on derivative financial instruments not taken into account in the table described in paragraph 87 will need to be sufficient to enable the reader to understand the significance of such instruments for the entity's non-trading book interest rate risk, without providing excessive detail. Amongst other things, this might include disclosing, on a summarised basis:
- (a) the notional amounts of principal involved;
 - (b) the period for which the instruments are operative;
 - (c) the main potential effect of the instruments on information provided in the analysis described in paragraph 87; and
 - (d) terms of any options contained within the instruments.

Currency risk disclosures

- 90 Viewed from the same perspective as that adopted in SSAP 20, the currency risk exposure of banks and similar institutions comprises three elements:
- (a) the structural currency exposures that arise from the entity's foreign equity investments as mitigated by the foreign currency borrowings taken out to finance or hedge such investments.
 - (b) the currency exposures arising on the monetary assets and monetary liabilities held in the non-trading book.
 - (c) the currency exposures that arise on the monetary assets and monetary liabilities held in the trading book.

- 91 The currency exposures that arise on the trading book are dealt with in the trading book disclosures set out in paragraphs 104-111. The other currency exposures are dealt with in the disclosures described in paragraphs 92-97, which will need to be constructed to reflect the entity's application of SSAP 20.
- 92 **The entity should provide an analysis of its foreign net investments:***
- (a) **by reference to the principal functional currencies involved; and**
- (b) **showing the extent to which such investments are financed or hedged by foreign currency borrowings that qualify under SSAP 20 as hedges of those investments.**
- 93 This disclosure focuses on the entity's structural currency exposures. These exposures arise because the entity's operations involve functional currencies other than its reporting currency. As a result, the entity will need to translate the foreign currency denominated results and foreign currency net assets of subsidiaries, branches and associates into its reporting currency. This gives rise to translation gains and losses which, under SSAP 20, are recognised in the statement of total recognised gains and losses.
- 94 To mitigate the effect of such exposures, the reporting entity may take out foreign currency borrowings to finance or hedge its foreign net investments. Under SSAP 20, if these borrowings meet certain criteria, the gains and losses on the borrowing can be offset against the translation gains and losses on the foreign net investments.

* Although the FRS uses the term 'foreign net investment', SSAP 20 uses two different terms to describe the same item: 'foreign equity investments' and 'net investments'.

- 95 **An analysis should be provided of the net amount of monetary assets and liabilities* in the non-trading book at the balance sheet date showing the amount denominated in each principal currency, analysed by reference to the principal functional currencies of the operations involved. The analysis should not, however, include:**
- (a) monetary assets and liabilities denominated in the same currency as the functional currency of the operations involved; and**
 - (b) those foreign currency borrowings referred to in paragraph 92(b).**
- 96 This disclosure focuses on the currency exposures on the monetary items in the entity's non-trading book. Many banks and similar institutions transfer all their currency risk arising from the commercial banking/lending activities to their trading book. If there are no remaining currency exposures in the non-trading book—or if the remaining exposures are immaterial—the disclosure set out in paragraph 95 will not need to be given. In such circumstances it will often be helpful to explain why no disclosures have been provided.

* As the currency disclosure required by the FRS is intended to reflect the entity's application of SSAP 20, the terminology of SSAP 20 (ie 'monetary assets' and 'monetary liabilities') has been used instead of the FRS's usual references to financial assets and financial liabilities.

- 97 In preparing the disclosures set out in paragraphs 92 and 95, account should as far as possible be taken of the effect of currency swaps, forward contracts and other derivative financial instruments that contribute to the matching of currency exposures and a summary should be provided of the main effect of any such instruments that have not been taken into account.**

Fair value disclosures

- 98 The disclosures required by paragraphs 101 and 102 should be provided in respect of:**
- (a) all financial assets and financial liabilities held in the trading book; and**
 - (b) the following financial assets and financial liabilities held in the non-trading book:**
 - (i) all derivative financial instruments;**
 - (ii) all listed and/or publicly traded securities; and**
 - (iii) any other financial asset or financial liability for which a liquid and active market exists, either for the asset or liability itself or for its component parts,**
- regardless of whether they are recognised or unrecognised.**

- 99 For the purposes of paragraph 98(b)(iii), a market for a financial asset (or financial liability) is liquid and active if all of the following apply:
- (a) assets (or liabilities) of the same type are regularly traded on the market.
 - (b) the price determined from the market (by reference to, for example, quoted prices or last traded prices) is a reliable indicator of the price that would be obtained if some or all of the asset (or liability) was actually sold in the market in normal market conditions.
 - (c) there are willing buyers and sellers in the market at all times during normal business hours at the price referred to in subparagraph (b).
- 100 As markets are evolving rapidly, the fact that a liquid and active market does not exist for an item at present does not mean that such a market will not exist in the future.
- 101 **The financial assets and financial liabilities referred to in paragraph 98 should be grouped into appropriate categories of trading book and non-trading book items and, for each category, the reporting entity should disclose either:**
- (a) **the aggregate fair value as at the balance sheet date, together with the aggregate carrying amount; or**
 - (b) **the aggregate fair value of items with a positive fair value and, separately, the aggregate fair value of items with a negative fair value, in both cases as at the balance sheet date and in each case accompanied by the relevant aggregate carrying amount.**

- 102 **Entities within the scope of this part of the FRS should also provide the required disclosures, after taking into account the explanations, set out in paragraphs 45-52.**

Disclosures about financial assets and financial liabilities held or issued for trading

- 103 **Entities within the scope of this part of the FRS should provide the disclosures required by paragraph 57.**

- 104 **Subject to paragraph 111, the entity should disclose the highest, lowest and average exposure of its trading book to market price risk during the reporting period, together with the exposure at the balance sheet date, using at least one of the following methods:**

(a) **The value at risk of the trading book as a whole.**

(b) **Sensitivity analysis showing the potential effect on earnings or net assets of selected hypothetical changes in market prices and rates. In this analysis:**

(i) **separate disclosures should be provided for each type of market price risk; and**

(ii) **the hypothetical changes used should be reasonably possible during the twelve months following the date on which the financial statements are approved by the directors. Furthermore, one of these hypothetical changes should be a fall of at least 10 per cent in the period-end market prices or rates unless such a fall can be shown not to be reasonably possible.**

- (c) **Some other market price risk measure, but only if:**
- (i) **the entity’s management uses the model from which the measure has been derived for the purpose of managing the market price risk of the trading book; and**
 - (ii) **the entity’s model has been approved by the entity’s prudential regulator for the purpose of providing that regulator with capital adequacy returns on the entity.**

105 Value at risk and sensitivity analysis are discussed further in paragraph 68. Although value at risk is generally regarded at present as the most sophisticated means available for measuring market price risk, in time to come risk management models may well be developed that are then regarded as more sophisticated than value at risk. The purpose of paragraph 104(c) is to allow for this possibility by permitting the use of unspecified models that have gained the approval of, inter alia, the prudential regulator.

106 Although a separate value at risk figure could be calculated for each type of market price risk to which the trading book is exposed, such a disclosure would not take account of the extent to which different market prices (such as interest rates and exchange rates) move together. The FRS therefore requires disclosure of a single value at risk figure that encapsulates the total market price risk of all kinds to which the entity’s trading book is exposed. This is not practicable with sensitivity analysis, which is why paragraph 104(b)(i) requires separate disclosures for each type of market price risk.

- 107 If one of the methods described in paragraph 104 is used to provide disclosures, those disclosures should be supplemented by the following:**
- (a) an explanation of the method used and of the main parameters and assumptions underlying the data provided.**
 - (b) an explanation of the objective of the method used and of the limitations that may result in the information not fully reflecting the market price risk of the trading book.**
 - (c) the frequency with which the figures were calculated when determining the highest, lowest and average figures for the period. This should, as a minimum, be the frequency at which the figures are calculated for risk management purposes. However, if those figures are calculated more frequently than daily, it will be sufficient to use daily figures for the purposes of the disclosure.**
 - (d) reasons for any material changes in the amount of reported market price risk when compared with that reported for the previous period.**
- 108 If material changes are made to the method, or the main assumptions and parameters, used in providing the disclosure required by paragraph 104, the reasons for the change should be given and the previous period's balance sheet date information should be restated using the basis adopted in the current period.**

- 109 The purpose of the requirement described in paragraph 108 is to provide a degree of comparability between the trading book information provided for the reporting period and for the previous period. The requirement refers to the restatement of balance sheet date information only, rather than also to the highest, lowest and average information required by paragraph 104, in order to avoid imposing a burden on those entities that might find such restatement particularly burdensome. However, entities are encouraged to restate all the information provided in respect of the previous period wherever possible.
- 110 The intention is that any material change in method, assumptions or parameters that has had a significant effect on the comparability of the information should be dealt with by restating the balance sheet date figures for the previous period; changes that do not have a significant effect on the comparability of the information do not require such restatement.
- 111 **If none of the methods described in paragraph 104 is used by the entity to manage the market price risk of its trading book, the entity may provide, instead of the disclosures required by that paragraph, trading book disclosures in the format described for the non-trading book in paragraphs 87-89 and 95-97. Such disclosures should be provided separately from those for the non-trading book.**

Disclosures about hedges

- 112 **Entities within the scope of this part of the FRS should provide the required disclosures, taking into account the explanations, set out in paragraphs 58-63.**

Disclosures about commodity contracts

- 113 Subject to the exemption referred to in paragraph 114, entities within the scope of this part of the FRS should treat cash-settled commodity contracts and all other contracts for the delivery of gold as if they were financial assets or financial liabilities for the purposes of:**
- (a) the narrative disclosures required by paragraph 84;**
 - (b) the required fair value disclosures described in paragraphs 98-102;**
 - (c) the required disclosures, about financial assets and financial liabilities held or issued for trading, described in paragraphs 103-111; and**
 - (d) the disclosures about hedges required by paragraph 112.**
- 114 The exemption given by paragraph 65 applies also to entities required to provide the disclosures set out in this part of the FRS except that, in paragraph 65(b), the reference to paragraph 64(b), (c) and (d) shall be taken to refer to paragraph 113(b), (c) and (d).**

Additional disclosures about market price risk

- 115 Entities within the scope of this part of the FRS are encouraged to disclose the information described in paragraphs 66-68. If they do so, they should also provide the required disclosures, after taking into account the explanations, set out in paragraphs 69-72.**

Disclosure of accounting policies

- 116 Paragraphs 73–76 are of relevance also to entities required to provide the disclosures set out in this part of the FRS.

Amendment to FRS 4

- 117 **The amendment to FRS 4 described in paragraphs 77 and 78 applies also in the context of entities within the scope of this part of the FRS.**

Date from which effective

- 118 **Paragraphs 79 and 80, which set out the date from which the FRS is to take effect and refer to the need for corresponding amounts to be disclosed, apply also to entities within the scope of this part of the FRS.**

PART C - FINANCIAL INSTITUTIONS AND FINANCIAL INSTITUTION GROUPS, OTHER THAN BANKS AND SIMILAR INSTITUTIONS AND BANKING AND SIMILAR GROUPS

Definitions

- 119 The following definitions, in addition to those set out in paragraphs 2 and 81, shall apply in Part C of the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Financial institution:-

An entity whose principal activity is to carry on one or more of the following activities:

- (a) acceptance of deposits and other repayable funds from the public.
- (b) lending.
- (c) financial leasing.
- (d) money transmission services.
- (e) issuing and administering means of payment (eg credit cards, travellers' cheques and bankers' drafts).
- (f) guarantees and commitments.
- (g) trading for own account or for account of customers, or investing for own account, in:

- (i) money market instruments (cheques, bills, certificates of deposit, etc).
- (ii) foreign exchange.
- (iii) financial futures and options.
- (iv) exchange and interest rate instruments.
- (v) transferable securities.
- (h) participation in share issues and the provision of services related to such issues.
- (i) advice to undertakings on capital structure, industrial strategy, and related questions and advice and services relating to mergers and the purchase of undertakings.
- (j) money broking.
- (k) portfolio management and advice.
- (l) safekeeping and administration of services.

The definition set out above is based on the definition of financial institution contained in the Second Banking Coordination Directive (89/646/EEC), although it has been extended slightly to include—primarily through the inclusion of subparagraph (a)—banks and similar institutions (as defined in the FRS) and—through the inclusion of the phrase ‘investing for own account’ in subparagraph (g)—investment vehicles such as investment trusts and unit trusts.

Financial institution group:-

A group where:

- (a) the parent company is a financial institution; or
- (b) the parent company:
 - (i) does not itself carry on any material business apart from the acquisition, management and disposal of interests in subsidiary undertakings; and
 - (ii) its principal subsidiary undertakings are wholly or mainly entities that are financial institutions.

Entities required to provide the disclosures set out in this part of the FRS

120 Part C of the FRS applies to all financial statements that are intended to give a true and fair view of the reporting entity's financial position and profit or loss (or income and expenditure) for a period and are prepared by a reporting entity that is a financial institution or financial institution group and has any of its capital instruments listed or publicly traded on a stock exchange or market, except that it does not apply:

- (a) if the entity is:
 - (i) a bank or similar institution or a banking or similar group; or
 - (ii) an entity that is applying the Financial Reporting Standard for Smaller Entities (FRSSE).

- (b) to a parent’s own financial statements when those statements are presented together with the parent’s consolidated financial statements.

Instruments to be dealt with in the disclosures

- 121 The instruments to be dealt with in the disclosures set out in this part of the FRS are those referred to in paragraphs 5-10, except that:
- (a) in paragraphs 5 and 6 the references to paragraphs 34-37 shall be taken to refer to paragraphs 34-37 or 90-97 (as applicable);
 - (b) in paragraph 10 the reference to paragraph 64 shall be taken to refer to paragraph 64 or 113 (as applicable); and
 - (c) financial assets and financial liabilities arising from traditional lending and deposit-taking activities shall not be treated as falling within the meaning of the term ‘short-term debtors and creditors’.

Disclosure of objectives, policies and strategies

- 122 Entities within the scope of this part of the FRS should provide the required disclosures, after taking into account the explanations, set out in paragraphs 11-23.

Numerical disclosures—general matters

- 123 Paragraphs 24 and 25 are relevant also in the context of the numerical disclosures required in this part of the FRS.

Interest rate and currency risk disclosures

- 124 **Entities within the scope of this part of the FRS should:**
- (a) **provide all the required disclosures, after taking into account the explanations, set out in paragraphs 26-37; or**
 - (b) **provide all the required disclosures, after taking into account the explanations, set out in paragraphs 86-97.**

Liquidity disclosures

- 125 **Entities within the scope of this part of the FRS should provide the required disclosures, after taking into account the explanations, set out in paragraphs 38-43.**
- 126 Paragraph 43 will often be of particular relevance to entities providing the disclosures set out in this part of the FRS.

Fair value disclosures

- 127 **Entities within the scope of this part of the FRS should provide the required disclosures, after taking into account the explanations, set out in paragraphs 44-56.**

Disclosures about financial assets and financial liabilities held or issued for trading

- 128 **Entities within the scope of this part of the FRS should provide the disclosures required by paragraph 57. Furthermore, if they provide the disclosures required by paragraphs 86-97, they should also provide the required disclosures, after taking into account the explanations, set out in paragraphs 104-111.**

Disclosures about hedges

- 129 **Entities within the scope of this part of the FRS should provide the required disclosures, after taking into account the explanations, set out in paragraphs 58–63.**

Disclosures about commodity contracts

- 130 **Subject to the exemption referred to in paragraph 131, entities within the scope of this part of the FRS should treat cash-settled commodity contracts and all other contracts for the delivery of gold as if they were financial assets or financial liabilities for the purposes of:**
- (a) the narrative disclosures required by paragraph 122;**
 - (b) the fair value disclosures required by paragraph 127;**
 - (c) the disclosures, about financial assets and financial liabilities held or issued for trading, required by paragraph 128; and**
 - (d) the disclosures about hedges required by paragraph 129.**
- 131 **The exemption given by paragraph 65 applies also to entities required to provide the disclosures set out in this part of the FRS except that, in paragraph 65(b), the reference to paragraph 64(b), (c) or (d) shall be taken to refer to paragraph 130(b), (c) or (d).**

Additional disclosures about market price risk

- 132 Entities within the scope of this part of the FRS are encouraged to disclose the information described in paragraphs 66-68. If they do so, they should also provide the required disclosures, after taking into account the explanations, set out in paragraphs 69-72.**

Disclosure of accounting policies

- 133 Paragraphs 73-76 are of relevance also to entities required to provide the disclosures set out in this part of the FRS.

Amendment to FRS 4

- 134 The amendment to FRS 4 described in paragraphs 77 and 78 applies also in the context of entities within the scope of this part of the FRS.**

Date from which effective

- 135 Paragraphs 79 and 80, which set out the date from which the FRS is to take effect and refer to the need for corresponding amounts to be disclosed, apply also to entities within the scope of this part of the FRS.**

ADOPTION OF FRS 13 BY THE BOARD

Financial Reporting Standard 13 - ‘Derivatives and other Financial Instruments: Disclosures’ was approved for issue by the ten members of the Accounting Standards Board.

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Raymond Hinton

Huw Jones

Professor Geoffrey Whittington

Ken Wild

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APPENDIX I

TYPES OF RISK ARISING FROM FINANCIAL INSTRUMENTS

- 1 The two most familiar risks arising from financial instruments are credit risk and liquidity risk. These risks can be defined as follows:

Credit risk – *the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract.*

Liquidity risk (also referred to as *funding risk*) – *the risk that an entity will encounter difficulty in realising assets or otherwise raising funds to meet commitments associated with financial instruments.*

- 2 These risks are generally well understood and traditionally have been the main focus of what little disclosure on risk has appeared in financial statements. For example, some information about credit risk can be obtained from the nature of an entity's business and the numerical disclosures of debtors and provisions. Similarly, the disclosure of the terms and conditions of borrowings and broad indicators, such as the current ratio and quick assets ratio, provide some information about liquidity risk.

- 3 However, financial instruments also entail two other important types of risk—cash flow risk and market price risk. These can be defined as follows:

Cash flow risk – *the risk that future cash flows generated by a monetary financial instrument will fluctuate in amount.*

Market price risk – *the possibility that future changes in market prices may change the value, or the burden, of a financial instrument.*

The main components of market price risk likely to affect most entities are:

Interest rate risk – *the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.*

Currency risk – *the risk that the value of a financial instrument will fluctuate because of changes in foreign exchange rates.*

Other market price risk – *the risk that the value of a financial instrument will fluctuate as a result of changes in market prices caused by factors other than interest rates or currencies. This category includes risks stemming from commodity prices and share prices.*

- 4 Typically, information in financial statements on these risks has been scant and lacking a focus. For example, in the case of borrowings and interest-bearing assets, the fact that market price risk and cash flow risk are diametrically opposed is rarely mentioned, yet the relationship between the two has a significant impact on the risk profile. A fixed rate interest-earning asset exposes an entity to a change in the market value of the asset as a consequence of a change in market rates of interest ('market price risk') but, as the entity is not exposed to a change in future cash flow arising from interest rate changes, credit risk aside it has no cash flow risk. By contrast, a floating rate asset exposes an entity to a change in future cash flow if interest rates change ('cash flow risk' of reduced or increased cash receipts) but, aside from credit risk, has no risk of a gain or loss due to a change in the market value of that asset ('market price risk').
- 5 Depending on management's attitude to these particular risks, transactions may be undertaken to reduce one of the risks at the expense of increasing the other. Consequently, the choice of which risk it seeks to reduce will have an important bearing on the entity's financial position, financial results and cash flows.

APPENDIX II

EXAMPLES APPLYING THE DEFINITION OF A FINANCIAL INSTRUMENT

The examples set out in this appendix are intended to clarify the meaning of the FRS but do not form part of it.

The FRS does not deal with the recognition or measurement of financial instruments. Therefore, although certain recognition and measurement practices have been assumed in this appendix in order to illustrate various points, the FRS does not require their use.

General principles

- 1 As defined in the FRS, a financial instrument is a contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.
 - (a) A financial asset is any asset that is cash, a contractual right of an entity to receive a financial asset from another entity, a contractual right of an entity to exchange financial instruments with another entity under conditions that are potentially favourable or an equity instrument of another entity.
 - (b) A financial liability is any liability that is a contractual obligation to deliver a financial asset to another entity or to exchange financial instruments with another entity under conditions that are potentially unfavourable.

- 2 Although the definitions of a financial asset and a financial liability include the terms ‘financial asset’ and ‘financial instruments’, the definitions are not circular. When there is a contractual right or obligation to exchange financial instruments, the instruments to be exchanged give rise to financial assets, financial liabilities, or equity instruments. A chain of contractual rights or obligations may be established but it ultimately leads to the receipt or payment of cash or to the acquisition or issue of an equity instrument.
- 3 As more fully explained in the paragraphs below, these definitions mean that the following are financial instruments:
 - (a) deposits, debtors, creditors, notes, loans, bonds, and debentures to be settled in cash.
 - (b) unconditional lease obligations.
 - (c) shares, including ordinary shares, preference shares and deferred shares.
 - (d) warrants or options to subscribe for shares of, or purchase shares from, the issuing entity.
 - (e) obligations of an entity to issue or deliver its own shares, such as a share option or warrant.
 - (f) derivative financial instruments such as forward contracts, futures, swaps and options that will be settled in cash or another financial instrument. An example of the latter is an option to purchase shares.
 - (g) contingent liabilities that arise from contracts and, if they crystallise, will be settled in cash—an example is a financial guarantee.

- 4 Similarly, the definitions mean, again as more fully explained in the paragraphs below, that the following are not financial instruments:
- (a) physical assets, such as stock, property, plant and equipment.
 - (b) intangible assets, such as patents and trade marks.
 - (c) prepayments for goods or services, since these will not be settled in cash or another financial instrument.
 - (d) obligations to be settled by the delivery of goods or the rendering of services, such as most warranty obligations.
 - (e) income taxes (including deferred tax), since these are statutory rather than contractual obligations.
 - (f) forwards, swaps and options to be settled by the delivery of goods or the rendering of services.
 - (g) contingent items that do not arise from contracts, for example a contingent liability for a tort judgment.
 - (h) the minority interest that arises on consolidating a subsidiary that is not wholly-owned.

Contracts and contractual rights

- 5 The terms ‘contract’, ‘contractual right’ and ‘contractual obligation’ are fundamental to the definition of financial instrument, financial asset and financial liability. Paragraphs 6–10 below explain how these terms are to be applied in the context of the definitions in the FRS.

- 6 The reference to a ‘contract’ is to an agreement between two or more parties that has clear economic consequences and which the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
- 7 Contractual rights and contractual obligations are rights and obligations that arise out of a contract. Assets and liabilities that are not contractual in nature are not financial assets or financial liabilities. For this reason, tax liabilities, which arise not from a contract but from statutory requirements imposed by governments, are not financial liabilities.
- 8 Most contracts give rise to a variety of rights and obligations, and the rights and obligations arising from a contract will often change or be added to as the contract is performed. Some of these rights and obligations may fall within the definition of a financial instrument and some may not. For example, an unperformed contract for the purchase or sale of a tangible asset usually gives rise to rights and obligations to exchange a physical asset for a financial asset (although it is possible that, if the contract is breached, the exchange will involve the payment of compensation). These rights and obligations do not represent a financial instrument. Under the same contract, once the physical asset has been delivered, a debtor or creditor will usually arise and this will be a financial instrument. A contract that, at some point in its performance, gives rise to rights and obligations that are financial assets and financial liabilities will, however, not be a financial instrument until those particular rights and obligations arise and it will cease to be a financial instrument when those rights and obligations no longer exist.

- 9 'Contractual rights' and 'contractual obligations' encompass both rights and obligations that are contingent on the occurrence of a future event and those that are not. Examples of contingent rights and obligations are those arising under a financial guarantee. Such a guarantee meets the definition of a financial instrument since it gives rise to both a liability for the guarantor (the contractual obligation to pay the lender if the borrower defaults) and an asset for the lender (the contractual right to receive cash from the guarantor if the borrower defaults).
- 10 Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:
- (a) trade debtors and creditors;
 - (b) notes receivable and payable;
 - (c) bonds held or issued; and
 - (d) other debt instruments held or issued.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive), meaning that each case is an example of a financial instrument.

Cash and bank deposits

- 11 Cash, including foreign currency, is a financial asset because it represents the medium of exchange and is the basis on which all transactions are measured and reported in financial statements.

- 12 Cash deposited in banks and other institutions is a financial instrument of both the depositors and the deposit-takers. The depositors have a contractual right to receive currency, and the deposit-takers have a contractual obligation to deliver cash.

Stocks, plant, equipment, patents and trade marks

- 13 Although control of tangible assets, such as stocks, plant and equipment, and intangible assets, such as patents and trade marks, creates an opportunity to generate an inflow of cash or other assets, it does not give rise to a present contractual right to receive cash or other financial assets. Such assets are therefore not financial assets.

Prepayments

- 14 Assets, such as prepayments, for which the future economic benefit is the receipt of goods rather than a financial asset are not financial assets.

Provisions

- 15 Some provisions are financial liabilities and some are not: it will depend on the nature of the obligation (ie whether it is contractual) and how that obligation is to be met (ie whether it will be met by the transfer of cash or other financial assets).
- (a) Most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset. However, where a warranty involves a contractual obligation to pay compensation (for example, to cover the cost of a repair by an approved supplier), the provision will be a financial liability because the contractual obligation relates to the transfer of cash.

- (b) Usually provisions for redundancy costs will not initially involve a contractual obligation to pay cash and, as such, will not be a financial liability. Similarly, many provisions to cover the cost of making good environmental damage will not initially involve contractual obligations.

Lease obligations

- 16 Under SSAP 21 'Accounting for leases and hire purchase contracts', a finance lease contract is regarded as a contract for payments that are substantially the same as those under a loan agreement. In other words, the finance lease is accounted for as a sale with delayed payment terms. A finance lease is therefore a financial instrument.
- 17 An operating lease, on the other hand, is regarded under SSAP 21 as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor therefore continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, the only operating lease assets and liabilities recognised in accordance with SSAP 21 that are financial instruments are the individual payments currently due and payable. However, some of the rights and obligations in respect of future payments that arise from certain types of operating lease are financial instruments even though they are not at present recognised in financial statements. To avoid unnecessary complexity, such financial instruments are excluded from the scope of the FRS.

Derivative financial instruments

- 18 A derivative is a contract that derives its value from the price or rate of an underlying item such as equities, bonds, commodities, interest rates, exchange rates and stock market and other indices. A derivative financial instrument is a derivative that is also a financial instrument.
- 19 On inception, derivative financial instruments give one party a contractual right to exchange financial assets with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets with another party under conditions that are potentially unfavourable. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative financial instrument, those terms may become either favourable or unfavourable as prices in financial markets change.
- 20 A put or call option to exchange financial instruments gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instruments underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instruments. The contractual right of the holder and the obligation of the writer meet the definition of a financial asset and a financial liability respectively.

- 21 An example of a derivative that is not a financial instrument is an option to buy or sell an asset other than a financial asset (such as a commodity). Such an option does not give rise to a financial asset or financial liability because it does not fit the requirements of the definitions for the receipt or delivery of financial assets or exchange of financial instruments.

APPENDIX III

ILLUSTRATIONS OF THE DISCLOSURES

The following illustrations are provided for general guidance only and do not form part of the FRS.

The illustrations are intended to show the kind of information that could result from the application of the disclosures described in the Statement of Standard Accounting Practice contained in the FRS. They should not be taken as suggesting policies that companies should adopt.

The appendix contains three illustrations:

- *Illustration 1 shows the sort of information that the majority of companies will need to provide to comply with the FRS.*
- *Illustration 2 is for a more complex company.*
- *Illustration 3 shows an example of some of the information that a bank or similar institution will need to provide to comply with the FRS.*

The paragraph numbers in the side-headings and footnotes refer to paragraphs in the FRS.

ILLUSTRATION 1

A SIMPLER COMPANY

Narrative disclosures (paragraphs 11-23)

For the purposes of this illustration, it has been assumed that the narrative disclosures are provided in the operating and financial review. As such, the notes to the financial statements will need to contain a cross-reference to the disclosures below. This cross-reference is not shown in this illustration.

It is envisaged that the discussion set out below will usually be preceded by a general discussion of, inter alia, the entity's activities, structure and financing. This discussion will typically consider the financial risk profile of the entity as a whole as a prelude to the narrative disclosures required by the FRS.

The Group's financial instruments, other than derivatives, comprise borrowings, some cash and liquid resources, and various items, such as trade debtors, trade creditors etc, that arise directly from its operations. The main purpose of these financial instruments is to raise finance for the Group's operations.

The Group also enters into derivatives transactions (principally interest rate swaps and forward foreign currency contracts). The purpose of such transactions is to manage the interest rate and currency risks arising from the Group's operations and its sources of finance.

It is, and has been throughout the period under review, the Group's policy that no trading in financial instruments shall be undertaken.

The main risks arising from the Group's financial instruments are interest rate risk, liquidity risk and foreign currency risk. The Board reviews and agrees policies for managing each of these risks and they are summarised below. These policies have remained unchanged since the beginning of 19X0.

Interest rate risk

The Group finances its operations through a mixture of retained profits and bank borrowings. The Group borrows in the desired currencies at both fixed and floating rates of interest and then uses interest rate swaps to generate the desired interest profile and to manage the Group's exposure to interest rate fluctuations. The Group's policy is to keep between 50 per cent and 65 per cent of its borrowings at fixed rates of interest. At the year-end, 62 per cent of the Group's borrowings were at fixed rates after taking account of interest rate swaps.

Liquidity risk

As regards liquidity, the Group's policy has throughout the year been that, to ensure continuity of funding, at least 50 per cent of its borrowings should mature in more than five years. At the year-end, 57 per cent of the Group's borrowings were due to mature in more than five years.

Short-term flexibility is achieved by overdraft facilities.

Foreign currency risk

The Group has one significant overseas subsidiary—Foreign—which operates in the USA and whose revenues and expenses are denominated exclusively in US dollars. In order to protect the Group's sterling balance sheet from the movements in the US dollar/sterling exchange rate, the Group finances its net investment in this subsidiary by means of US dollar borrowings.

About one-third of the sales of the Group's UK businesses are to customers in continental Europe. These sales are priced in sterling but invoiced in the currencies of the customers involved. The Group's policy is to eliminate all currency exposures on sales at the time of sale through forward currency contracts. All the other sales of the UK businesses are denominated in sterling.

Numerical information (Notes to the accounts)

Although not shown in this illustration, an explanation of the material accounting policies adopted in accounting for financial instruments will need to be provided. The Group would also need to explain that it has taken advantage of the exemption available for short-term debtors and creditors.

The accounting period dealt with in this illustration is the 12 months to 31 December 19X1. Although corresponding amounts are not shown in the illustration, they will need to be provided except in respect of the first accounting period in which the FRS comes into effect.

Interest rate risk profile of financial assets and financial liabilities (paragraphs 26–33)

Financial assets

The Group has no financial assets, other than short-term debtors and an immaterial amount of cash at bank.

Financial liabilities

After taking into account the various interest rate swaps and forward foreign currency contracts entered into by the Group, the interest rate profile of the Group's financial liabilities at 31 December 19X1 was:

Currency	Total	Floating rate financial liabilities	Fixed rate financial liabilities	Financial liabilities on which no interest is paid
	£ millions	£ millions	£ millions	£ millions
Sterling	415	150	250	15
US dollar	200	80	120	-
Total	615	230	370	15

	Fixed rate financial liabilities		Financial liabilities on which no interest is paid
Currency	Weighted average interest rate	Weighted average period for which rate is fixed	Weighted average period until maturity
	%	Years	Years
Sterling	10	5	1.4
US dollar	7	8	-
Total	-	6	1.4

The floating rate financial liabilities* comprise:

- sterling denominated bank borrowings and overdrafts that bear interest at rates based on the six-month LIBOR, and
- US dollar denominated bank borrowings that bear interest at rates based on the US Prime rate.

Currency exposures (paragraphs 34-37)

As at 31 December 19X1, after taking into account the effects of forward foreign exchange contracts the Group had no currency exposures.

* It should be noted that other accounting standards or legislation may require additional information to be provided on these liabilities. For example, Schedule 4 to the Companies Act 1985 and to the Companies (Northern Ireland) Order 1986 both require disclosure of the rate of any interest payable on creditors, unless that would result in a statement of excessive length in which case it shall be sufficient to give a general indication of the rates of interest payable. As such, although not required by the FRS, the interest rate differential will often need to be stated as well as identification of the benchmark rate.

Maturity of financial liabilities (paragraphs 38 and 39)

The maturity profile of the Group's financial liabilities at 31 December 19X1 was as follows:

	£m
In one year or less, or on demand	200
In more than one year but not more than two years	15
In more than two years but not more than five years	60
In more than five years	<u>340</u>
	<u>615</u>

Borrowing facilities (paragraphs 40-42)

The Group has various undrawn committed borrowing facilities. The facilities available at 31 December 19X1 in respect of which all conditions precedent had been met were as follows:

	£m
Expiring in one year or less	40
Expiring in more than one year but not more than two years	7
Expiring in more than two years	<u>3</u>
	<u>50</u>

***Fair values of financial assets and financial liabilities
(paragraphs 44–56)***

Set out below is a comparison by category of book values and fair values of the Group's financial assets and liabilities as at 31 December 19X1.

	Book value £ millions	Fair value £ millions
Primary financial instruments held or issued to finance the Group's operations:		
Short-term financial liabilities and current portion of long-term borrowings	(215)	(223)
Long-term borrowings	(400)	(370)
Financial assets	7	8
Derivative financial instruments held to manage the interest rate and currency profile:		
Interest rate swaps	-	15
Forward foreign currency contracts	-	(5)

The fair values of the interest rate swaps, forward foreign currency contracts and sterling denominated long-term fixed rate debt with a carrying amount of £250 million have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

Gains and losses on hedges (paragraphs 58–63)

The Group enters into forward foreign currency contracts to eliminate the currency exposures that arise on sales denominated in foreign currencies immediately those sales are transacted. It also uses interest rate swaps to manage its interest rate profile. Changes in the fair value of instruments used as hedges are not recognised in the financial statements until the hedged position matures. An analysis of these unrecognised gains and losses is as follows:

	Gains	Losses	Total net gains/(losses)
	£ millions	£ millions	£ millions
Unrecognised gains and losses on hedges at 1.1.X1	9	12	(3)
Gains and losses arising in previous years that were recognised in 19X1	8	9	1
Gains and losses arising before 1.1.X1 that were not recognised in 19X1	1	3	(2)
Gains and losses arising in 19X1 that were not recognised in 19X1	18	6	12
Unrecognised gains and losses on hedges at 31.12.X1	19	9	10
Of which:			
Gains and losses expected to be recognised in 19X2	12	6	6
Gains and losses expected to be recognised in 19X3 or later	7	3	4

Market price risk (paragraphs 66-72)

The Group's exposure to market price risk comprises interest rate and currency risk exposures. It monitors these exposures primarily through a process known as sensitivity analysis. This involves estimating the effect on profit before tax over various periods of a range of possible changes in interest rates and exchange rates. The sensitivity analysis model used for this purpose makes no assumptions about any interrelationships between such rates or about the way in which such changes may affect the economies involved. As a consequence, figures derived from the Group's sensitivity analysis model should be used in conjunction with other information about the Group's risk profile.

The Group's policy towards currency risk is to eliminate all exposures that will impact on reported profit as soon as they arise. This is reflected in the sensitivity analysis, which estimates that five and ten percentage point increases in the value of sterling against all other currencies would have had minimal impact on profit before tax.

On the other hand, the Group's policy is to accept a degree of interest rate risk as long as the effects of various changes in rates remain within certain prescribed ranges. On the basis of the Group's analysis, it is estimated that a rise of one percentage point in all interest rates would have reduced 19X1 profit before tax by approximately 1.5 per cent and that a three percentage point increase would have reduced such profits by 4.2 per cent. This is well within the ranges that the Group regards as acceptable.

ILLUSTRATION 2

A MORE COMPLEX COMPANY

Narrative disclosures (paragraphs 11–23)*

For the purposes of this illustration, it has been assumed that the narrative disclosures are provided in the operating and financial review. As such, the notes to the financial statements will need to contain a cross-reference to the disclosures below. This cross-reference is not shown in this illustration.

It is envisaged that the discussion set out below will usually be preceded by a general discussion of, inter alia, the entity's activities, structure and financing, including a brief description of the entity's group treasury arrangements. This discussion will typically consider the financial risk profile of the entity as a whole as a prelude to the narrative disclosures required by the FRS.

The Group holds or issues financial instruments for three main purposes:

- to finance its operations
- to manage the interest rate and currency risks arising from its operations and from its sources of finance
- for trading purposes.

** If the narrative disclosures reflect a significant change from the explanations provided for the previous period, paragraph 16 requires this fact to be disclosed and reasons for the change to be given. In addition, if the directors have agreed to change the role that financial instruments have in creating or changing the risks of the reporting entity, paragraph 18 requires the change to be explained. Neither of these disclosures is illustrated here. Furthermore, as the period-end position is representative of the entity's agreed objectives, policies and strategies, the additional explanations required by paragraph 20 are not provided in this illustration.*

In addition, various financial instruments—for example, trade debtors, trade creditors, accruals and prepayments—arise directly from the Group's operations.

The Group finances its operations by a mixture of retained profits, bank borrowings, long-term loans and commercial paper. The Group's long-term loans are raised centrally by Group finance companies and on-lent to operating subsidiaries on commercial terms. The Group borrows in the major global debt markets in a range of currencies at both fixed and floating rates of interest, using derivatives where appropriate to generate the desired effective currency profile and interest rate basis. The derivatives used for this purpose are principally interest rate swaps, interest rate caps and collars, currency swaps and forward foreign currency contracts.

The types of financial instrument used for trading purposes must be approved in advance by the Board, which also sets down limits, both in terms of capital invested and market price risk taken on, for this trading activity. During the period under review, the only instruments that have been traded are listed debt securities, FTSE futures and forward foreign currency contracts.

The main risks arising from the Group's financial instruments are interest rate risk, liquidity risk, foreign currency risk and market price risk. The Board reviews and agrees policies for managing each of these risks and they are summarised below. These policies have remained unchanged since the beginning of 19X0.

Finance and interest rate risk

The Group's exposure to interest rate fluctuations on its borrowings and deposits is managed by using interest rate swaps, interest rate options (caps and collars) and forward rate agreements. The Group's policy is to keep between 30 per cent and 70 per cent of net borrowings at fixed or capped rates of interest for a period of up to ten years. The minimum proportion fixed or capped is higher in the near term than in the longer term, with the aim of reducing the volatility of short-term interest costs whilst maintaining the opportunity to benefit from movements in longer-term rates. At the year-end and after taking account of interest rate swaps, the proportion of the Group's borrowings at fixed rates was 36 per cent, fixed for an average period of 4.1 years. In addition, 14 per cent of the Group's borrowings were floating rate but were covered by interest rate caps; the remaining 50 per cent were at floating rates of interest and were not capped.

Liquidity risk

The Group's objective is to maintain a balance between continuity of funding and flexibility through the use of borrowings with a range of maturities. The Group's policy is that not more than 30 per cent of borrowings should mature in any twelve-month period. In addition, to preserve continuity of funding, at least 50 per cent of borrowings should mature in more than two years and at least 30 per cent in more than five years. During the year the maturity profile of borrowings was extended, mainly by three new debt issues with an average maturity of nine years. As detailed in Note [x], only 17 per cent of the Group's total borrowings at the year-end will mature in the next twelve months, 69 per cent will mature in more than two years and over 50 per cent will mature in more than five years.

It is, in addition, the Group's policy to maintain undrawn committed borrowing facilities of at least 10 per cent of borrowings in order to provide flexibility in the management of the Group's liquidity and backing for the Group's commercial paper programme. At the year-end, the Group had multicurrency committed facilities of £400 million with three banks, none of which was drawn (commercial paper outstanding at the year-end was £200 million). The weighted average period until maturity of these facilities was 1.6 years.

Currency risk

Although the Group is based in the UK, it has a significant investment in overseas operations in Australia, Japan and the USA. As a result, the Group's sterling balance sheet can be significantly affected by movements in the Australian dollar/sterling, yen/sterling and US dollar/sterling exchange rates. The Group seeks to mitigate the effect of these structural currency exposures by borrowing in the same currencies as the operating (or 'functional') currencies of its main operating units and by using currency swaps to match the currency of some of its other borrowing to its various functional currencies. Generally speaking, between 30 per cent and 50 per cent of the Group's investment in non-sterling operations will be hedged back into sterling in this way, with the exact percentage varying depending on the Group's transactional currency exposures (which are described below). In managing its structural currency exposures, the Group's objectives are to maintain a low cost of borrowings and to retain some potential for currency-related appreciation while partially hedging against currency depreciation.

The Group also has transactional currency exposures. Such exposures arise from sales or purchases by an operating unit in currencies other than the unit's functional currency. The Group requires all its operating units to use forward currency contracts to eliminate the currency exposure on any balance that is not expected to mature within thirty days of its arising.

The Group also hedges foreign currency sales that are expected to occur in future periods. Over 70 per cent of the Group's sales are denominated in currencies other than the functional currency of the operating unit making the sale, whilst almost 95 per cent of costs are denominated in the unit's functional currency. The Group's policy is actively to manage the resulting currency risk, taking out more cover at times when rates are judged to be favourable, within overall limits. Expected future net cash flows are covered on a rolling basis at levels from 40 per cent to 90 per cent for sales expected in the next year and from 10 per cent to 60 per cent for sales expected in one to two years. Cover takes the form of currency swaps or forward contracts. At 31 December 19X1, the Group had hedged 85 per cent of the foreign currency sales expected in 19X2 and 50 per cent of those expected in 19X3.

Numerical information (Notes to the accounts)

Although not shown in this illustration, an explanation of the material accounting policies adopted in accounting for financial instruments will need to be provided. The Group would also need to explain that it has taken advantage of the exemption available for short-term debtors and creditors.

The accounting period dealt with in this illustration is the 12 months to 31 December 19X1. Although corresponding amounts are not shown in the illustration, they will need to be provided except in respect of the first accounting period in which the FRS comes into effect.

The FRS requires non-equity shares issued and certain commodity contracts to be included in—but shown separately from—the disclosures as if they were financial assets and financial liabilities. Such disclosures are not shown in this illustration.

***Interest rate risk profile of financial liabilities
(paragraphs 26–31)***

The interest rate profile of the financial liabilities of the Group as at 31 December 19X1 was:

Currency	Total	Floating rate financial liabilities	Fixed rate financial liabilities	Financial liabilities on which no interest is paid
	£ millions	£ millions	£ millions	£ millions
Sterling	474	340	110	24
US dollar	325	200	120	5
Japanese yen	357	150	200	7
Australian dollar	149	100	40	9
Other	53	50	-	3
Total	1,358	840	470	48

	Fixed rate financial liabilities		Financial liabilities on which no interest is paid
Currency	Weighted average interest rate	Weighted average period for which rate is fixed	Weighted average period until maturity
	%	Years	Years
Sterling	12	4.2	0.8
US dollar	9	2.3	0.6
Japanese yen	6	5.4	1.2
Australian dollar	5	2.8	0.3
Other	-	-	0.5
Total	-	4.1	0.7

The floating rate financial liabilities comprise bank borrowings bearing interest at rates fixed in advance for periods ranging from three to six months by reference to the six-month LIBOR (in the case of the sterling and Australian dollar borrowings), the US Prime rate (in the case of US dollar borrowings) and the Japanese Government Bond rate (in the case of all other borrowings).*

* It should be noted that other accounting standards or legislation may require additional information to be provided on these liabilities. For example, Schedule 4 to the Companies Act 1985 and to the Companies (Northern Ireland) Order 1986 both require disclosure of the rate of any interest payable on creditors, unless that would result in a statement of excessive length in which case it shall be sufficient to give a general indication of the rates of interest payable. As such, although not required by the FRS, the interest rate differential will often need to be stated as well as identification of the benchmark rate.

The figures shown in the tables above take into account various interest rate and currency swaps used to manage the interest rate and currency profile of financial liabilities. Further protection from interest rate movements is provided by interest rate caps on £150 million at 10 per cent until June 19X4 and US\$60 million at 6.5 per cent until August 19X5. The Group also has a A\$120 million collar at 6.5 per cent floor/7.5 per cent cap commencing in June 19X2 for four years.

***Interest rate risk of financial assets
(paragraphs 32 and 33)***

The Group held the following financial assets as at 31 December 19X1:

	£m
Assets held as part of the financing arrangements of the Group:	
Sterling cash deposits	36
Assets held or issued for trading purposes:	
Investments in sterling denominated debt securities	32
Forward foreign currency contracts	6
	<u>74</u>

The sterling cash deposits comprise deposits placed on money markets at call, 7-day and monthly rates. All the investments in debt securities are in fixed rate securities; the weighted average interest rate on these securities is 4.3 per cent and the weighted average time for which the rate is fixed is 2.4 years. The weighted average period until maturity of the forward foreign currency contracts held for trading purposes is 4.7 months.

Currency exposures (paragraphs 34-37)

As explained on page [x] of the operating and financial review, the Group's objectives in managing the currency exposures arising from its net investment overseas (in other words, its structural currency exposures) are to maintain a low cost of borrowings and to retain some potential for currency-related appreciation while partially hedging against currency depreciation. Gains and losses arising from these structural currency exposures are recognised in the statement of total recognised gains and losses.

The table below shows the Group's currency exposures; in other words, those transactional (or non-structural) exposures that give rise to the net currency gains and losses recognised in the profit and loss account. Such exposures comprise the monetary assets and monetary liabilities of the Group that are not denominated in the operating (or 'functional') currency of the operating unit involved, other than certain non-sterling borrowings treated as hedges of net investments in overseas operations. As at 31 December 19X1, these exposures were as follows:

Functional currency of Group operation	Net foreign currency monetary assets/(liabilities) in £ millions					
	Sterling	US dollar	Yen	Australian dollar	Other	Total
Sterling	-	80	30	-	-	110
US dollar	45	-	-	-	-	45
Yen	(60)	80	-	(90)		(70)
Australian dollar	75	(120)	40	-	-	(5)
Other	(10)	(30)	-	40	10	10
Total	50	10	70	(50)	10	90

The amounts shown in the table above take into account the effect of any currency swaps, forward contracts and other derivatives entered into to manage these currency exposures.

As at 31 December 1991, the Group also held open various currency swaps and forward contracts that the Group had taken out to hedge expected future foreign currency sales.

Maturity of financial liabilities (paragraphs 38 and 39)

The maturity profile of the Group's financial liabilities, other than short-term creditors such as trade creditors and accruals, at 31 December 19X1 was as follows:

	£m
In one year or less, or on demand	220
In more than one year but not more than two years	235
In more than two years but not more than five years	243
In more than five years	<u>660</u>
	<u><u>1,358</u></u>

Borrowing facilities (paragraphs 40-42)

The Group has various borrowing facilities available to it. The undrawn committed facilities available at 31 December 19X1 in respect of which all conditions precedent had been met at that date were as follows:

	£m
Expiring in one year or less	150
Expiring in more than one year but not more than two years	220
Expiring in more than two years	<u>30</u>
	<u><u>400</u></u>

***Fair values of financial assets and financial liabilities
(paragraphs 44–56)***

Set out below is a comparison by category of book values and fair values of all the Group's financial assets and financial liabilities as at 31 December 19X1.

	Book value £ millions	Fair value £ millions
Primary financial instruments held or issued to finance the Group's operations:		
Short-term borrowings and current portion of long-term borrowings	(220)	(234)
Long-term borrowings	(1,090)	(1,223)
Cash deposits	36	36
Other financial liabilities	(48)	(46)
Derivative financial instruments held to manage the interest rate and currency profile:		
Interest rate swaps and similar instruments	–	(35)
Interest rate caps and collars	–	15
Currency swaps	–	25
Forward foreign currency contracts	–	12
Derivative financial instruments held or issued to hedge the currency exposure on expected future sales:		
Currency swaps	–	15
Forward foreign currency contracts	–	17
Financial instruments held or issued for trading:		
Debt securities	32	32
Forward foreign currency contracts	6	6

All financial instruments held or issued for trading purposes are carried in the financial statements at fair value.

Market values have been used to determine the fair value of all swaps, forward foreign currency contracts and all listed debt issued and held. The fair values of the interest rate caps and collars have been calculated using option-pricing models. The fair values of all other items have been calculated by discounting expected future cash flows at prevailing interest rates.*

Gains and losses on financial assets and financial liabilities held or issued for trading (paragraph 57)†

The net gain from trading in financial assets and financial liabilities shown in the profit and loss account for the period to 31 December 19X1 can be analysed as follows:

	£m
Investments in debt securities	2
FTSE futures	1
Forward foreign currency contracts	<u>7</u>
	<u><u>10</u></u>

* By virtue of paragraph 53, fair values of certain assets and liabilities do not need to be disclosed if they cannot be determined with sufficient reliability. In such circumstances, paragraph 53 requires other information to be provided. These disclosures are not shown in this illustration.

† Paragraph 57(c) requires the disclosure of the fair value of financial assets and of financial liabilities held or issued for trading. This information is given in this illustration in the disclosure provided to comply with paragraphs 44-56. If these fair values are materially unrepresentative of the entity's typical position during the period, paragraph 57(d) also requires the average fair value of financial assets and of financial liabilities held or issued for trading to be disclosed.

Hedges (paragraphs 58-63)*

As explained in the operating and financial review on page [x], the Group's policy is to hedge the following exposures:

- interest rate risk—using interest swaps, caps and collars; currency swaps; and forward foreign currency contracts;
- structural and transactional currency exposures, and currency exposures on future expected sales—using currency swaps and forward foreign currency contracts.

Gains and losses on instruments used for hedging are not recognised until the exposure that is being hedged is itself recognised. Unrecognised gains and losses on instruments used for hedging, and the movements therein, are as follows:

** Paragraph 62 requires further disclosures if an instrument used as a hedge has been redesignated before the hedged position has matured. Such disclosures are not shown in this illustration.*

	Gains	Losses	Total net gains/(losses)
	£ millions	£ millions	£ millions
Unrecognised gains and losses on hedges at 1.1.X1	53	28	25
Gains and losses arising in previous years that were recognised in 19X1	22	21	1
Gains and losses arising before 1.1.X1 that were not recognised in 19X1	31	7	24
Gains and losses arising in 19X1 that were not recognised in 19X1	66	41	25
Unrecognised gains and losses on hedges at 31.12.X1	97	48	49
Of which:			
Gains and losses expected to be recognised in 19X2	71	40	31
Gains and losses expected to be recognised in 19X3 or later	26	8	18

Paragraph 59 also requires certain disclosures to be provided about deferred gains and losses on hedges. However, as there are no such gains or losses in this example, these disclosures are not illustrated.

Market price risk (paragraphs 66-72)*

The Group monitors its interest rate and currency risks and other market price risks to which it is exposed primarily through a process known as 'sensitivity analysis'. This involves estimating the effect on profit before tax over various periods of a range of possible changes in interest rates and exchange rates.

The model used for this purpose makes various assumptions about the interrelationships between movements in interest rates and exchange rates and about the way in which such movements may impact on the economies involved. Although these assumptions are based on past experience, such experience may not be reflected in the future. Furthermore, the results of the analysis cannot be simply extrapolated to other price changes. For these reasons, the figures disclosed below need to be treated with a degree of caution.

The Group accepts a degree of interest rate risk, currency risk and other market price risk as long as the effects of various changes in rates and prices, as calculated using its sensitivity analysis model, remain within certain prescribed ranges. The figures disclosed below are well within those ranges.

** As already mentioned, corresponding amounts will usually need to be provided for all disclosures. If there are material changes in the amount of market price risk disclosed for the reporting period when compared with that disclosed for the previous period, paragraph 69(c) requires the reasons for the changes to be disclosed. Furthermore, if material changes have been made to the method, or main assumptions or parameters, used since the previous period, paragraph 71 requires the reasons for the changes to be given and the previous period's information to be restated.*

On the basis of the Group's analysis, it is estimated that the maximum effect of a rise of one percentage point in one of the principal interest rates to which the Group is exposed would, after taking into account the most likely consequential impact on other interest rates and on exchange rates, be a reduction in profit before tax for 19X1 of between 1.6 per cent and 2.4 per cent and the maximum effect of a rise of three percentage points would be a reduction in profit before tax for 19X1 of between 6.5 per cent and 9.8 per cent. Similarly, it is estimated that a strengthening of sterling by 10 per cent against all the currencies in which the Group does business would generate currency losses equal to about 3 per cent of profit before tax for 19X1, whereas a 30 per cent strengthening would have generated currency losses equal to about 8.4 per cent of 19X1 profit before tax. The Group's exposure to other market price risk is not material.

ILLUSTRATION 3

A BANK OR SIMILAR INSTITUTION

The examples set out below are intended to illustrate the disclosure requirements in the FRS that are in Part B of the FRS but not in Part A.

The accounting period dealt with in this illustration is the 12 months to 31 December 19X1. Although corresponding amounts are not shown in the illustration, they will need to be provided except in respect of the first accounting period in which the FRS comes into effect.

Interest rate sensitivity gap analysis (paragraphs 86–89)

Part of the Bank's return on financial instruments is obtained from controlled mismatching of the dates on which interest receivable on assets and interest payable on liabilities are next reset to market rates or, if earlier, the dates on which the instruments mature. The table below summarises these repricing mismatches on the Bank's non-trading book as at 31 December 19X1. Items are allocated to time bands by reference to the earlier of the next contractual interest rate repricing date and the maturity date.

	<i>Not more than three months</i>	<i>More than three months but not more than six months</i>	<i>More than six months but not more than one year</i>	<i>More than one year but not more than five years</i>	<i>More than five years</i>	<i>Non-interest bearing</i>	<i>Total</i>
	£m	£m	£m	£m	£m	£m	£m
Assets:							
Treasury bills and other eligible bills	6,243	1,231	643	125	207	92	8,541
Loans & advances to banks	25,876	4,124	2,439	648	371	840	34,298
Loans & advances to customers	59,435	10,354	8,639	11,453	7,633	4,958	102,472
Debt securities & equity shares	5,657	4,321	6,125	7,345	9,620	7,401	40,469
Other assets	1,032	854	523	595	-	28,945	31,949
Total assets	98,243	20,884	18,369	20,166	17,831	42,236	217,729
Liabilities:							
Deposits by banks	23,921	5,168	1,641	261	96	217	31,304
Customer accounts	73,654	2,101	1,561	1,353	121	13,611	92,401
Debt securities in issue	21,961	3,142	3,189	789	376	52	29,509
Other liabilities	673	265	134	1,311	2,064	12,192	16,639
Loan capital & other subordinated liabilities	2,631	1,692	211	2,164	10,617	60	17,375
Minority interests & shareholders' funds	-	-	-	-	-	30,501	30,501
Total liabilities	122,840	12,368	6,736	5,878	13,274	56,633	217,729
Off balance sheet items	(3,931)	(2,962)	3,381	2,916	212	384	-
Interest rate sensitivity gap	(28,528)	5,554	15,014	17,204	4,769	(14,013)	
Cumulative gap	(28,528)	(22,974)	(7,960)	9,244	14,013		

This table does not take into account the effect of interest rate options used by the Bank to hedge its own positions. Details of these options are set out in note [x].

A negative interest rate sensitivity gap exists when more liabilities than assets reprice during a given period. Although a negative gap position tends to benefit net interest income in a declining interest rate environment, the actual effect will depend on a number of factors, including the extent to which repayments are made earlier or later than the contracted date and variations in interest rate sensitivity within repricing periods and among currencies.

Currency risk disclosures (paragraphs 90-97)

The Group's main overseas operations are in the European Union, the USA and Japan, although it also has operations elsewhere in Asia, and in Canada and Eastern Europe. The main operating (or 'functional') currencies of its operations are therefore sterling, the euro, US dollars, and the yen. As the currency in which the Group prepares its consolidated financial statements is sterling, it follows that the Group's consolidated balance sheet is affected by movements in the exchange rates between these functional currencies and sterling. These currency exposures are referred to as structural currency exposures. Translation gains and losses arising from these exposures are recognised in the statement of total recognised gains and losses.

The Group mitigates the effect of these exposures by financing a significant proportion of its net investment in its overseas operations with borrowings in the same currencies as the functional currencies involved. Currency swaps are also used to match the currency of some of its other borrowings to the functional currencies involved.

The Group's structural currency exposures as at 31 December 19X1 were as follows:

Functional currency of the operation involved	Net investments in overseas operations	Borrowings taken out in the functional currencies of the overseas operations in order to hedge the net investments in such operations	Remaining structural currency exposures
	£ millions	£ millions	£ millions
US dollar	10,123	8,867	1,256
Yen	8,981	8,831	150
Euro	5,621	5,146	475
Other non-sterling	648	593	55
Total	25,373	23,437	1,936

The entity would also need to produce numerical currency disclosures similar to those shown in the illustration for a complex company.

Trading book disclosures (paragraphs 104–111)

Although the Bank uses a range of techniques to manage the market price risk in its trading book, the main method involves the use of value at risk (VAR) limits. The VAR of a trading book is the expected loss that will arise on the trading book over a specified period of time (holding period) from an adverse market movement with a specified probability (confidence level). The Bank sets a range of VAR limits, using different confidence levels and holding periods, for the purposes of monitoring the level of

various market price risks arising from its trading book and action is taken to keep the VAR within the ranges specified. Actual outcomes are monitored to test the validity of the assumptions made in the calculation of VAR.

Assuming a 95 per cent confidence level and a one-day holding period, the VAR for the Bank's trading book as at 31 December 19X1 was £3.6 million and the average, highest and lowest VARs for the trading book during 19X1 were £4.5 million, £8.3 million and £2.9 million respectively. This means, inter alia, that, on the basis of the risks in the trading book at 31 December 19X1, the Bank expected not to incur a loss on its trading book of more than £3.6 million in any one day more than 5 per cent of the time.*

Although the Bank is satisfied that the package of controls it uses to manage the market price risk in its trading book is an effective means of controlling that risk, it recognises that all measures of market price risk, when considered in isolation, have limitations. The VAR figures disclosed above, for example, have the following main limitations.

- The historical data on which the calculations have been based may not reflect all the factors that are relevant to the estimation of VAR, give the correct weight to these factors, or be the best estimate of risk factor changes that will occur in the future.

* As already mentioned, corresponding amounts will usually need to be provided for all disclosures. If there are material changes in the amount of market price risk disclosed for the reporting period when compared with that disclosed for the previous period, paragraph 107(d) requires the reasons for the changes to be disclosed. Furthermore, if material changes have been made to the method, or main assumptions or parameters, used since the previous period, paragraph 108 requires the reasons for the changes to be given and the previous period's balance sheet date information to be restated.

- Using a one-day time horizon does not fully capture the market price risk of positions that cannot be closed off within one day. Similarly, focusing on the maximum loss that is expected to be incurred 95 per cent of the time says little about the, admittedly smaller, losses that are expected to be incurred more frequently or the size of the losses in excess of the VAR that are expected to be incurred 5 per cent of the time.
- The highest, lowest and average figures disclosed are based on calculations performed at the end of each business day, and the balance sheet date figure is also an end-of-day figure. The VAR during the course of a single day may change substantially and there is no reason why the end-of-day figure should be representative of the figure at other times of the day.

APPENDIX IV

GUIDANCE ON PROCEDURES FOR ESTIMATING FAIR VALUES

This appendix provides examples of procedures for estimating the fair value of financial assets and financial liabilities. The examples are illustrative and do not portray all possible ways of estimating fair value to comply with the provisions of the FRS.

Fair value

- 1 The fair value of a financial asset or financial liability is the amount at which it could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.
- 2 Underlying the concept of fair value is therefore a presumption that the entity, being a going concern, has no intention or need to liquidate or otherwise wind up its operations or undertake a transaction on adverse terms. For example, if the entity is able to dispose of a large position in an orderly manner over a period of time and therefore does not have to accept a discount to the market price, the quoted market price will be the fair value.
- 3 On the other hand, an entity's current circumstances should be taken into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of an asset that an entity is committed to sell for cash in the immediate future is the amount that it expects to receive from such a sale.

Types of market price information available

- 4 Fair value information is frequently based on information obtained from market sources. In broad terms, there are four kinds of markets in which financial instruments can be bought, sold, or originated and the information available about prices varies from market to market.
 - (a) *Exchange market.* An exchange or ‘auction’ market provides high visibility and order to the trading of financial instruments. Typically, closing prices and volume levels are readily available in an exchange market.
 - (b) *Dealer market.* In a dealer market, dealers stand ready to trade—either buy or sell—for their own account, thereby providing liquidity to the market. Typically, current bid and offer prices are more readily available than information about closing prices and volume levels. ‘Over-the-counter’ markets are dealer markets.
 - (c) *Brokered market.* In a brokered market, brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party’s price requirements. In such a market, prices of completed transactions are sometimes available.
 - (d) *Principal-to-principal market.* Principal-to-principal transactions, both originations and resales, are negotiated independently with no intermediary and typically little, if any, information is released publicly.

Financial instruments with quoted market prices

- 5 Quoted market prices, if available, usually provide the best evidence of fair value of financial instruments. Where more than one quoted price is available, the price in the most active market for transactions of the relevant size should normally be used.
- 6 When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date.

Financial instruments with no quoted market prices

- 7 Quoted market prices may not be indicative of the fair value of the instrument if there is infrequent activity in the market, the market is not well established (as is the case, for example, for some 'over-the-counter' markets) or small volumes are traded relative to the number of units of a financial instrument to be valued. Where this is the case, as well as when a quoted market price is not available, estimation techniques will need to be used and are in most cases capable of determining fair value with sufficient reliability to satisfy the requirements of the FRS.
- 8 Estimation techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis and option-pricing models. One method of applying discounted cash flow analysis is to discount the cash flows at a rate equal to the prevailing market rate of interest for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term

over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made.

- 9 When it is difficult to determine fair value of a financial asset or financial liability or of a class of financial assets or financial liabilities, it may be useful to disclose a range of amounts within which the fair value of the financial instrument or class is reasonably believed to lie.

Short-term financial instruments and loans that reprice frequently at market rates

- 10 For some short-term financial instruments, the carrying amount in the financial statements may approximate to fair value because of the relatively short period of time between the origination of the instruments and their expected realisation. This would also be true of loans that reprice frequently at market rates, provided there was no significant change in credit risk.

Custom-tailored financial instruments

- 11 Some financial instruments (for example, interest rate swaps and foreign currency contracts) may be 'custom-tailored' and, thus, may not have a quoted market price.
- (a) In the case of some 'custom-tailored' financial instruments (for example, interest rate swaps and foreign currency contracts), it is often possible to base an estimate of fair value on the quoted market price of a similar financial instrument, adjusted as appropriate for the effects of the tailoring. Alternatively, the estimate might be based on the estimated current replacement cost of that instrument.

- (b) In the case of 'custom-tailored' options, a variety of option-pricing models (such as the Black-Scholes model and binomial models) are available. The use of such pricing models to estimate fair value is appropriate under the requirements of the FRS.

Loans receivable

- 12 Quoted market prices may be more readily available for some categories of loans receivable than for others. If no quoted market price exists for a category of loans, an estimate of fair value may be based on:
 - (a) the market prices of traded loans with similar credit ratings, interest rates, and maturity dates;
 - (b) current prices (interest rates) offered for similar loans in the entity's own lending activities; or
 - (c) valuations obtained from loan-pricing services offered by various specialist firms or from other sources.
- 13 An estimate of the fair value of a loan or group of loans may be based on the discounted value of the future cash flows expected to be received from the loan or group of loans. The selection of an appropriate current discount rate reflecting the relative risks involved requires judgement, and several alternative rates and approaches are available to an entity.
 - (a) A single discount rate could be used to estimate the fair value of a homogeneous category of loans. For example, an entity might apply a single rate to each aggregated category of loans.

- (b) An entity could use a discount rate commensurate with the credit, interest rate, and prepayment risks involved, which could be the rate at which the same loans would be made under current conditions.
- (c) An entity could select a discount rate that reflects the effects of interest rate changes and then make adjustments to reflect the effects of changes in expected credit losses and in the variability of those losses. Those adjustments could include:
 - (i) revising cash flow estimates;
 - (ii) revising the discount rate; or
 - (iii) some combination of (i) and (ii).

Financial liabilities

- 14 The fair value of financial liabilities for which quoted market prices are not available can generally be estimated using the same techniques used for estimating the value of financial assets. For example, a loan payable to a bank could be valued at the discounted amount of future cash flows using an entity's current incremental rate of borrowing for a similar liability. Alternatively, the discount rate could be the rate that an entity would have to pay to a creditworthy third party to assume its obligation, with the creditor's legal consent (sometimes referred to as the 'settlement rate') or the rate that an entity would have to pay to acquire essentially matching assets to extinguish the obligation.

Deposit liabilities with defined maturities

- 15 For deposit liabilities with defined maturities such as certificates of deposit, an estimate of fair value might be based on the discounted value of the future cash flows expected to be paid on the deposits. The discount rate could be the current rate offered for similar deposits with the same remaining maturities.

APPENDIX V

NOTE ON LEGAL REQUIREMENTS

- 1 This note sets out the main statutory requirements relating to the disclosures to be provided on financial instruments.

GREAT BRITAIN

- 2 The Companies Act 1985 requires a range of general disclosures about assets and liabilities that are, or will sometimes be, financial assets and financial liabilities. The Act also requires some disclosures about issues specifically addressed in the FRS, and paragraphs 3–11 below summarise these specific disclosure requirements.

Interest rate risk disclosures

- 3 Paragraph 48(2) and (3) of Schedule 4 to the Act requires the disclosure of the interest terms on certain items of debt shown under ‘creditors’ in the balance sheet or, if in the opinion of the directors this would result in a statement of excessive length, a general indication of the rates of any interest repayable on such debt.

Liquidity disclosures

- 4 Paragraph 48(1) and (3) of Schedule 4 requires, for each item included in the balance sheet under ‘creditors’, the disclosure of:

- (a) the aggregate of:
 - (i) the amount that is payable or repayable otherwise than by instalments and is due for repayment in more than five years from the balance sheet date; and

- (ii) in respect of any amounts payable or repayable by instalments, the amount of any instalments falling due for payment in more than five years from the balance sheet date.
 - (b) the terms of payment or repayment of each item or, if this would in the opinion of the directors result in a statement of excessive length, a general indication of the terms of payment or repayment.
- 5 Note 5 to the Schedule 4 balance sheet formats requires the amount falling due after more than one year to be shown separately for each item included under debtors.
- 6 Paragraph 38(2) of Schedule 4 requires, in the case of any part of the allotted share capital that consists of redeemable shares, the disclosure of:
- (a) the earliest and latest dates on which the company has the power to redeem those shares; and
 - (b) an explanation whether redemption is mandatory or is at the option of either the company or the shareholder.

Fair value disclosures

- 7 Paragraph 45(2) of Schedule 4 requires:
- (a) the disclosure of the aggregate market value of those listed investments held that are not carried in the balance sheet at market value; and
 - (b) the disclosure of both the market value and the stock exchange value of any listed investments held of which the former value is, for the purposes of the accounts, taken as higher than the latter.

Banking companies and groups (references are to Schedule 9)*Maturity disclosures*

- 8 Paragraph 61 requires banking companies and groups to provide a maturity analysis of certain assets in the form of loans and advances and of certain liabilities in the form of deposits by banks, customer accounts and debt securities in issue. Paragraph 62 requires banking companies and groups to disclose the amount of debt securities and other fixed income securities that will become due within one year. Paragraph 63 requires, inter alia, disclosure of the maturity date of subordinated liabilities.
- 9 Paragraph 51(2) contains an identical requirement for banking companies and groups to that referred to in paragraph 6 above.

Fair value disclosures

- 10 Paragraph 68(2) contains an identical requirement for banking companies and groups to that described in paragraph 7(a) above.

Disclosures about hedges

- 11 Paragraph 72(1) requires banking companies and groups to disclose the following information about unmatured forward transactions outstanding at the balance sheet date:
- (a) the categories of such transactions, by reference to an appropriate system of classification; and
 - (b) whether, in the case of each such category, they have been made, to any material extent, for the purpose of hedging the effects of fluctuations in interest rates, exchange rates and market prices or whether they have been made, to any material extent, for dealing purposes.

NORTHERN IRELAND

- 12 Schedules 4 and 9 to the Companies (Northern Ireland) Order 1986 require similar information about financial instruments to that required by Schedules 4 and 9 to the Companies Act 1985 and described in paragraphs 3-11 above.

REPUBLIC OF IRELAND

- 13 The statutory requirements in the Republic of Ireland are similar to those in Great Britain. The following table shows the references to the legislation in the Republic of Ireland that correspond to the references in paragraphs 3-11 above.

The following abbreviations have been used in the table:

1986 Act	Companies (Amendment) Act 1986	
1992 Regulations	European Communities (Credit Institutions: Accounts) Regulations 1992	
<i>Paragraph above</i>	<i>Great Britain</i>	<i>Republic of Ireland</i>
3	Schedule 4, paragraph 48(2)	No equivalent
3, 4	Schedule 4, paragraph 48(3)	No equivalent
4	Schedule 4, paragraph 48(1)	Paragraph 34(1) of the Schedule to 1986 Act
5	Note 5 to Schedule 4 balance sheet formats	Note 4 to the Schedule balance sheet formats 1986 Act
6	Schedule 4, paragraph 38(2)	Paragraph 26(2) of the Schedule to 1986 Act
7	Schedule 4, paragraph 45(2)	Paragraph 31(2) of the Schedule to 1986 Act
8	Schedule 9, paragraphs 61-63	Paragraphs 61-63 of Part I, the Schedule to 1992 Regulations
9	Schedule 9, paragraph 51(2)	Paragraph 51(2) of Part I, the Schedule to 1992 Regulations
10	Schedule 9, paragraph 68(2)	Paragraph 68(2) of Part I, the Schedule to 1992 Regulations
11	Schedule 9, paragraph 72(1)	Paragraph 72(1) of Part I, the Schedule to 1992 Regulations

APPENDIX VI

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

- 1 The International Accounting Standards Committee has issued IAS 32 'Financial Instruments: Disclosure and Presentation'. Features of IAS 32 are covered by FRS 4 'Capital Instruments', FRS 5 'Reporting the Substance of Transactions', this FRS and companies legislation. Compliance with those FRSS, this FRS and companies legislation will ensure compliance in all material respects with IAS 32 except in respect of the matters set out below. The Board's reasons for adopting certain disclosure requirements that are not consistent with the provisions of IAS 32 are set out in Appendix VII.

Scope

- 2 IAS 32 applies to the financial statements of all entities. The FRS, on the other hand:
 - (a) applies only to entities that have a capital instrument listed or publicly traded and to banks, banking groups and similar institutions and groups; and
 - (b) does not apply to insurance companies or groups, to entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) or to a parent's own financial statements where they are presented together with its consolidated financial statements.

- 3 IAS 32 applies to all financial instruments held or issued by entities, other than those instruments specifically excluded from its scope. The same approach is adopted in the FRS, although there are certain differences in the financial instruments excluded.
- (a) Whilst IAS 32 exempts all interests in subsidiaries, associates and joint ventures, the FRS exempts only those not held exclusively with a view to subsequent resale.
 - (b) The FRS exempts certain equity shares issued by the reporting entity and certain warrants and options on such shares that are issued by the reporting entity. IAS 32 has no similar exemption.
 - (c) The FRS permits short-term debtors and creditors to be excluded from the disclosures. IAS 32 has no similar exemption.
 - (d) The FRS requires all the financial assets and financial liabilities of an insurance company or group to be excluded from the disclosures. IAS 32 exempts obligations arising under insurance contracts only.
- 4 In addition, the FRS requires certain contracts and instruments that are not financial assets and financial liabilities—in particular non-equity shares issued by the reporting entity that are equity instruments and certain types of commodity contracts—to be dealt with in the disclosures. IAS 32 has no similar requirement.

Disclosure

- 5 Generally speaking, the FRS's disclosure requirements are more specific than the requirements in IAS 32. They are also more extensive in certain respects. For example, IAS 32 does not require the narrative disclosures required by the FRS. Compliance with IAS 32 will not therefore ensure compliance with the FRS. On the other hand, compliance with the FRS will ensure compliance with the disclosure requirements of IAS 32 except as discussed in paragraphs 6–8 below.
- 6 IAS 32 requires, for each class of financial asset, financial liability and equity instrument, information to be provided on the extent and nature of the instruments, including specific terms and conditions that may affect the amount, timing and certainty of future cash flows. The FRS does not require the disclosure of significant terms and conditions, although it does require disclosures that show the effect of the instruments on the entity's interest rate and currency profiles, liquidity position and other market price risk exposures.
- 7 IAS 32 requires numerical disclosures to be provided about credit risk exposures. The FRS does not require numerical disclosures on these matters although, where an entity has significant exposure to credit risk, a discussion of the entity's policy for controlling and managing the risk is required.
- 8 IAS 32 requires that, when an entity carries one or more financial assets at an amount in excess of fair value, the entity should disclose the carrying amount and the fair value involved and the reasons for not reducing the carrying amount. The FRS does not require a similar disclosure.

Presentation

- 9 IAS 32 requires preferred shares where the holder has the right to require redemption to be classified as liabilities. It also requires compound instruments that have equity and liability rights to be divided, with the liability element classified as liabilities and the equity element treated as part of shareholders' funds (so-called 'split accounting'). Neither the FRS nor FRS 4 adopts these requirements, for the reasons given in Appendix II to FRS 4.
- 10 There are also differences in the way in which offsetting is dealt with.
- (a) Whilst IAS 32's offsetting provisions apply to all financial assets and financial liabilities, FRS 5's offsetting provisions apply only to some, and no other FRS deals with offsetting in the context of those financial assets and financial liabilities that are not covered in FRS 5.
 - (b) Whilst IAS 32 treats offsetting as a matter of presentation, FRS 5 treats it as a recognition issue. Therefore, whilst IAS 32 permits financial assets and financial liabilities to be offset in certain limited cases, under FRS 5 assets and liabilities should not be offset, although a debit and credit balance are required to be added together when they constitute a single asset or liability.
 - (c) IAS 32 requires a financial asset and a financial liability to be offset and the net amount reported in the balance sheet only when an entity has a legally enforceable right to set off the recognised amounts and it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. This reference to an intention to settle either net or simultaneously is not included in FRS 5 (for the reasons given in Appendix III to FRS 5).

APPENDIX VII

THE DEVELOPMENT OF THE FRS

Background and history

- 1 The dynamic nature of international financial markets has resulted in the widespread use by entities of both traditional primary financial instruments, such as bonds and shares, and various forms of derivative financial instruments, such as futures, options, forward contracts and swaps. This growth in the use of financial instruments has outstripped the development of guidance for their accounting. As a result, although many entities now use financial instruments in a way that can transform their financial position, financial performance and risk profile overnight, the accounting treatment of the instruments does not always portray effectively their impact and risks.

- 2 Accounting for financial instruments has been a topic of international concern for some time. For example, in 1993 a study by the Group of Thirty^{*} stressed the need for improved disclosures in financial statements about transactions in derivatives and other financial instruments. The US financial reporting standard-setter, the Financial Accounting Standards Board, has been working on financial instruments for more than ten years and has issued a number of standards on the subject. Standards on financial instruments have also been issued in the last few years by the financial reporting standard-setters in Australia, Canada and New Zealand and the International Accounting Standards Committee (IASC).

^{*} *The Group of Thirty (or G30) is an international association of bankers and former government officials which provides a forum for discussion of economic issues of global significance. The study referred to is entitled 'Derivatives: Practices and Principles' and was published in July 1993.*

- 3 The Accounting Standards Board's own concerns over the apparent inadequacy of accounting rules and guidance in this area caused it to issue a wide-ranging Discussion Paper 'Derivatives and other Financial Instruments' in July 1996. The Paper highlighted three main concerns—the measurement of financial instruments, the use of hedge accounting, and the disclosures provided about financial instruments (both generally and in the context of hedge accounting)—and tentatively reached the following main conclusions.
 - (a) It was not appropriate to continue to measure financial instruments on a historical cost basis. They should, instead, be measured at fair value (the term used in the Discussion Paper was 'current value'). The Paper recognised, however, that such a change would have far-reaching implications and therefore proposed that time should be allowed to explore the implications and debate the issues involved.
 - (b) Disclosures about financial instruments needed to be improved urgently. The Paper concluded that it was feasible to make these improvements relatively quickly and therefore proposed that priority should be given to this aspect of the subject.
- 4 Amongst those responding to the Discussion Paper there was general agreement with its conclusions on disclosure and with the specific disclosures proposed. The Board refined these disclosure proposals in the light of the comments received, and published them in April 1997 as FRED 13 'Derivatives and other Financial Instruments: Disclosures'. The Board also concluded that a separate set of disclosures was needed for banks, and these were issued in draft form in July 1997 as FRED 13 Supplement 'Derivatives and other Financial Instruments: Disclosures by banks and similar institutions'.

- 5 These proposals were generally well received and consequently form the basis of this FRS. However, some changes have been made in the light of the comments received, and these are discussed in this appendix.
- 6 As already mentioned, the Discussion Paper also dealt with the measurement of financial instruments and the extent to which hedge accounting should be allowed. These topics stimulated much debate, although there was general support for an accounting standard on them. Work on measurement and hedge accounting is therefore continuing and the Board expects to publish proposals on these subjects in due course.

Approach adopted in the FRS

- 7 The FRS is based on the premise that, in order to be able to make assessments about the financial performance and financial position of an entity, users of financial statements need information on the main aspects of the entity's risk profile and an understanding of how this risk profile is being managed. Since financial instruments contribute to this risk profile and are often used to manage it, they need to be dealt with fully in the disclosures provided. Although some disclosures are already required for financial instruments,* they do not represent a coherent set of requirements that cover all the main risks involved. The main purpose of the FRS is therefore to build a set of such requirements.

* For example, in Great Britain the Companies Act 1985 requires companies preparing their financial statements in accordance with Schedule 4 to the Act to disclose information about the maturity and interest rate terms of indebtedness; FRS 4 'Capital Instruments' and SSAP 21 'Accounting for leases and hire purchase contracts' also require certain maturity analyses; and the Board's Statement 'Operating and Financial Review' encourages disclosures on undrawn committed borrowing facilities. Similarly, in the case of banks and certain similar institutions, the Companies Act 1985 and the SORP 'Derivatives' issued by the British Bankers' Association and the Irish Bankers' Federation require the disclosure of some fair value information.

- 8 In developing the FRS, the Board has taken the view that the most meaningful form in which the information can be provided is through a structured mixture of narrative and numerical disclosures. The narrative disclosures will explain the entity’s chosen risk profile, including its risk-management policies, and the numerical disclosures will show how these policies were implemented in the period and will provide information to enable significant or potentially significant exposures to be evaluated. Taken together, the disclosures are intended to give a broad overview of the risks arising on financial instruments, focusing on those instruments and risks that are of greatest significance. The approach, in particular, seeks to avoid requiring a mass of detail.
- 9 In framing the disclosure requirements, the Board has drawn on the work of other financial reporting standard-setters with the result that the FRS is broadly consistent with present international practice. However, the Board recognises that this is a developing area and it intends to review the FRS in the light of experience and in the context of its proposals on measurement and hedge accounting.

To which entities should the FRS apply?

- 10 It is the Board’s view that all entities should provide disclosures on their risk position and on how their financial instruments affect that position. Notwithstanding this, it also took the view in FRED 13 that it would be best, initially, to require the proposed disclosures only where the case for them was most compelling—the intention being that, in due course, the requirement would be extended to other entities—and that the case for disclosure was most compelling for entities whose capital instruments are listed or publicly traded on a stock exchange or market and for entities that are banks or insurance companies.

- 11 This proposal attracted much comment, with some respondents suggesting that the scope of the FRS should be narrower and some that it should be wider. Others agreed that it was necessary to limit the scope of the FRS, but disagreed on how it should be done. Although these comments have been considered at length, the Board remains of the view that the approach adopted in FRED 13 is the most realistic and pragmatic approach available at present. Therefore, with one exception (see 'Insurance companies' below), the scope of the FRS is the same as that proposed in the FRED.
- 12 It nevertheless remains the Board's view that there is no reason in principle why all entities should not, in due course, be required to provide disclosures on the risks arising on their financial instruments. Accordingly, when the Board comes to review the FRS it intends to consider extending the scope to all entities.

Specialised industries

- 13 In developing the requirements set out in the FRS, the Board decided that a degree of prescription as to the form and content of the disclosures was necessary to help ensure that those provided are of a satisfactory standard and will achieve some consistency. In order to prescribe disclosures that are clear and reasonably precise as well as conforming to the objectives of the FRS, assumptions have had to be made about the way in which financial instruments are used and the main types of risk that arise from that use. Although the Board recognised that its assumptions would not be equally valid for all entities, at the time that it issued FRED 13 its view was that the assumptions it had made could be applied to all entities other than banks and certain similar institutions. It therefore developed and

published one set of disclosure proposals for most types of entity (FRED 13) and a second set of disclosure proposals for banks and certain similar institutions (FRED 13 Supplement).

Banks and similar institutions

- 14 Financial instruments play an integral part in the wealth-generating activities of banks, often being the primary source of a bank's net income. This net income arises from the management of the mismatches in the exposures arising from financial instruments and the margins earned on them. This is quite different from a typical non-financial institution, where the entity's financial instruments are primarily a result of the entity's financing arrangements or are a by-product of its operating activities. This difference makes it difficult for the traditional accounting model, supplemented by some general risk disclosures, to convey the true significance that the exposures arising from financial instruments have for a bank. For example, the interest rate risk disclosures in FRED 13 assumed that the main interest rate risk arises from borrowings that are used to finance operating activities. This assumption is not, however, appropriate for banks, where the main interest rate risk arises from mismatches between interest rate exposures on assets and on liabilities that form an integral part of the bank's operations.
- 15 Another difference that has to be taken into account is that most banks operate a trading book that is distinct from their other assets and liabilities. The risks arising from the trading book tend to be a rapidly changing mix of different types of risk, whilst the risks arising from the non-trading book tend to be more stable and long-term. The different nature of these risks can best be reflected by dealing with them separately in the disclosures.

Other financial institutions

- 16 When it published FRED 13 Supplement, the Board explained that, although it recognised that there are other types of entity whose business—like banks—is concerned with the handling of financial instruments, it had not been convinced that any of these entities had characteristics that meant that the disclosures proposed in FRED 13 would not be appropriate for them. This issue was by far and away the most controversial aspect of the Supplement, with very few of the respondents agreeing with the approach adopted.
- 17 In the light of the comments received, and after further discussions with some of the entities involved, the Board has accepted that some financial institutions other than banks would find the disclosures described in the Supplement (subject to certain amendments) better suited to their circumstances than those prescribed in FRED 13. On the other hand, it has also concluded that for some financial institutions the opposite will be true. Various ways of identifying which type of financial institution should provide which set of disclosures have been considered but, as none appears able to achieve a satisfactory fit between entities and disclosures, it has been decided to give financial institutions other than banks and certain similar institutions the choice of providing either the FRED 13 disclosures or (subject to certain amendments) the Supplement's disclosures. In this way different types of financial institution will be able to provide the disclosures in the form that best suits their circumstances.

Insurance companies

- 18 The Board believes that insurance companies should be required to provide disclosures on their financial instruments and the risks that arise from them. However, a number of those responding to FRED 13 argued that the disclosures described in FRED 13 were not well-suited to insurance companies, primarily because:
- the matching of the investment portfolio to the obligations of the insurer is crucial to an insurer’s business, and financial risk disclosures that do not take this matching fully into account will be misleading; and
 - financial risk disclosures that do not differentiate between risks borne by the shareholders and risks borne by the policy-holders will provide a misleading picture of the risk profile of the entity.
- 19 The Board has accepted that there is merit in these arguments and that, as a result, it would not be appropriate to require insurance companies to provide the disclosures set out in FRED 13 or its Supplement. Therefore, rather than delay publication until a suitable set of disclosures for insurance companies has been developed, it has chosen to exempt all insurance companies from the scope of the FRS. It is expected that the Board will shortly add to its work programme a project on certain aspects of insurance accounting. One of the issues that will be considered in this project is the disclosures that should be provided on derivatives and other financial instruments.

To which instruments should the disclosures apply?

Exempt financial instruments

- 20 FRED 13 proposed that the FRS would not apply to certain specified financial instruments. These items are, generally speaking, already adequately dealt with in other accounting standards (for example, interests in subsidiaries), or are the subject of other projects (for example, pension and operating lease obligations) or seem to fall outside the main focus of the disclosures being proposed and involve a number of potentially difficult issues (for example, take-or-pay or similar executory contracts that are financial instruments). In the light of the comments received, the list of exempted items in the FRED has been simplified and brought more into line with that contained in IAS 32 'Financial Instruments: Disclosure and Presentation'.
- 21 None of these exemptions apply in the case of the currency disclosures. That is because those disclosures are to be based on the way in which the entity has applied SSAP 20 'Foreign currency translation' and, as a result, need to take into account all the assets and liabilities relevant to that standard's application.

Short-term debtors and creditors

- 22 Many respondents expressed concern at the inclusion of trade debtors, trade creditors, prepayments, accruals and similar items (referred to in the FRS as short-term debtors and creditors) within the scope of the disclosures, arguing that the primary focus of the FRS should be complex financial instruments such as derivative financial instruments. The Board does not believe it appropriate to narrow the focus of the FRS so

that it applies merely to complex financial instruments. On the other hand, although short-term debtors and creditors *are* financial instruments and *do* give rise to the sort of risks that the FRS is seeking to address, it is accepted that they are not the primary target of the disclosures. In recognition of this, the Board was minded to exempt such items from the FRS in order to simplify its implementation. It is understood, however, that some entities may find it easier, or regard it as preferable, to include such items in their disclosures. In the light of this, one option might have been to allow complete flexibility as to which short-term debtors and creditors are included in each disclosure. However, this would not have resulted in simple or consistent disclosure. The Board has therefore chosen to give entities the flexibility to decide whether all such items should be included in all the disclosures or whether they should all be excluded from all the disclosures (other than the currency disclosures).

Commodity contracts

- 23 Contracts that require settlement by the delivery of non-financial assets are not financial instruments. An example of such a contract is one that provides for settlement by receipt or delivery of a commodity (a commodity contract). Notwithstanding the settlement terms of commodity contracts, it is not uncommon for those that are standard in form to be traded on organised markets whose general practice is to permit the contracts to be ‘closed out’ through settlement in cash or with another financial instrument rather than by taking physical delivery of the underlying commodity. Where this is the case, such contracts are, in many ways, very similar to financial instruments and, as a result, are often used for

the same purposes (for example, for hedging or speculative purposes), seen as interchangeable and managed in a similar manner to each other. The FRED therefore proposed that these types of commodity contract (referred to as cash-settled commodity contracts) should be included in the disclosures in the same way as financial instruments. There was general support for this proposal, and it has therefore been carried forward into the FRS.

- 24 Contracts for the delivery of gold are commodity contracts. Many of them are also cash-settled commodity contracts and will therefore be dealt with in the disclosures for the reasons set out in the previous paragraph. However, gold is used by many entities as a reserve currency and so, even when settlement is achieved through physical delivery, gold contracts are often seen as interchangeable with certain financial instruments. It was for this reason that FRED 13 proposed that all other contracts for the delivery of gold should also be included in the disclosures. However, as a number of respondents pointed out, this would have the effect, in the case of gold producers and entities using gold in their production processes, of bringing stock-in-trade within the scope of the FRS, which was not the Board's intention. The requirement to include all gold contracts has therefore been amended so that it now applies only in the case of the type of entities most likely to be using gold as a reserve currency, ie financial institutions.

Non-equity shares issued by the reporting entity

- 25 The definitions of the terms ‘financial instrument’, ‘financial asset’ and ‘financial liability’ used in the FRS are taken from IAS 32. These definitions rely, in part, on the definition of ‘equity instrument’, a term that assumes that all shares are categorised as either evidence of an ownership interest in an entity (in other words, equity instruments) or liabilities. Such a categorisation is not adopted for accounting purposes in the UK. FRS 4, for example, does not permit shares to be treated as liabilities. FRED 13 attempted to reconcile these two different approaches by proposing that non-equity shares that behaved like debt should be treated as liabilities for the purpose of the disclosures. This proposal was not supported by respondents, who argued that it would, in view of FRS 4’s requirements, cause confusion; would introduce unwelcome complexity to the disclosures; and, in any event, would still not achieve consistency with IAS 32. In the light of these comments, the Board has decided not to proceed with this approach. Instead, it has decided to require all non-equity shares issued by the reporting entity to be treated in the same way as the entity’s financial liabilities, regardless of whether such shares are financial liabilities or equity instruments. This approach has been adopted for pragmatic reasons in order to address the most significant of the anomalies that would otherwise arise but is not intended to set a precedent for, or to indicate the future direction of, accounting for non-equity shares generally.

Narrative disclosures

- 26 The detailed content of the narrative disclosures proposed in FRED 13 received general support, although some concerns were expressed that the requirements lacked clarity and precision. The requirements have therefore been extensively rewritten, although the objective of the disclosures remains unchanged: to explain the main risks that arise from financial instruments and to explain what the entity's response is to those risks. As such, the disclosures are intended to be a summary of the facts—drawing on documented policies and decisions and on transactions and exposures that have occurred—not subjective statements or a forecast of what will happen in the future.
- 27 The Board believes that the narrative disclosures are very important, not least because they set the numerical disclosures in their proper context. Indeed, without the narrative disclosures some of the numerical disclosures might be misunderstood. Because of this central role, the Board concluded during the development of FRED 13 that the narrative disclosures should be a necessary disclosure in financial statements intended to show a true and fair view. This means, amongst other things, that:
- (a) such disclosures will need to be audited in the same way as other information that is included in the financial statements; and
 - (b) if the reporting entity chooses to locate the narrative disclosures outside of the financial statements—by, for example, including them in the operating and financial review—they will need to be incorporated into the financial statements by means of a cross-reference in the notes.

- 28 A number of respondents expressed concern at this, arguing that:
- (a) by making the disclosures mandatory the Board might inhibit the flexibility entities need to tailor the discussion to reflect their circumstances;
 - (b) making the narrative disclosures subject to audit might result in entities providing rather bland and unhelpful disclosures; and
 - (c) the disclosures, or at least parts of them, are not capable of being audited.
- 29 The Board does not accept the first two criticisms. Although the disclosures make it clear what information is required, they still leave plenty of scope for entities to tailor the discussion to reflect their circumstances. Furthermore, if required disclosures are provided in a way that is not meaningful it will be difficult for the financial statements to show a true and fair view. In the case of the third criticism, the Board believes that the disclosures as amended are capable of being audited.

Numerical disclosures to be provided by non-financial institutions

- 30 The main purpose of the numerical disclosures is to illustrate the narrative disclosures by showing how the entity's objectives and policies for holding and issuing financial instruments were implemented during the period. To this end, detailed disclosures focusing on the risks that are likely to be the most significant in practice are prescribed. Furthermore, in order to avoid a mass of detail that obscures more than it enlightens, the FRS encourages, and in places requires, the disclosures to be provided in a highly aggregated form; the emphasis being on the effect of the instruments as a whole rather than on their individual terms and conditions.

- 31 With the exception of the fair value and hedging disclosures and, to a lesser extent, the currency disclosures, the detailed numerical disclosures proposed in FRED 13 were generally well received and, as a result, have been carried forward to the FRS largely unchanged. The main amendments that have been made to the proposals were made to simplify and clarify the requirements, to make them easier to implement and to make the resulting disclosures easier to understand. The paragraphs below discuss the most significant changes made to the proposals as well as the most debated issues.

Interest rate risk disclosures

- 32 FRED 13 proposed that entities other than banks (and certain similar institutions) should provide an analysis of the interest rate risk exposure arising from certain of their financial assets and financial liabilities. This proposal received a broad level of support and has therefore, with one exception, been retained largely unchanged. The exception relates to the instruments to be dealt with in the disclosure. FRED 13 proposed that the disclosures should focus on borrowings and on investments in interest-bearing assets and other debt instruments. However, some respondents criticised this proposal, arguing that the terms and definitions involved were imprecise; the disclosure would not include all the items that needed to be included; and, by including only some financial instruments in the disclosure, unnecessary complexity was being introduced. In order to address these concerns, the scope of the disclosures has been amended so that the focus is now on financial liabilities and financial assets. This change, taken together with the exemption available for short-term debtors and creditors, will have the effect of extending the scope of the disclosure a little while simplifying implementation.

- 33 Some entities manage the interest rate risk on their assets separately from the interest rate risk on their liabilities. On the other hand, some deduct cash and liquid resources, and sometimes even other financial assets, from their borrowings and manage the interest rate risk on a ‘net borrowings’ basis. It has been argued that entities should be required, or at least allowed, to prepare the interest rate risk disclosures on a basis that reflects how they manage the risks. Although this argument was considered during the development of FRED 13, it was thought important, if there were material amounts of cash and liquid resources, that they be shown separately from borrowings. The FRED therefore proposed that a gross analysis should be provided unless the amount of cash and liquid resources was immaterial, in which case net or gross figures could be used. This approach was generally supported by those responding to the FRED, and has been retained in the FRS.

Liquidity disclosures

- 34 FRED 13 proposed that entities should provide a maturity analysis of borrowings and of undrawn committed borrowing facilities. The two main issues that arose in respect of these proposals were as follows:
- (a) *The instruments to be dealt with* – For the reasons set out in paragraph 32 above, the FRED’s proposal that only borrowings should be included in the first analysis has been amended; the disclosure now needs to be provided for financial liabilities rather than borrowings only.

- (b) *The need for the analysis of undrawn committed borrowing facilities* – FRED 13’s proposal that entities should provide an analysis of undrawn committed borrowing facilities met with a mixed response. Some respondents argued that the liquidity profile of an entity can be properly understood only if such an analysis is given. Some of these respondents pointed out that this disclosure is already required in the USA and by IAS 32 and is one of the disclosures suggested in the Board’s own Statement ‘Operating and Financial Review’. Others argued that the level and profile of undrawn committed borrowing facilities is of limited relevance and could, in fact, mislead users because it says nothing about the facilities that could be obtained should the entity need to obtain them. Having considered the arguments, the Board believes that, on balance, this information is useful to an understanding of the liquidity profile of the entity and should be disclosed. The FRS therefore continues to require a maturity analysis of undrawn committed borrowing facilities.

Currency disclosures

- 35 The currency risk disclosures proposed in FRED 13 were criticised by a number of respondents, who argued variously that the disclosures were misleading, meaningless, too complex, not practicable or very costly to prepare. Although the Board had thought that the disclosures were capable of being produced relatively easily and at little additional cost, it now understands that that will not always be the case. A

particular difficulty for some entities that are not financial institutions stemmed from the fact that their application of SSAP 20 did not easily lend itself to providing the proposed structural disclosures. The currency risk disclosure requirements for such entities have therefore been simplified to focus on the underlying primary purpose of the disclosure, which is to show the currency exposures that give rise to the net currency gains and losses recognised in the profit and loss account. Such exposures are the main currency exposures that arise from financial instruments in the case of most entities that are not financial institutions.

- 36 One consequence of this is that the FRS does not require such entities to provide any disclosures relating to their structural currency exposures (in other words, relating to the exposures that give rise to the translation gains and losses that are recognised in the statement of total recognised gains and losses under SSAP 20). Although these exposures are not the primary focus of the FRS, for many entities they are important. The Board will therefore be considering whether to propose that SSAP 20 should be amended to require disclosure of information about such exposures.

Fair value disclosures

- 37 FRED 13 proposed that entities should be required to disclose the fair value of all financial instruments (other than those for which a reliable fair value could not be determined). These proposals were the subject of more comment from respondents than any other matter. Some, for example, argued that there should not be any requirement to disclose fair values. Others argued that fair values should not be required for certain financial assets and financial liabilities such as own debt, instruments that management intends to hold to maturity or instruments held for hedging purposes. Despite these comments, the Board remains convinced of the need to disclose the fair values of all financial assets and financial liabilities. It believes that fair value is a useful measure in the case of assets and liabilities that are not recognised because their cost on acquisition is nil. Even in the case of instruments that are recognised, fair value is a useful additional measure, enabling the instruments to be viewed from a different perspective from that used for recognition purposes. The requirement to disclose fair values has therefore been retained in the FRS.
- 38 As already mentioned FRED 13 recognised that there will be circumstances, albeit limited, in which it will not be practicable for non-financial institutions to determine with sufficient reliability the fair value of a non-traded financial instrument. In such circumstances, the FRED proposed that it should not be necessary to disclose fair value. This approach was generally supported and has been carried forward into the FRS.

- 39 However, in two important respects the fair value disclosure proposals have been modified.
- (a) FRED 13 proposed that the FRS should require the fair value of financial instruments that are not traded on organised markets in a standard form to be shown separately from the fair values of other financial instruments. This proposal was criticised by respondents, who thought that its focus was inappropriate and that it was too detailed a disclosure. In the light of these comments, the requirement has not been included in the FRS.
 - (b) It had been proposed that financial assets and financial liabilities should be grouped into appropriate categories and that a single fair value should be given for each category. Whilst this approach was supported by the majority of respondents, a number thought that one aggregate figure should be given for instruments with a positive fair value and another for instruments with a negative fair value. The Board has reconsidered the matter and has decided that, as the arguments involved are evenly balanced and the issue is not central to the usefulness of the disclosure, the FRS should permit a choice.
- 40 FRED 13 also contained an appendix setting out guidance on procedures for estimating fair values, and those responding to the FRED were asked to comment on whether this guidance was sufficient. Most respondents thought that it was sufficient, although a few suggested that the guidance should be much more specific on matters such as bid, offer or mid-market prices; large holdings; changes in creditworthiness of own debt; and portfolios. The Board believes, however, that it is not appropriate at this stage to be prescriptive on such matters. The guidance has therefore been carried forward into the FRS largely unchanged.

- 41 IAS 32 contains a requirement that, if a financial asset is carried in the balance sheet at an amount in excess of fair value, the reasons why the carrying amount has not been written down to the fair value should be disclosed, together with details of the carrying amount and fair value concerned. As IAS 32 goes on to say, “management exercises judgement in determining the amount it expects to recover from a financial asset and whether to write down the carrying amount of the asset when it is in excess of fair value. [This disclosure] provides users of financial statements with a basis for understanding management’s exercise of judgement and assessing the possibility that circumstances may change and lead to a reduction in the asset’s carrying amount in the future.” When FRED 13 was published, it was explained that, although consideration had been given to including a similar requirement in the FRS, it had been decided that, whilst this disclosure was likely to be of relevance in the context of an FRS dealing with the measurement of financial instruments, it was unlikely to contribute to an understanding of the main risks arising from the entity’s use of financial instruments. Those who responded to FRED 13 supported this conclusion. The FRS therefore adopts the same approach as the FRED.

Disclosures about financial assets and financial liabilities held or issued for trading

- 42 In response to comments received on FRED 13, the disclosures required for financial instruments held or issued for trading have been simplified in that the proposed requirement to analyse net gains and losses by type of financial instrument has not been retained.

Disclosures about hedges

- 43 As mentioned already, the Board’s work on hedge accounting continues. One of the concerns about the use of hedge accounting is that, because practice varies widely and because it is management intention that determines what is a hedge, it is difficult to know how to interpret the financial statements of an entity that uses hedge accounting extensively. Therefore, although it is possible that the Board will in due course restrict or even prohibit the use of hedge accounting, there is a need now to improve the disclosures about its use. For this reason, proposals on disclosures for hedges of future transactions were put forward in FRED 13. The purpose of the disclosures proposed was to explain how the entity accounts for hedges of future transactions and, if it uses hedge accounting, to show the effect on the performance statements.
- 44 These proposals attracted much comment. Some respondents thought that few, if any, hedging disclosures should be required, some accepted the need for some disclosures but viewed the proposed disclosures as excessive, and some thought the disclosures would reveal commercially sensitive information and therefore should be subject to a commercial sensitivity exemption. Generally speaking, the Board has not been persuaded by such arguments and continues to believe that, in the absence of an accounting standard on the recognition and measurement aspects of hedge accounting, extensive disclosures are essential.

- 45 That said, the FRS makes two significant changes from the hedging disclosures proposed in FRED 13.
- (a) The FRED proposed that the disclosures should apply only to hedges of future transactions. This left a gap in the information provided about hedges, and the disclosures in the FRS therefore extend to all hedges.
 - (b) The FRED proposed that the disclosures should be analysed to show information on hedges of firm contracts separately from information on other hedges. However, in response to the comments received, this requirement has not been included in the FRS.

Disclosures about commodity contracts treated as financial instruments

- 46 As already mentioned, FRED 13 proposed that certain types of commodity contract should be included in the disclosures as if they were financial instruments. The FRED also proposed that, if any of these disclosures were commercially sensitive, in certain circumstances that disclosure need not be given. Some respondents, however, thought that this exemption should also be available in other circumstances. The Board has considered at great length the comments made on this matter but, having taken into account:

- the degree of aggregation required or permitted by the FRS
- the flexibility given regarding the form that the disclosures should take
- the delay that will usually arise before the financial statements become publicly available

it has not been convinced that there is a need to extend the exemption.

- 47 Three changes have nevertheless been made to the exemption proposed by FRED 13.
- (a) The FRED proposed that the exemption should be available in respect of all disclosures provided on commodity contracts. However, as the Board does not believe that the narrative disclosures could require the disclosure of commercially sensitive information, the FRS excludes such disclosures from the scope of the exemption.
 - (b) The FRS requires that to take advantage of the exemption, it is necessary that, inter alia, disclosure would be ‘seriously prejudicial’ to the interests of the entity; FRED 13 referred only to ‘prejudicial’. This amendment brings the wording of the exemption in the FRS into line with the wording of the commercial sensitivity exemptions contained in other accounting standards.
 - (c) The FRS acknowledges that whether disclosure will be seriously prejudicial to the interests of the entity is essentially a matter of the directors’ opinion.

Encouraged additional disclosures about market price risk

- 48 There is much concern about the absence of good quality disclosures about the market price risk that entities take on through financial instruments and similar contracts. On the other hand, the measurement of market price risk is evolving and a consensus has yet to emerge on the best method of providing adequate and meaningful information in a cost-effective manner. For these reasons, FRED 13 proposed to encourage, but not require, additional numerical disclosures concerning market risk. This approach was generally supported by respondents and has therefore been retained in the FRED.

Offsetting

- 49 FRED 13 proposed the extension, subject to minor amendments, of the offset provisions of FRS 5 'Reporting the Substance of Transactions' to all financial assets and financial liabilities. The proposal was criticised by respondents, who thought it inappropriate or confusing. Others argued that it was inappropriate for an FRS on disclosure to prescribe the rules to be applied when offsetting for recognition purposes. The Board accepts that, whilst it is necessary for the FRS to make it clear what level of aggregation and offsetting should be used in preparing the disclosures, it is not necessary for this FRS to address offsetting in the primary accounting statements themselves. The proposal has therefore been dropped.

Numerical disclosures to be provided by banks and certain other institutions*Main changes*

- 50 Respondents generally supported the detailed disclosure requirements proposed in FRED 13 Supplement and, as a result, there have been only three significant changes to the disclosures.
- (a) *Currency disclosures* - There was much debate about the currency disclosures proposed. This is discussed in paragraph 54 below.
 - (b) *Maturity analysis* - The Supplement proposed that the FRS should repeat the maturity analysis disclosure requirements for banks that are contained in other accounting standards and in legislation and it proposed that the FRS should require all these analyses to be provided together in a single note. Neither of these proposals has been carried forward to the FRS.

- (c) *Trading book disclosures* – The Supplement proposed that the trading book disclosures should show the position at the balance sheet date (unless such information is not typical of the figures during the period). However, in the light of comments received, the Board concluded that providing information about the position at the balance sheet date only will not enable the user to understand the significance of the trading book to the reporting entity. The requirement in the FRS has therefore been extended to include disclosure of the highest, lowest and average positions during the period.

Currency disclosures

- 51 Although worded somewhat differently from the proposals set out in FRED 13, the Supplement’s currency disclosure proposals were in essence very similar to the FRED’s in that they proposed that banks and similar institutions should disclose details of their structural currency exposures and of the currency exposures in the non-trading book that give rise to the net currency gains and losses recognised in their profit and loss account. Although these proposals were criticised for some of the same reasons as the FRED’s proposals, the Board has decided that the requirement to disclose the structural currency exposures should be retained for banks and certain similar institutions, albeit in a simplified form. There are two main reasons why this approach is not the same as the approach adopted for non-financial institutions.
- (a) The structural currency exposures of most financial institutions arise primarily from financial instruments and therefore need to be dealt with in the FRS’s disclosures if its objective is to be met.

- (b) It would appear that the disclosures would not cause the same practical problems for banks and similar institutions as they would cause for non-financial institutions.

Fair value disclosures

- 52 In developing FRED 13 Supplement, the Board decided that the fair value disclosure requirements proposed in FRED 13 should be slightly modified for banks and similar institutions. For such entities, markets for some non-trading book items have generally not evolved to the point where fair values can be determined by reference to a readily available market price. Furthermore, although valuation techniques may exist that will enable entities with a few of those assets and liabilities to determine a reliable fair value reasonably easily, they have not yet developed to the point where fair values for large numbers of such assets and liabilities can be determined without incurring significant expense. The Board therefore concluded that the disclosure of fair values for these assets and liabilities should not, at present, be required. This approach was generally supported by those responding to the Supplement and has been reflected in the FRS. This is, however, a developing area and the Board intends to keep the matter under review, particularly in the light of developments in valuation techniques and as markets evolve.

- 53 As already mentioned, when the Board came to devise a disclosure regime for financial institutions other than banks, it concluded that, in the main, such entities should be able to choose to provide either the ‘FRED 13 disclosures’ or the ‘Supplement’s disclosures’. However, after careful consideration it concluded that it would be inappropriate to allow such flexibility for fair value disclosures. This conclusion was based on the Board’s view that the circumstances described in paragraph 52 above do not hold true for the majority of financial institutions other than banks, and it is not practicable to try to differentiate between those institutions where it does hold true and those where it does not. Such entities will, of course, be able to avail themselves of the exemption referred to in paragraph 38 above.

Value at risk

- 54 Value at risk methods are widely viewed as the most sophisticated means available at present for measuring market price risk. For this reason, the Board was minded, in developing the proposals in the Supplement, to require all banks to disclose the value at risk of their trading books. However, this is not realistic at present; although there is a trend towards the use of value at risk for both internal risk management purposes and external prudential supervisory purposes, there are many banks that do not use the technique. The Board therefore concluded that it would be necessary to permit banks to use an alternative method to provide the disclosures. Similarly, although ‘value at risk’ is a generic term for a type of method it is not realistic at present to specify the precise method to be used by banks for external reporting purposes. These conclusions were reflected in the proposals set out in the Supplement and were supported by most respondents. The same approach has therefore been adopted in the FRS.

Credit risk disclosures

- 55 Although IAS 32 requires numerical disclosures about an entity's exposure to maximum credit risk and concentrations of such risk, the FRS contains no similar requirements. When the Board was developing its Discussion Paper it took soundings to discover which information about financial instruments users thought was most relevant. This revealed that further disclosures relating to the credit risk of financial instruments in general, and derivative financial instruments in particular, were not normally of concern to users of financial statements, particularly for reporting entities that are not financial institutions. The Board therefore concluded that it should not require the disclosure of such information. This issue was specifically highlighted in the preface to FRED 13 and the Board's conclusion was generally supported by respondents.
- 56 The Board accepts that, whilst this approach may be appropriate for non-financial institutions, it may progressively become less appropriate in the context of financial institutions, particularly in view of the use of credit derivatives and similar instruments. This matter will be kept under review in the light of developments in the markets and accounting techniques for such instruments.

Amendment to FRS 4

- 57 Paragraph 38 of the FRS requires certain entities to provide a liquidity analysis of financial liabilities. As mentioned in paragraph 39 of the FRS, maturity analyses of debt and obligations under finance leases are already required by paragraph 33 of FRS 4 and paragraph 52 of SSAP 21 respectively. The Board believes that many preparers and users would like to be able to meet those requirements and the requirements of paragraph 38 of this FRS through a single disclosure. However, paragraph 33 of FRS 4 requires very slightly different time bands to be used in its analysis from those that are required to be used by paragraph 52 of SSAP 21. The purpose of the amendment to FRS 4 is to eliminate these differences and thereby enable entities to meet all these requirements through a single disclosure.

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