

JOINT WORKING GROUP OF STANDARD-SETTERS



Financial Instruments and Similar Items

A consultation paper
incorporating the JWG's draft standard

published by

the Accounting Standards Board

December 2000



For the convenience of respondents in compiling their responses, the text of the Request for Comments section of the JWG's paper can be downloaded (in Word format) from the 'Derivatives and other Financial Instruments' page in the Current Projects section of the ASB Website (www.asb.org.uk).

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or sent by email to
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and should be dispatched so as to be received not later than 30 June 2001. All replies will be regarded as on the public record unless confidentiality is requested by the commentator.

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Foreword by the Accounting Standards Board

- a This consultation paper, which is written in the form of a draft accounting standard, presents proposals for the recognition, measurement, presentation and disclosure of financial instruments and certain similar items. The proposals have been developed by the Financial Instruments Joint Working Group of standard setters (JWG),* and are now being published for comment.
- b The Accounting Standards Board has not yet formed a view on the JWG's proposals. It does, however, support the notion of a common approach to accounting for financial instruments that is consistent with its Statement of Principles for Financial Reporting and it regards the development of an accounting standard on financial instruments as a priority for standard-setting bodies throughout the world.
- c The JWG's paper contains the most comprehensive consideration yet of the issues that would arise if a full 'fair value' model were to be implemented for financial instruments, and the Board will be taking into account the proposals, and the comments received in response to them, in its future work on the subject. It therefore strongly advises those interested in accounting for financial instruments to participate fully in this stage of the consultation process. In particular, ***the Board hopes that the Paper will receive the detailed consideration more usually given to exposure drafts in order to provide a serious UK contribution to the simultaneous international debate on this important issue.***

* Details of the standard-setters participating in the work of the JWG, and of the JWG's terms of reference, are set out in the Preface to the JWG's Draft Standard.

Background

- d The Board has long been concerned that accounting practice is finding it difficult to cope with the growth in the use of financial instruments and, in particular, with the increasingly complex types of financial instruments that are being used and the increasingly complex transactions that are being undertaken. Financial instruments can rapidly transform the risk profile of an entity in a way that is not made apparent under present reporting practices. For example, a derivative contract can be used to convert a dollar floating rate exposure into a sterling fixed rate exposure. A forward foreign currency contract may be used to mitigate the risk that expected future sales denominated in a foreign currency may be worth less when converted into sterling because sterling has strengthened in the meantime. In both cases, the value of the contract involved can change significantly so that it comes to represent a substantial asset or liability. Yet, under the present, historical cost based system of reporting, the consequences of events that affect the value of the contracts—and therefore that affect the entity's financial performance and financial position—are typically not recognised when they occur. As a result, it will usually not be apparent to users that significant gains may have been made or losses incurred, nor may the entity's exposure to future gains and losses be apparent.
- e The Board explored these concerns in some detail in a Discussion Paper, 'Derivatives and other Financial Instruments', published in 1996. On measurement and hedge accounting, the Discussion Paper concluded that:
- all financial instruments should be measured in the financial statements at current value; and
 - the use of hedge accounting techniques should probably be restricted in some way or prohibited.

However, it also concluded that more time was needed for these issues to be debated and explored before an accounting standard could be developed.

- f In 1997, the Board joined with other standard-setters in establishing the JWG as a means of developing an internationally harmonised approach to a subject that has been of concern to standard-setters around the world. It also saw the JWG as providing the ideal forum in which to stage the additional debate, and to carry out the additional exploration, that it had concluded in its Discussion Paper was necessary.
- g It is worth noting that, in recent years, the International Accounting Standards Committee (IASC) and the USA's Financial Accounting Standards Board (FASB) have both issued accounting standards (IAS 39 'Financial Instruments: Recognition and Measurement' and FAS 133 'Accounting for Derivative Instruments and Hedging Activities' respectively) that make a partial move towards measurement of financial instruments at fair value. The Board has chosen not to adopt such an approach, preferring instead to consider fully the merits of the comprehensive fair value model it proposed in its Discussion Paper. The publication of the JWG's proposals is an important part of this process.

Status of the JWG's proposals

- h Although presented in the form of an exposure draft, the JWG's paper has a status more akin to a discussion paper. Therefore, any accounting standard that the Board decides to issue on the matters addressed in the JWG's paper will be preceded by an ASB exposure draft.
- i As already mentioned, the Board has not yet formed a view on the JWG's proposals. Nevertheless, the importance of this document—and of responding to it *in detail*—cannot be overstated. The Board has made clear its concerns about existing accounting practice for financial instruments and its belief that significant changes are necessary, and it will be taking the proposals, and the comments received in response to them, into account in developing an accounting standard on the subject.

- j In developing its own standard, the Board intends to make every effort to develop requirements that achieve the same accounting in the UK and the Republic of Ireland as is achieved by the financial instrument standards issued in other jurisdictions participating in the JWG. The Board hopes that international consensus will develop as a result of the JWG's efforts and that it will be able to develop a standard based on such a consensus.

Integrating the proposals with UK GAAP

- k The JWG's proposals have been developed in an international context and, accordingly, do not address in detail how they would interact with existing standards in any particular national jurisdiction. However, if the proposals were to be implemented as drafted, the more significant changes that would have to be made to existing accounting standards in the UK and the Republic of Ireland are as follows:

- *SSAP 20 'Foreign currency translation'*—Most of the requirements of SSAP 20 would remain unchanged. However:
 - the standard requires, both for individual entity financial statements (paragraph 51) and consolidated financial statements (paragraph 57), exchange gains and losses on foreign currency borrowings used to finance or hedge the entity's foreign equity investments to be offset, in the statement of total recognised gains and losses, against exchange differences on the foreign equity investments. Under the JWG's proposals, exchange gains and losses on such foreign currency borrowings would be recognised immediately in the profit and loss account. Paragraphs 51 and 57 of SSAP 20 will therefore need to be amended to accommodate this proposal, if implemented. UITF Abstract 19 'Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise', which permits any tax charge on such exchange gains and losses to be recognised in the statement of total recognised gains and losses, would, for the same reason, need to be withdrawn.

- a minor amendment to SSAP 20 would be needed to ensure that that standard contained nothing that would prevent the implementation of the JWG's proposal that forward exchange contracts should be fair valued on the basis of the *current* forward exchange rates.

- *FRS 3 'Reporting Financial Performance'*—FRS 3 requires entities to prepare two performance statements—the profit and loss account and the statement of total recognised gains and losses—and then specifies that gains and losses that are required by other accounting standards or law to be recognised outside of the profit and loss account should be recognised in the statement of total recognised gains and losses. In certain limited circumstances those gains and losses could include certain gains and losses on financial instruments. As the JWG's proposals envisage that gains and losses arising on financial instruments would be recognised in the profit and loss account, an amendment would need to be made to FRS 3 and the relevant accounting standard or law to eliminate the inconsistency between existing requirements and the proposals.*

- *FRS 4 'Capital Instruments'*—The JWG's proposals have three main implications for FRS 4:
 - The key distinction that FRS 4 draws between capital instruments is between those that are reported within shareholders' funds and those that are reported as liabilities. Some non-equity instruments, as well as all equity instruments, are reported within shareholders' funds. The distinction the JWG draws is different: it is between own-equity instruments and liabilities, with only the latter being within the scope of the proposals. Therefore, if the JWG's proposals were to be implemented as drafted, the way in which FRS 4 classifies capital instruments would need to be amended.

* In December 2000, the Board published FRED 22 'Revision of FRS 3 "Reporting Financial Performance"', which proposes that the profit and loss account and the statement of total recognised gains and losses should be combined in a single performance statement.

- FRS 4 sets out in some detail how the finance costs of a capital instrument should be determined and how that cost should be allocated to accounting periods. A specific point relating to this subject is addressed in UITF Abstract 11 ‘Capital instruments: issuer call options’. The JWG proposes that all financial instruments (with certain very limited exceptions) should be measured at fair value. If that proposal were implemented as drafted, the provisions of FRS 4 that deal with finance costs, and UITF Abstract 11, would need to be amended so that they did not apply to capital instruments falling within the scope of that new requirement.
- Paragraph 25 of FRS 4 requires convertible debt to be reported within liabilities. Under the JWG’s proposals, such instruments are hybrid contracts and would, therefore, need to be split into their equity and debt elements, with only the debt elements being accounted for in accordance with the JWG’s proposals. FRS 4 would therefore need to be amended to accommodate this accounting treatment.
- *FRS 5 ‘Reporting the Substance of Transactions’*—FRS 5 contains, inter alia, the criteria for determining whether an asset or liability should be derecognised. The JWG’s proposals contain provisions setting out the derecognition criteria to use for *financial* assets and *financial* liabilities, and those provisions are significantly different from those in FRS 5. Therefore, if the JWG’s proposals were implemented as drafted, FRS 5 would need to be amended to limit the scope of its derecognition provisions to non-financial items.
- *FRS 13 ‘Derivatives and other Financial Instruments: Disclosures’*—The disclosure requirements proposed in the JWG’s paper represent a comprehensive package of disclosures for financial instruments, designed for use under a fair value model. As such, they would replace the disclosures required by FRS 13, thus enabling that standard to be withdrawn.

In addition, the references in existing standards to the measurement basis used for various types of instrument falling within the scope of the JWG's paper would need to be amended to enable those instruments to be measured at fair value.

Request for comments

- l Each standard-setter participating in the JWG is publishing the JWG's paper at approximately the same time and is inviting comments on the paper from its constituents within approximately the same period.
- m The comments received in response to this consultation paper will be placed on the public record and will be shared among the participating standard-setters, unless confidentiality is requested.
- n Respondents are urged to reply to any or all of the issues included in the Request for Comments section of the JWG document. Responses will be most useful if they are structured around the issues identified in the Request for Comments and include not only conclusions on each issue but also the reasons for those conclusions.
- o Respondents are also encouraged to identify additional issues and matters they believe are relevant to accounting for financial instruments and similar items. In particular, as the JWG's proposals have been developed in an international context, the Board is interested in comments on any circumstances that respondents believe are unique to the environment in the UK and the Republic of Ireland that should result in an ASB standard differing from an international standard. If respondents believe such circumstances exist, it would help the Board if they specified the circumstances and explained the consequential effect on the JWG's proposals were they to be modified to take account of those unique circumstances.

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