

Developments in IFRS for financial instruments

Issue 24—February 2007

 **ERNST & YOUNG**

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Introduction

This newsletter summarises the main discussions and conclusions reached concerning financial instruments at the December 2006 and January 2007 meetings of the International Accounting Standards Board (IASB or Board) and the January 2007 meeting of the International Financial Reporting Interpretations Committee (IFRIC or Committee).

It also reports on other developments in the reporting of financial instruments under International Financial Reporting Standards (IFRS).

Fair value measurements

At its January meeting, the IASB agreed to extend the comment letter deadline for its Fair Value Measurements Discussion Paper (DP) to 4 May 2007. This is a welcome decision and demonstrates the Board's willingness to respond to comments and concerns raised by constituents.

More discussion on this DP can be found in the February 2007 special edition of this newsletter (available at ey.com/ifrs).

Hedging portions of risk

At its December meeting, the IASB continued its discussions relating to hedging risks associated with a specific portion of an exposure. Refer to the August 2006 and December 2006 editions of this newsletter for additional discussion on this subject (available at ey.com/ifrs).

The Board agreed to propose an amendment to IAS 39 *Financial Instruments* to specify the risks and 'portions' of a financial instrument that would be permitted to be designated as a hedged risk. Additionally, the IASB decided that the amendment would be developed as a stand-alone project rather than included in the annual improvements process.

Currently, IAS 39 does not specify the types of risks that can be designated as a hedged risk. The risks considered by the Board to be eligible for hedge accounting include: market interest rate risk, foreign currency risk, credit risk, prepayment risk, and "risks associated with the cash flows of a financial instrument that are contractually specified and are independent of the other cash flows of the same instrument."

In the Observer Notes for the meeting an example was given of the last of these eligible risks: a debt instrument that provides a periodic coupon based on an inflation rate. However, if a debt instrument pays a fixed return (which can be thought of as the combination of the inflation rate plus a residual ‘real’ return), the entity should not be allowed to designate the changes in inflation as a hedged risk, since the inflation rate and the residual rate are dependent on each other. In other words, the Board’s decision implies that it would not be possible to hedge the inflation risk implicit in fixed rate debt.

The IASB staff will conduct additional research to determine if there are additional risks, other than those noted above, that should be included in the list of eligible risks.

Currently, IAS 39 explicitly permits certain ‘portions’ of a financial instrument to be designated as the hedged risk (the December 2006 *IASB Update* lists partial term hedges, hedges of a percentage of the cash flows of the hedged item, or hedges of one-sided risks). The Board agreed to provide guidance on what ‘other portions’ of a financial instrument would be eligible for designation as a hedged risk in specified situations.

An example of an ‘other portion’ that is considered to be eligible for hedge designation under IAS 39 is when a swap paying LIBOR in return for fixed interest at, say, 7% is used to hedge a financial asset that pays a fixed rate of, say, 10%. The swap can be designated as a hedge of the principal value of the asset plus 7% interest, so there will be little or no hedge ineffectiveness (see paragraph 81 of IAS 39).

The IASB will need to be careful how it refers to ‘one-sided risks’ since there is debate as to whether it is possible to designate the whole of an option, including changes in its time value, as a hedging instrument, without giving rise to hedge ineffectiveness (as permitted under US GAAP: Statement of Financial Accounting Standards (SFAS) No. 133 *Disclosures about Derivative Instruments and Hedging Activities* Implementation Issue G20), or whether it is only possible to designate the change in the intrinsic value of an option, as illustrated by Implementation Guidance F1.10 of IAS 39. The Observer Notes specifically refer to F1.10 and make no mention of the time value, so there is no indication that the IASB intends to permit time value to be included in the portion designated as the hedged risk. This question is important since it is one of the issues referred to IFRIC that gave rise to the concern about hedging portions in the first place.

Interest margin hedging

At the January IASB meeting, the European Banking Federation (EBF) presented a summary of a revised proposed interest margin hedge model, as part of an initiative by the European banks that seek to have IAS 39 amended so as to remove the need for the EU carve-out of hedge accounting. The EBF’s revised proposal is for a cash flow hedge model, in contrast to the previous fair value hedge model, but it still involves a simplified process for identifying the hedged risk and measuring hedge effectiveness, compared with IAS 39. The IASB staff and the Board still have issues with the proposal.

According to the December 2006 *IASB Update*, the EBF representatives agreed that:

- any deferral of gains or losses on hedging instruments must be reported in shareholders’ equity
- only a gross amount of assets, liabilities, or forecast transactions can be designated as a hedged item
- assets, liabilities, or forecast transactions that have no interest rate exposure (eg, zero coupon liabilities) cannot be designated as a hedged item in respect of interest rate exposure
- ineffectiveness must be recognised in profit or loss.

Board members suggested that the IAS 39 provisions that some banks believe prevent them from qualifying for hedge accounting are not, in fact, impediments. Clarification of these provisions may be sufficient to render the EBF’s proposal unnecessary.

The EBF agreed to prepare a list of those paragraphs in IAS 39 that the banking community believe to be an issue. The IASB will review this list to determine if any clarifications to IAS 39 are necessary and appropriate.

Financial instruments puttable at fair value

At the January meeting, the IASB began discussing comment letters received on its Exposure Draft (ED) of Proposed Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*. An analysis of the comment letters indicates that a majority of the respondents agree with equity classification for financial instruments at fair value. The Board instructed the IASB staff to prepare a detailed analysis of the scope of any possible amendments.

Hedging net investments

At the January meeting, IFRIC continued its discussions relating to whether it should develop additional guidance on the accounting for hedges of net investments in foreign operations, in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 39. Refer to the December 2006 edition of this newsletter (available at ey.com/ifrs) for additional discussion on this issue.

The Committee considered the following issues:

Hedged risk

IFRIC members believe that a hedged risk should represent an economic exposure that is created by differences in functional currencies, so that the value of the parent's net investment will change with exchange rate fluctuations between the parent's functional currency and the functional currency of the net investment. This means that it would not be possible to hedge the risk of changes in the subsidiary's functional currency compared to the group's presentation currency, unless the presentation currency is the same as the parent's functional currency.

The Committee requested the IASB staff to investigate two alternative views: at the group consolidated level, the hedgeable risk created by a net investment would be limited to the difference between the functional currency of the net investment and the functional currency of: (1) the group parent, or (2) the group parent or any intermediate parent.

Location of the hedging instrument

IFRIC noted that IAS 39 does not require the entity within a group that is exposed to the risk to hold the hedging instrument. The Committee requested the IASB staff to investigate further to determine if this would be applicable to hedges of net investments.

Application under US GAAP

IFRIC agreed to further investigate the net investment hedge treatment under US GAAP, as the requirements as stated in US GAAP might achieve the principles sought by the Committee.

Items not taken onto the IFRIC agenda

Final decisions

At its January meeting, IFRIC concluded on the following issues:

■ IAS 39: definition of a derivative – indexation on own EBITDA or own revenue

Paragraph 9 of IAS 39 excludes from the definition of a derivative contracts whose values change in response to changes in non-financial variables that are specific to a party to the contract. In July 2006, IFRIC came to the tentative decision that this exclusion is not restricted to insurance contracts. After reconsidering the issue, IFRIC decided in January 2007 to withdraw the tentative decision. Instead, the Committee referred the issue to the IASB, recommending an amendment to IAS 39 (possibly as part of the IASB's annual improvements process) to limit the exclusion to insurance contracts.

The decision side-steps two questions: 1) what is a 'non-financial variable specific to a party, and 2) should it reduce the expected diversity in accounting practice? The amendment's effect would be (for instance) that loans whose repayments are linked to profit, EBITDA, revenue, or the profits made on the sale of a specific asset would all be considered to contain an embedded derivative that needs to be separately recorded at fair value through profit or loss.

■ IAS 39: short trading

After considering comment letters received on this issue, IFRIC agreed to revise the tentative decision previously published in November 2006 that concluded that a short sale between its trade date and settlement date meets the definition of a derivative financial instrument (ie, a forward contract). Comment letters received from constituents reminded IFRIC that: (1) under current industry practice (in which short sales are accounted for in a similar manner to purchases, so that a trade debtor and a liability for the 'negative security' are normally recorded on trade date), the profit or loss would be the same as if accounting for the short sale as a derivative, and (2) considerable accounting and operational changes would be required to be made if short sales are accounted for as derivatives, with little improvement in the quality of financial information.

For these reasons and because there is little diversity in practice, IFRIC decided not to take this issue onto its agenda.

■ **IAS 39: financial instruments puttable at other than fair value**

There are two issues: (1) whether instruments that must be classified by the issuer as debt (under IAS 32) must also be recorded as debt by the investor, and (2) whether such classification would affect the decision as to whether the investor should consolidate the issue.

IFRIC noted that IAS 32 and IAS 39 do not require symmetrical accounting for instruments by the issuer and the investor. Additionally, the Committee noted that holding equity instruments of a company is not a determining factor as to whether the entity controls it and so whether consolidated financial statements must be prepared.

Therefore, the Committee decided not to take this issue onto its agenda.

■ **IFRS 39: derecognition**

After considering comment letters received on this issue, IFRIC agreed to withdraw the tentative decision previously published in November 2006. The Committee agreed to add a derecognition project to its agenda but indicated that any Interpretation would have a ‘tightly defined and limited scope’.

Refer to the December 2006 edition of this newsletter for additional discussion on these issues (available at ey.com/ifrs).

As noted above, IFRIC has demonstrated its willingness to respond to constituents’ comments and concerns by re-evaluating several of its previous tentative decisions. This is certainly a welcome approach to standard-setting and encourages interested parties to submit comment letters to IFRIC when appropriate—both when they disagree with, and when they support, the conclusions reached.

Tentative IFRIC decisions

The Agenda Committee presented to IFRIC recommendations not to take the following items onto its agenda. Final decisions will be made at the March 2007 IFRIC meeting.

■ **IAS 39: written options on retail energy contracts**

IFRIC discussed the application of the definition of a written option in paragraph 7 of IAS 39, in the context of retail energy contracts. If a contract that permits a purchaser to

choose the quantity of electricity it uses (as is the case, for example, with most household supply contracts for electricity) were to be considered to be a derivative, it would have to be recorded at fair value through profit or loss.

The Committee believes that in most situations such contracts would not meet the net settlement criteria of paragraphs 5 and 6. Paragraph 7 indicates that if: (1) the non-financial contract does not have contractual terms that enable either party to settle net in cash, or (2) the non-financial contract cannot be readily convertible to cash, then such a contract is not considered a written option within the scope of IAS 39. The Committee does not expect significant divergence in practice and, accordingly, decided not to take this issue onto its agenda.

While we agree with the conclusion that the contracts are not derivatives, the logic for the Committee’s view is not clearly stated. Without clarity as to why such contracts do not fall within paragraph 7 (in particular, why the contracts are deemed not to be readily convertible to cash), it is likely that similar questions will arise in other situations.

■ **IAS 39: hedge effectiveness**

IFRIC considered whether it would be appropriate only to consider undiscounted changes in cash flows in the assessment of hedge effectiveness when designating an interest rate swap as a hedging instrument in a cash flow hedge. If discounted cash flows are taken into account, then there will be some ineffectiveness if the interest payment dates for the hedged item and the hedging instrument do not coincide, or if the swap already has a fair value when it is designated as a hedge.

The Committee noted that to compare the undiscounted cash flows of the interest rate swap and the undiscounted cash flows of the hedged item, it would be to consider only a portion of the movements in the fair value of the interest rate swap. The designation of a portion of the change in fair value of an interest rate swap is not permitted under IAS 39.

IFRIC does not expect significant diversity in practice and, accordingly, decided not to take this issue onto its agenda.

The successor to IAS 39

At its December and January meetings, the IASB continued its discussions on the due process document on financial instruments, to be issued by January 2008 as part of the IASB/FASB Memorandum of Understanding. It is expected that the due process document will discuss possible approaches to accounting for financial instruments and will invite comments on these alternative approaches, in addition to the preliminary views of each Board. Refer to the October 2006 and December 2006 editions of this newsletter for additional discussion on this project (available at ey.com/ifrs).

The IASB made the following tentative decisions:

- No hedge accounting will be permitted for recognised assets, recognised liabilities, firm commitments, or forecast transactions that would be, or result in, an item within the scope of the due process document. Previously, the IASB agreed that all items within the scope of the due process document should be measured at fair value, with changes in fair value reported in profit or loss. Therefore, the Board believes there will be no need for hedge accounting, as no accounting anomalies will arise.
- The due process document will include a discussion as to whether hedge accounting can be applied to assets, liabilities, and firm commitments that would be outside the scope of the document. Not to do so would create accounting anomalies, as the assets, liabilities, or firm commitments would not be measured at fair value. However, any special accounting for such items will probably require the entity to recognise the hedged item (or the portion related to the hedged risk) as if it were a financial instrument.
- A credit card contract gives the card holder the option to borrow money, but exercising this option would normally be beneficial to the credit card company. If portfolios of credit card contracts are transferred then a premium is normally paid by the acquirer to reflect this value. The Board decided not to divide the fair value of the credit card contract into a financial liability and a non-financial asset, but it has yet to decide whether such contracts will be in the scope of the due process document.
- Although a loan contract may give the borrower the right to repay early, because of other factors he may not do so even if the interest rate on the loan is greater than the market rate. This tendency increases the fair value of the loan to the lender. The Board decided that the lender should not report part of the loan's fair value separately, as a non-financial asset.
- Bank deposit agreements will not be included in the scope of the due process document, as it is not clear whether they meet the definition of a financial instrument. Typically, a bank does not have an obligation to accept deposits.
- Financial liabilities with an embedded demand feature (eg, that allow the holder to demand repayment of the instrument with little or no notice, such as some types of bank deposit) should be measured based on the expected timing of cash flows, discounted at market rates for equivalent borrowings of similar risk and maturity. This follows from the principal in SFAS 157 *Fair Value Measurements* included in the Fair Measurements DP (referred to earlier) that a liability's fair value should be the value at which it would be transferred to another market participant (rather than its settlement value). The measurement of such liabilities should also include the usual incremental servicing or other costs that are expected to be incurred.

This decision would appear to require a bank to record a 'day one' profit when it first accepts such a deposit, if it pays interest at below market rates for similar borrowings of equivalent maturity. While under IAS 39 such a profit is likely to be deferred, as the fair value would be derived using model inputs that are not observable, this deferral will not occur if the day one profit provisions of SFAS 157 are incorporated into IFRS.
- A third-party contractual guarantee does not affect the measurement of the liability by the debtor if the guarantee does not release the debtor from its obligation. This will be the situation for most financial guarantees and it is consistent with the position taken in many separate IFRS financial statements of subsidiaries with borrowings guaranteed by their parent.
- Conversely, if a third-party contractual guarantee does release the debtor from its obligation, the debtor will recognise an asset for the guarantee in addition to measuring the fair value of the liability based on the combined probability of cash flows.
- The measurement of a liability should include any effect from the regulatory environment in which the debtor operates (eg, statutory deposit insurance). (The logic appears to be that the insurer would pay the liability and so release the bankrupt debtor from its obligation.)

The successor to IAS 32

At its January meeting, the IASB held the first of a series of meetings in which the staff will update the Board on the progress and results of the liabilities and equity joint project with the US Financial Accounting Standards Board (FASB). The IASB will hold three sessions before May 2007 to discuss the FASB's project results. Refer to the July 2006 and December 2006 editions of this newsletter for additional discussion on this project (available at ey.com/ifrs).

Additionally, the IASB discussed a number of IAS 32 implementation issues and constituents' views on what should be the definition of 'equity'. The purpose of this discussion was to identify the implementation issues that should be included in the liability and equity joint project.

The IASB anticipates publishing a DP later in 2007, which will be an invitation to comment on the FASB Preliminary Views document due to be issued in May 2007. The IASB DP is not expected to include any of the IASB's preliminary views, but it may include supplemental commentary and questions tailored to the IASB's constituents.

US GAAP derivative disclosure ED

On 8 December 2006, the FASB issued a proposed amendment to SFAS 133. The proposal seeks to enhance the current US GAAP disclosure framework regarding information about the entity's use of derivatives and the effect on the financial statements. The proposed disclosures are, generally, similar to those required by IFRS 7 *Financial Instruments: Disclosure*. However, the ED proposes to require: (1) quantitative information relating to the estimated magnitude that leverage factors have on the notional amount and underlying risk of derivative instruments, and (2) qualitative and quantitative information relating to contingent features in instruments in qualifying hedge relationships. Interestingly, the basis for conclusions indicates that the proposed amendments were "not developed with the objective of international convergence."

US GAAP valuation guidance for financial reporting

On 15 January 2007, the FASB issued an Invitation to Comment on *Valuation Guidance for Financial Reporting*. The Invitation to Comment seeks comments from constituents on: (1) whether there is a need for valuation guidance, (2) whether the FASB should be solely responsible for such guidance, and (3) the process that should be used to issue such guidance. SFAS 157 provides general measurement guidance, but it does not address the many specific valuation issues that exist.

Included in the Invitation to Comment is a question as to whether the process of valuation guidance should be operated on an international level (ie, in co-ordination with the IASB).

If you would like to discuss financial instruments in more detail, please contact your regular Ernst & Young representative or one of the people below:

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