Implications for the Conceptual Framework Arising From Accounting for Financial Instruments

This article describes some of the issues faced by standard setters in developing guidance on accounting for financial instruments and the implications these issues have for the conceptual framework (CF). The objective is to outline issues, not necessarily to resolve them, and to consider the implications they have for further developing the conceptual framework.

Given the current trend of harmonization and convergence of accounting practice towards international standards, it seems reasonable to assume that any policy implications will be most relevant to the CF inherited by the International Accounting Standards Board (IASB). Unless otherwise stated, references will be made to International Accounting Standards (IAS).

Key words: Accounting; Concepts; Financial instruments.

DEVELOPMENT OF IAS FOR FINANCIAL INSTRUMENTS

Financial Instruments
In 1989 the IASC and the Canadian Institute of Chartered Accountants (CICA) began a joint project to develop a comprehensive standard on the recognition, measurement and disclosure of financial instruments. The IASC issued an exposure draft (E40, Financial Instruments) for comment in September 1991. The proposals were re-drafted and re-exposed as E48, Financial Instruments, in January 1994. The CICA issued similar exposure drafts at the same time.

In view of the critical responses to E48 the IASC and the CICA decided to divide the project into two phases. The first phase was completed in June 1995 when IAS 32, Financial Instruments: Disclosure and Presentation, was issued. In March 1997, the second phase resulted in a discussion paper (DP), Accounting for Financial Instruments.

1 Most of the G4+1 representatives (Australia, Canada, IASC, New Zealand, U.K. and U.S.) have similar conceptual frameworks.
**Assets and Financial Liabilities.** The discussion paper, which addresses the issues of recognition, transfers and derecognition, measurement, and hedge accounting, notes (para. 1.5): ‘It will be readily apparent that the proposed accounting differs substantially from traditional historical cost practices...However, it is emphasized that the principles proposed in this paper are reasoned within the IASC Framework for the Preparation and Presentation of Financial Statements.’

In the light of the comments received on the DP (1977), the IASC decided to proceed in two phases: (a) an interim standard (resulting in IAS 39 in December 1998) and (b) a comprehensive longer term project in partnership with national standard setters. The second phase resulted in the establishment of the Financial Instruments Joint Working Group of standard setters (JWG) in late 1997. The objective of the JWG was to examine whether a standard that would implement the fair value based principles set out in DP (1997) was feasible. The JWG comprised representatives from accounting standard setters or professional bodies in Australia, Canada, France, Germany, Japan, New Zealand, the Nordic Federation, the United Kingdom, the United States and the IASC. Its proposals, *Accounting for Financial Instruments and Similar Items* (JWG, 2000), were in the form of an exposure draft, application supplement and basis for conclusions.

The IASC, however, could not wait for the completion of the JWG’s proposals. It needed a recognition and measurement standard for financial instruments in order to complete a core set of international standards that could be endorsed by the International Organization of Securities Commissions for cross-border capital raising and listings. In June 1998 the IASC issued E62, *Financial Instruments: Recognition and Measurement*. This was finalized as IAS 39 in December 1998. IAS 39 was issued as an interim standard and is a compromise on the comprehensive fair value approach recommended by DP (1997) and JWG (2000). Under IAS 39, some financial assets and financial liabilities are measured at cost, while others are measured at fair value.

The IASB has included aspects of accounting for financial instruments as part of its ‘active research’ agenda. In particular it is concerned that the mixed-attribute measurement model leads to a number of difficulties and complexities. In the short term, as part of its ‘improvements project’, the IASB has issued *Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation* and IAS 39, *Financial Instruments: Recognition and Measurement* (EDIAS 32 and EDIAS 39). The improvements do not relate to fundamental changes to the concepts in these standards, but are suggestions and recommendations received from preparers and auditors on the implementation of the standards.

**Framework**

The IASC *Framework for the Preparation and Presentation of Financial Statements (Framework)* was issued as an exposure draft in May 1988 and a final document in July 1989. Except for SIC 6, it has remained unchanged since that time.²

² SIC 6, issued in response to the ‘Y2K problem’, deals with when to create a liability and the capitalization of costs relating to modifying existing software.
The development of international accounting standards on financial instruments began in 1989, the same year the Framework was issued, and is still incomplete. The DP (1997) and the JWG (2000) were based on Framework principles. However, opposition to these proposals has resulted in IAS 39, an interim mixed model solution. The delay in producing a financial instruments standard consistent with the Framework is a result of the complexity of financial instruments, the incompleteness of the Framework, and the lack of acceptance of a Framework based solution by financial statement preparers. The issues arising from the financial instruments debate have implications for most of the seven statements that comprise the Framework. The purpose of this article is to discuss these implications.

RECOGNITION

The recognition of ‘financial instruments’ under IAS 39 usurps the CF recognition criteria. Under the Framework, recognition of an asset (or a liability) requires probable receipt (or sacrifice) of a future benefit and reliability of measurement, whereas EDIAS 39.27 simply requires: ‘An entity shall recognize a financial asset or financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.’ Thus for financial instruments the probability of a future benefit (or sacrifice) is not a hurdle for recognition, but part of the measurement of fair value. The focus on the contractual conditions indicates a movement away from the traditional exchange basis towards a contract basis of accounting (see Hughes, 1978, Bradbury and Prangnell, 2002). Consider, for example, the case of a convertible note that gives the holder the ability to convert into equity at a future date. An exchange view would classify the convertible instrument as either all debt or all equity, depending on the probability of conversion. Under a contract basis the components of a financial instrument that are themselves financial instruments may be recognized and measured separately. Thus a convertible instrument could lead to the recognition of a debt component and an option (to convert to equity) component.

MEASUREMENT

There is strong standard setting support for the proposition that fair value is the most appropriate basis of measurement for derivatives. The JWG (2000) extended the use of fair value beyond derivatives by concluding that it is the most appropriate

3 The Framework comprises a series of statements that outline: (a) the objectives of financial reporting, (b) the underlying assumptions, (c) the qualitative characteristics of financial statements, (d) the definitions of financial statement elements (assets, liabilities, equity, income and expenses), (e) the recognition criteria for financial statement elements, (f) the alternative measurement bases that may be used in recording transactions and events, and (g) the concepts of capital and income.

4 Measurement reliability for most financial instruments is simply assumed.

basis for all financial assets and liabilities. Fair value is a market-based notion unaffected by the specific entity that holds the asset or the intended disposition of the asset (see FASB, 1999). Under the central role of fair value measurement for financial instruments, three issues are raised that have implications for the CF: (a) the attribute to be valued, (b) the meaning of fair value, and (c) the accounting for transaction costs.

The Attribute to be Valued
EDIAS 39.66 requires initial recognition at historical cost, which is ‘the fair value of consideration given’. This is consistent with the definition of historical cost in the framework. For many financial assets EDIAS 39.69 also requires subsequent measurement at fair value. However, there is a subtle difference between the fair value at initial measurement and the fair value for subsequent measurement because they are valuing two distinct attributes. The objective for subsequent measurement is based on the fair value of the financial instrument. On the other hand initial measurement is concerned with the fair value of the consideration given. An acquirer might pay more than the estimated amount of a willing buyer, willing seller because it has a special use for the asset (i.e., the fair value of consideration given might contain an element of value-in-use). While this difference is unlikely to be a material issue for financial instruments, the principle involved might be significant for the acquisition of non-financial assets.

The Meaning of Fair Value
The JWG (2000) concludes that fair value is an exit price. EDIAS 39 is not explicit as to the nature of fair value. However, not everyone shares the view that fair value ought to be an exit price. Some prefer other measurement bases such as deprival value (e.g., Horton and Macve 2000) or value-in-use (e.g., Barth and Landsman, 1995). This is not the forum in which to debate that issue. The matter is raised to illustrate that the Framework contains no discussion of ‘fair value’, ‘deprival value’ or ‘value-in-use’. Furthermore, paragraph 101 of the Framework states that the ‘measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost’. This may not be correct given the expansive scope of IAS 39, which encompasses all financial instruments, many of which will be reported at fair value (e.g., available-for-sale and held-for-trading instruments).

The Accounting for Transaction Costs
Another issue that needs be addressed under the measurement section of the Framework is accounting for transaction costs. Exposure draft E62.44 required transaction costs to be included in the initial measurement of held-to-maturity

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6 See Miller and Loftus (2000) for a full description of the relation between fair value and value-in-use.

7 EDIAS 39.69 states that there is to be no deduction for selling transaction costs. This implies that fair value is an exit value because selling transaction costs are irrelevant for entry values.
investments, but excluded from the measurement (both initial and subsequent) of financial assets and financial liabilities that are required to be measured at fair value. In 1998 E62 was released as IAS 39, in which the accounting for transaction costs had changed. IAS 39.66 requires transaction costs to be included in the initial measurement of all financial assets and liabilities. However, transaction costs must not be deducted from fair value measured subsequent to initial recognition.

Thus, the treatment of transaction costs has altered over the development of IAS 39. Furthermore, the treatment of transaction costs within the ‘improved’ IAS 39 is inconsistent. EDIAS 39.99 requires the use of bid-ask prices for fair value estimates in active markets. However, as the bid-ask spread is a transaction cost (see Callahan et al., 1997), the use of bid or ask prices is not consistent with the requirement for subsequent measurement to be at ‘fair value, without any deduction for transaction costs’ (EDIAS 39.69).

Inconsistencies in accounting for transaction costs also occur across other IAS standards. IAS 40, *Investment Property*, states that fair value is ‘without any deduction for transaction costs that the enterprise may incur on sale or other disposal’ (IAS 40.30). Conversely, IAS 2, *Inventories*, requires inventory to be measured at the lower of cost and net realizable value, where ‘net realizable value’ is ‘the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale’ (IAS 2.4).

**RELEVANCE AND RELIABILITY**

The classic qualitative characteristic trade-off between relevance and reliability (see Walker and Jones, 2003) has been a major feature of the financial instrument debate. The *Framework*, paragraph 92 states that:

Income is recognized in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

This is a clear statement that (a) reliability is an asset (or liability) measurement issue not an income statement issue, and (b) that fair value gains and losses should be recognized as income.

Many of the critics of the JWG proposals (JWG, 2000) claimed that, for many financial instruments, fair value could not be measured with reliability. The respondents to the JWG’s proposals were also concerned with the impact that fair value has on income volatility (see Bradbury, 2002, Hague, 2002). Fargher (2001) reports that members of the Australian Markets Association have a greater concern about income volatility than they have about measuring fair value. Some constituents’ arguments indicated confusion between the effect of volatility and the qualitative characteristic of reliability (see Bradbury, 1999).

The issue also highlights the tension between the balance sheet and the income statement. The CF’s definitions are balance sheet-based. Equity (and therefore income) is a residual after measuring assets and liabilities. However, some believe
the crucial issue in accounting for financial instruments is not fair value but performance measurement (e.g., Macve, 1999; Mumford, 2000). EDIAS 39 reaches a practical compromise, and contrary to the Framework (see para. 92, as quoted above) it allows some fair value gains and losses to go to equity (e.g., available-for-sale instruments, cash flow hedges, and hedges of the net investment in a foreign entity). This suggests that the IASB’s ‘active project’ on reporting financial performance is a prerequisite to solving issues relating to the change in fair value.

DERECOGNITION (TRANSFERS OF FINANCIAL ASSETS)

The transfer of financial assets (e.g., securitizations of mortgages and credit card receivables) is a complex area of accounting because some transfers do not result in a ‘clean’ sale. This arises because the transferor has a continuing interest in or involvement with the transferred assets (e.g., the transferor provides a guarantee or has the rights to service the assets or has a call option to re-purchase the assets or has provided the transferee with a put option to return the assets back to the transferor). The accounting issue is whether the transferor has relinquished control and must derecognize the assets (or a portion of the assets) or has entered into a financing transaction (collateralized over the assets) that does not affect recognition of the asset.

Establishing international harmonization in this area will be a major task for the IASB because the solutions arrived at by the U.K. and the U.S. are very different. For example, FRS 5, Reporting the Substance of Transactions, issued by the U.K. ASB has adopted a ‘risk and rewards’ approach. Under this approach an entity only derecognizes a financial asset if it no longer bears the risk and rewards inherent in the financial asset. Consider, for example, an entity that transfers a portfolio of mortgages of $100, where the expected loss of the portfolio is $10. The transferor also provides a guarantee of $20 (i.e., there is recourse to the transferor for the first $20 of losses). If a risk and rewards approach is applied, it would be argued that the transferor has not, in substance, relinquished control because it is still exposed to all the credit risk. If certain conditions are met, FRS 5 might allow linked presentation (i.e., the borrowing to be shown as a deduction from the asset).

The FASB’s SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, applies what might be termed as a condition-based approach. Under this approach, derecognition of financial assets is not based on a judgment as to whether the transferee has assumed the risk and rewards but whether a series of conditions exist that indicates control has been relinquished. For example, the entity is required to derecognize a financial asset if the transferee has the right to pledge and exchange the asset, the asset is beyond the transferor and its creditors in bankruptcy or receivership, or the transferor is not entitled or obligated to repurchase or redeem the asset. Thus, in the prior example if the

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8 The JWG (2000) and Beaver and Wolfson (1984) consider that all foreign currency adjustments related to net investment should be recognized in income.
transferee has the ability to pledge or sell the mortgages, the guarantee would not prevent the transfer from being derecognized (sold) because control has passed.

The JWG (2000) proposed a components approach, which would recognize the components retained or acquired and derecognize those that have been transferred. The components approach would not classify the whole (or a portion of the whole) transaction as a sale or borrowing. Rather, the transferor would seek to derecognize those components that have been unbundled and sold and continue to recognize the components in which it has a continuing interest. Hence in the above example, the transferor would derecognize (as a sale) the entire portfolio of mortgages ($100) and recognize the $20 guarantee at fair value ($10), thereby recognizing a gain of $10.

The compromise arrived at in EDIAS 39 is also a conditions-based approach that limits derecognition where there is a continuing involvement. In the above example, the entity would derecognize $80 of receivables (i.e., the amount of receivables not subject to the guarantee) and recognize a debt (for failed sale) of $20. The ‘failed sale’ obligations have been called ‘fictitious borrowings’ because they do not meet CF definitions (see Dissenting Views, EDIAS 39, Appendix D).

The fact that four different approaches have arisen in accounting for the derecognition of financial instruments suggests that the CF was not helpful in producing a uniform solution. The basic issue is the interpretation of ‘control’ or, more precisely, ‘loss of control’. Derecognition further highlights the tension between concepts such as ‘risk and rewards’ and a ‘components approach’.

**ELEMENT DEFINITIONS**

The inadequacy of the CF to deal with the complexity of innovations in the hybrid security market raises difficult conceptual issues and has resulted in considerable diversity in practice with regard to balance sheet classification. For example, trust preferred securities are generally reported in the ‘mezzanine’ layer between debt and equity, although some are reported in debt, some in equity and some are unclassified (Frischmann et al., 1999). The diversity in practice is extended to the correspondence between balance sheet classifications and income statement.

EDIAS 32 represents a substantial modification to the definition of equity contained in the Framework. Under CF definitions equity is indirectly defined, as a residual of defining asset and liability elements. However, EDIAS 32.22D adopts a direct approach by considering whether the counter-party holds a residual interest in the entity. Thus equity is no longer a residual. Furthermore, the exposure draft attempts to define equity from the holder’s viewpoint, not the viewpoint of the entity that is issuing the equity instrument. This results in situations where the entity has a financial obligation that is reported as a liability even though the entity is 100 per cent committed to settling the obligation by delivering its own equity instruments!

Another fundamental concept in accounting for compound instruments is whether to adopt a single instrument (either all equity or all debt) approach or a component approach. Ma and Lambert (1998) advocate the reporting of a compound instrument
with a dual nature as a single instrument. On the other hand, EDIAS 32.19 requires classification of an instrument to be on the basis of an assessment of the substance and without regard to probabilities of the manner of settlement. Again, there is a conceptual appeal to the substance of the transaction.\(^9\)

**RISK**

Perhaps one of the underlying weaknesses of the CF in relation to financial instruments is that it almost ignores risk—one of the main attributes of financial instruments. The CF element definitions are preoccupied with the measurement of assets and liabilities with a view to the determination of income to shareholders. Assets are defined as resources from which future economic benefits are expected to flow. The language of the CF focuses, almost exclusively, on expected values rather than the variation about the expected value. Knowledge of the possible variation in measurement and the variation in outcome is important in understanding financial instruments and financial statements. Consider, again, the derecognition example above. The entity, pre-derecognition, has a $100 financial asset with an expected loss of $10. After securitization it might have a $20 financial asset with a likely default of $10. Thus to understand fully asset transfers and a derecognition transaction, the financial statement descriptions and risk disclosures are as essential as the recognition and measurement rules.

**CONCLUDING REMARKS**

The objective of this article is to document interactions between accounting for financial instruments and the CF. Financial instruments cover a wide range of assets and liabilities, from everyday monetary items (such as receivables, payables and debt) to complex derivatives. Financial instruments therefore represent a wide-ranging test case for the application of the CF to an accounting issue. An additional benefit is that, in many cases, the valuation and measurement issues of financial instruments are much less significant than those of non-financial assets and liabilities.

One set of users of the CF is standard setters. Current accounting standards (albeit interim standards awaiting further development) represent practical and political compromises of CF principles. However, recent documents on financial instruments (such as the DP, 1997, and the JWG, 2000) have been based on the CF. This article has highlighted areas where current practice conflicts with those proposals based on the CF.

Another set of users of the CF is the preparers of financial statements. Understanding the CF is essential for preparers if they wish to influence standard setters on an accounting issue. Unfortunately, some responses to financial instrument pronouncements indicate that the underlying concepts (such as reliability) of the CF are not well understood. More importantly, constituents invoke strongly held

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\(^9\) However, in this particular case it is difficult to imagine that the probability of settlement is not part of the substance of the transaction. It is certainly not part of the contractual form of the arrangement.
beliefs based on concepts that are not contained in the CF. The most significant of these beliefs relates to the role of ‘management intention’ (especially related to hedging), the consistency with internal management practices, the role of earnings in determining dividends, taxation and pricing (see Hague, 2002, and Bradbury, 2002).

This article has highlighted implications that financial instruments have for significantly refining existing concepts, such as element definitions, recognition, measurement and qualitative characteristics, of the CF. The financial instrument debate also provides new concepts that need to be incorporated in the CF. Examples include derecognition, transaction costs, and the role of management intent. There is at least one aspect where the Framework is a promise unfulfilled. Paragraph 4 of the Framework states that it ‘will be revised from time to time on the basis of the Board’s experience of working with it’. This revision is long overdue.

REFERENCES


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