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**International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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11 October 2002

Dear Sir or Madam,

Czech National Bank would like to express sincere thanks the Board for this opportunity to comment on the Exposure draft of proposed Amendments to IAS 32 and IAS 39. In general, we support the Board's efforts to more closely align disclosure, presentation, recognition and measurement of financial instruments with true and fair view / fair presentation.

Since 1st January 2002 accounting rules for financial institutions in the Czech Republic are very similar to International Accounting Standards. Bridges between Czech accounting rules and IAS have almost disappeared due to our effort to adopt IAS. We are ready to change accounting rules in the future in the line with the changes of IAS.

We think that the adoption of Basle risk categorisation would be appropriate for IAS. The reason is that Basle Capital Accord has adopted the best practices of risk measurement. Such practices are commonly used not only in banks but also in other entities. In this sense it is worth mentioning that there is only one kind of interest rate risk (which is known in IAS 32 as "fair value interest rate risk"). The "cash flow interest rate risk" is not considered by the Basle Capital Accord as a risk.

However, we have to reject the proposed treatment of collectively assessed financial assets for impairment as it is illogical and is inconsistent with the concept of risk included in the Basle Capital Accord. The primary idea of the concept of collectively assessment of financial assets with similar credit risk characteristics that are collectively assessed for impairment, shall be the facilitation of the burden associated with individual assessment of a huge number of small financial assets.

The principle that the individually impaired financial asset shall be removed from a group of collectively assessed financial assets generates no need for any allowance against impairment of

financial assets in a group of non-impaired financial assets. Such conclusion is against the primary idea of creating the allowance against a group of collectively assessed financial assets. The idea is further analysed in comment Nr. 24. Thus we have fully to disagree with the proposal included in paragraphs 112-133D.

Comments on main changes proposed in the Exposure Draft are included in the enclosure.

Yours sincerely,

Josef Jílek
Professor in Economics

Answers to questions: IAS 32

- Question 1: Yes
Question 2: Yes
Question 3: Principally yes (see comments Nr. 3 and 4)
Question 4: Yes

Answers to questions: IAS 39

- Question 1: Yes
Question 2: Yes
Question 3: Yes
Question 4: Yes
Question 5: Yes
Question 6: No
Question 7: Yes
Question 8: Yes
Question 9: Yes
Question 10: Yes

Comments on IAS 32

Comment Nr. 1
Paragraph 19

19. The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's balance sheet. Although substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. The classification of an instrument is made on the basis of an assessment of its substance and without regard to probabilities of the manners of settlement when the instrument is first recognised (except as provided in paragraphs 29C – 29G). That classification continues at each subsequent reporting date until the financial instrument is derecognised (except as provided in paragraph 29F).

Rationale:

Probabilities of the manners of settlement are taking into account in derivatives based on an entity's own equity instruments (paragraphs 29C - 29G).

Comment Nr. 2
Paragraph 29E

29E.If a derivative contract has more than one settlement alternative (such as net in cash, net in an entity's own equity instruments, or by exchanging an entity's own equity instruments for cash or other financial assets), the contract is a derivative asset or derivative liability unless the entity:

- (a) has an unconditional right and ability to settle the contract by exchanging a fixed number of its own equity instruments (other than derivatives) for a fixed amount of cash or other financial assets;
- (b) has an established practice of settling such contracts by exchanging a fixed number of its own equity instruments (other than derivatives) for a fixed amount of cash or other financial assets; and
- (c) intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets.

If these conditions are met, the contract is an equity instrument ~~unless it may result in the entity delivering cash or other financial assets in exchange for receiving the entity's own equity instruments, in which case paragraph 29F applies~~. If the counterparty can require an entity to settle a derivative contract on a net basis in cash or in the entity's own equity instruments, the contract is a derivative asset or derivative liability ~~unless the counterparty can require the entity to deliver cash or other financial assets in exchange for receiving the entity's own equity instruments, in which case paragraph 29F applies~~.

Rationale:

If the contract may result in the entity delivering cash or other financial assets in exchange for receiving the entity's own equity instruments then contract has the equity component and the financial liability component. It is shown in the original illustrative example 6 (paragraph A55) and in the corrected illustrative example 3 (paragraph A40).

Comment Nr. 3
Paragraph 29F

29F. When an entity enters into a derivative contract (such as a forward repurchase contract, **purchased call option** or written put option on the entity's own shares) that requires settlement by the delivery of cash or other financial assets in exchange for receiving the entity's own equity instruments, ~~those equity instruments cease to meet the definition of equity instruments because the entity has an obligation to redeem them for cash or other financial assets.~~ then the equity component of the derivative contract is subject to paragraphs 29 C – 29E and ~~4~~ The obligation to deliver cash or other financial assets (for example, for the forward repurchase price, option exercise price, or other redemption amount) is a financial liability. When the financial liability is recognised initially under IAS 39, its cost (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with IAS 39. If the derivative contract expires without delivery of cash or other financial assets, the carrying amount of the financial liability is reclassified to equity.

Rationale:

The right to exercise a derivative (i.e. an option) should not be taken into account. If an option is exercised or not, it does not depend on the willingness of the option purchaser but it depends on economic conditions (interest rate, market value of shares, taxation, economic outlook etc). Both european style option and american style option are exercised only if the intrinsic value is positive. Thus both purchased call option and written put option have the liability component. The rule "loss of purchased call option is limited on premium and loss of written put option is unlimited" should not be taken into account, as such a loss is not expensed. According paragraph 29F if the financial liability is recognised initially under IAS 39, its cost is reclassified from equity.

If the contract may result in the entity delivering cash or other financial assets in exchange for receiving the entity's own equity instruments then contract has the equity component and the financial liability component. It is shown in the original illustrative example 6 (paragraph A55) and in the corrected illustrative example 3 (paragraph A40).

Comment Nr. 4
Paragraph 31B

31B. Transaction costs that relate to the issue of a compound instrument that contains both a liability and an equity element are allocated to the components in proportion to the **carrying amounts assigned to the liability and equity components** ~~allocation of proceeds~~. Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

Rationale:

Allocation of transaction costs in proportion to the carrying amounts assigned to the liability and equity components is more objective than allocation of transaction costs in proportion to the allocation of proceeds. Allocation of proceeds is not defined.

43. Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information to assist users of financial statements in assessing the extent of risk related to financial instruments.

(a) *Market risk* — There are ~~three~~ four types of market risk: currency risk, ~~fair value~~ interest rate risk, ~~equity and price~~ risk and commodity risk.

(i) *Currency risk* is the risk that the value of a financial instrument will fluctuate because of changes in foreign exchange rates.

(ii) ~~Fair value~~ *Interest rate risk* is the risk that the value of a financial instrument will fluctuate because of changes in ~~risk-free~~ market interest rates.

(iii) ~~Price~~ *Equity risk* is the risk that the value of a financial instrument will fluctuate as a result of changes in ~~market equity~~ prices, whether those changes are caused by factors specific to the individual ~~equity security or its issuer~~ or factors affecting all ~~equity~~ securities traded in the market.

(iv) *Commodity risk* is the risk that the value of a financial instrument will fluctuate as a result of changes in commodity prices.

The term “market risk” embodies not only the potential for loss but also the potential for gain.

(b) *Credit risk* — Credit risk is the risk that ~~the value of a financial instrument will fluctuate as a result of changes in probability that~~ one party to a financial instrument will fail to discharge an obligation ~~and cause the other party to incur a financial loss~~.

(c) *Liquidity risk* — Liquidity risk, also referred to as funding risk, is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

~~(d) Cash flow interest rate risk — Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in interest rates. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.~~

Rationale:

Division of risks in IAS 32 does not correspond to risk categories in Basle Capital Accord (1996). The New Basle Capital Accord will not change it. Thus it is proposed that IAS 32 should have the same categories of market risk as Basle Capital Accord. Commodity risk is also considered to be category of market risk as some commodity instruments are in the scope of IAS 32 and IAS 39.

Similar to currency risk, interest rate risk, equity risk and commodity risk the value of a financial instrument can also fluctuate up and down because of the credit risk.

According to Basle Capital Accord there is only one variety of interest rate risk which is named “fair value interest rate risk” in the proposal of IAS 32. “Cash flow interest rate risk” is not any risk as any cash flow does not have an influence upon income statement. For example fair value (on the balance sheet) of floating rate debt instrument is not influenced by cash flows and is only a little influenced by a change in risk-free interest rate. Thus fluctuation of future cash flows of a financial instrument because of a change of risk-free interest rate is not a risk.

Interest rate risk is in Basle Capital Accord measured either by maturity method or duration method. There are some relations between the terms in IAS and Basle Capital Accord:

IAS

Basle Capital Accord

interest rate risk
equity risk
credit risk

general interest rate risk
general equity risk
credit risk + specific interest rate risk + specific equity risk

Comment Nr. 6
Paragraph 57

57. An entity provides information about its exposure to the effects of future changes in the prevailing level of interest rates. Changes in market interest rates have a direct effect on the contractually determined cash flows and on the fair value associated with some financial assets and financial liabilities (~~cash-flow~~ interest rate risk) ~~and on the fair value of others~~ (~~fair value interest rate risk~~).

Rationale

There is only one kind of interest rate risk.

Comment Nr. 7
Paragraph 58

58. Information about maturity dates, (or repricing dates when they are earlier), indicates the length of time for which interest rates are fixed, and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides financial statement users with a basis for evaluating the ~~fair value~~ interest rate risk to which an entity is exposed and, thus, the potential for gain or loss. For instruments that reprice to a market rate of interest before maturity, disclosure of the period until the next repricing is more important than disclosure of the period to maturity.

Rationale

There is only one kind of interest rate risk.

Comment Nr. 8
Paragraph 60

60. An entity indicates which of its financial assets and financial liabilities are:

- (a) exposed to ~~fair value~~ interest rate risk, such as financial assets and financial liabilities with a fixed interest rate;
- (b) ~~exposed to cash-flow interest rate risk, such as~~ only a little exposed to interest rate risk, ~~such as~~ financial assets and financial liabilities with a floating interest rate that resets as market rates change; and
- (c) not directly exposed to interest rate risk, such as some investments in equity securities.

Rationale

There is only one kind of interest rate risk.

Comment Nr. 9
Paragraph 62

62. The requirement in paragraph 56(b) applies to bonds, notes, loans, and similar financial instruments involving future payments that create a return to the holder and a cost to the issuer reflecting the time value of money. The requirement does not apply to financial instruments such as investments in equity securities and derivative instruments that do not bear a determinable effective interest rate. For example, even though instruments such as interest rate derivatives, (including swaps, forward rate agreements, and options), are exposed to ~~fair value or cash flow~~ risk from changes in market interest rates, disclosure of an effective interest rate is not relevant. However, when providing effective interest rate information, an entity discloses the effect on its interest rate risk exposure of hedging transactions such as interest rate swaps.

Rationale

There is only one kind of interest rate risk.

Comment Nr. 10
Paragraph 64

64. The nature of an entity's business and the extent of its activity in financial instruments determine whether information about interest rate risk is presented in narrative form, in tables, or by using a combination of the two. When an entity has a significant number of financial instruments exposed to ~~fair value or cash flow~~ interest rate risk, it may adopt one or more of the following approaches to presenting information:

(a) The carrying amounts of financial instruments exposed to interest rate risk may be presented in tabular form, grouped by those that are contracted to mature or be repriced in the following periods after the balance sheet date:

- (i) not later than one year;
- (ii) later than one year and not later than two five years;
- (iii) later than two years and not later than three years;
- (iv) later than three years and not later than four years;
- (v) later than four years and not later than five years; and
- (viii) later than five years.

(b) When the performance of an entity is significantly affected by the level of its exposure to interest rate risk or changes in that exposure, more detailed information is desirable. An entity such as a bank may disclose, for example, separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:

- (i) within one month of the balance sheet date;
- (ii) more than one month and less than three months from the balance sheet date; and
- (iii) more than three and less than twelve months from the balance sheet date.

~~(c) Similarly, an entity may indicate its exposure to cash flow interest rate risk through a table indicating the aggregate carrying amount of groups of floating rate financial assets and financial liabilities maturing within various future time periods.~~

~~(d)~~ Interest rate information may be disclosed for individual financial instruments or weighted average rates, or a range of rates may be presented for each class of financial instrument. An entity groups instruments denominated in different currencies or having substantially different credit risks into separate classes when these factors result in instruments having substantially different effective interest rates.

Rationale

There is only one kind of interest rate risk.

Comment Nr. 11
Paragraph A24A

A24A. The following example illustrates the application of paragraph 28 to the separation of the liability and equity elements of a compound instrument with multiple embedded derivative features. Assume that the proceeds received on the issue of a callable convertible bond are 60. The value of a similar bond without any call ~~or~~ and equity conversion option is 57. Based on an option-pricing model, it is determined that the value to the issuer of the embedded call feature in a similar bond without an equity conversion option is 2 and that the value to the counterparty of the equity conversion option in a similar bond without an embedded call feature is 12. In this case, the value allocated to the liability element under paragraph 28 is 55 (57-2) and the value allocated to the equity element is 5 (60-55). This allocation ensures that the joint value between the liability and equity elements attributable to interdependence between the embedded call and equity conversion features of 7 (12-5) is included in the liability element.

Rationale

Plain vanilla bond without any call and equity conversion option.

Comment Nr. 12
Paragraph A31

A31. The existence of multiple settlement alternatives (such as net in cash, net in shares, or an exchange of cash and shares) does not affect the treatment of a forward repurchase contract as an asset or liability, as described in (a)-(c) above. The accounting treatment is determined on the basis of the party that controls the settlement alternatives. If the counterparty has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a liability for the obligation to deliver cash, as illustrated in (c) above. If the issuing entity has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a derivative asset or derivative liability, as illustrated in (a) and (b) above, unless it has an established practice of settling through the exchange of a fixed amount of cash for a fixed number of the entity's own shares **and it intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, in which case it recognises a liability for the share redemption amount.

Rationale

Alignment with paragraph 29 E

Comment Nr. 13
Paragraph A36

A36. The existence of multiple settlement alternatives generally does not affect the treatment of a forward sale contract as a derivative asset/liability or equity instrument. If the counterparty has the right, among the different settlement alternatives, to require net cash or net share settlement, the issuer recognises a derivative asset or liability, as illustrated in (a) and (b) above. If the issuing entity has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares through physical delivery of shares, the issuer recognises a derivative asset or liability, as illustrated in (a) or (b), unless it has an established practice of settling through the exchange of a fixed amount of cash for a fixed number of the entity's own shares **and intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, in which case it classifies the forward sale contract as an equity instrument of the entity, as illustrated in (c) above.

Rationale

Alignment with paragraph 29 E

Comment Nr. 14

Paragraph A37

A37. This example illustrates the journal entries for a purchased call option right on the entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for the entity's own shares. It also discusses the effect of multiple settlement alternatives (see (d) below).

Assumptions:

Contract date	1 February 2002
Exercise date	31 January 2003 (European terms, i.e. it can be exercised only at maturity)
Exercise right	holder reporting entity (Entity A)
Market price per share on 1 February 2002	100
Market price per share on 31 December 2002	104
Market price per share on 31 January 2003	104
Fixed exercise price to be paid on 31 January 2003	102
Present value of exercise price on 1 February 2002	99
Number of shares under option contract	1,000
Fair value of option on 1 February 2002	5,000
Fair value of option on 31 December 2002	3,000
Fair value of option on 31 January 2003	2,000

Rationale

Alignment with paragraph 29 E

Comment Nr. 15

Paragraph A40

A40. Assume the same facts as in (a) except that settlement will be made by receiving a specified number of shares and paying a fixed amount of cash, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at 102. Accordingly, Entity A has a right to receive 1,000 of Entity A's own outstanding shares in exchange for an obligation to pay 102,000 (102 x 1,000) in cash, if Entity A exercises its option.

1 February 2002

Dr. Equity	5,000	
Cr. Cash		5,000

To record the cash paid in exchange for the right to receive the entity's own shares in one year for a fixed price. The premium paid is recorded against equity

Dr. Equity	99,000	
Cr. Liability		99,000

To record the present value of the obligation to deliver 102,000 in one year, i.e. 99,000 as a liability

31 December 2002

Dr. Interest expense	2,750	
Cr. Liability		2,750

To record accrued interest in accordance with the effective interest method on the liability for the share redemption amount.

~~No entry is made on 31 December because no cash is paid or received and a contract that gives a right to receive the entity's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity~~

31 January 2003

Dr. Interest expense	250	
Cr. Liability		250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A exercises the call option and the contract is settled gross. Entity B has an obligation to deliver 1,000 of Entity A's shares in exchange for 102,000 in cash.

Dr. Equity Liability	102,000	
Cr. Cash		102,000

To record the settlement of the option contract.

Rationale

Alignment with paragraph 29 E

Comment Nr. 16

Paragraph A41

A41. The existence of multiple settlement alternatives does not affect the treatment of a purchased call option right as described in (a)-(c) above. The accounting treatment is determined on the basis of the party that controls the settlement alternatives. If the counterparty has the right, among the different settlement alternatives, to require net share or net cash settlement, the issuer recognises a derivative asset, as illustrated in (a) and (b) above. If the issuing entity has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a derivative asset, as illustrated in (a) and (b) above, unless it has an established practice of the exchange of a fixed amount of cash for a fixed number of the entity's own shares **and intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, in which case it classifies the written call as an equity instrument, as illustrated in (c) above.

Rationale

Alignment with paragraph 29 E

Comment Nr. 17
Paragraph A46

A46. The existence of multiple settlement alternatives does not affect the treatment of a written call option contract as described in (a)-(c) above. The accounting treatment is determined on the basis of the party that controls the settlement alternatives. If the issuing entity has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a derivative liability, as illustrated in (a) and (b) above, unless it has an established practice of the exchange of a fixed amount of cash for a fixed number of the entity's own shares, in which case it classifies the written call as an equity instrument, as illustrated in (c) above. If the counterparty has the right, among the different settlement alternatives, to require net share or net cash settlement **and intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, the issuer recognises a derivative liability, as illustrated in (a) and (b) above.

Rationale
Alignment with paragraph 29 E

Comment Nr. 18
Paragraph A51

A51. The existence of multiple settlement alternatives does not affect the treatment of a purchased put option contract as described in (a)-(c) above. The accounting treatment is determined on the basis of the party that controls the settlement alternatives. If the counterparty has the right, among the different settlement alternatives, to require net share or net cash settlement, the issuer recognises a derivative asset, as illustrated in (a) and (b) above. If the issuing entity has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a derivative asset, as illustrated in (a) and (b) above, unless it has an established practice of the exchange of a fixed amount of cash for a fixed number of the entity's own shares **and intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, in which case it classifies the purchased put as an equity instrument, as illustrated in (c) above.

Rationale
Alignment with paragraph 29 E

Comment Nr. 19
Paragraph A55

A55. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a specified number of shares, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at 98. Accordingly, Entity A has an obligation to pay 98,000 in cash to Entity B (98 x 1,000) in exchange for **an obligation to pay** 1,000 of Entity A's outstanding shares, if Entity B exercises its option.

1 February 2002

Dr. Cash	5,000
Cr. Equity	90,000 5,000

To record the cash paid in exchange for the right to receive the entity's own shares in one year for a fixed price. The premium received of 5,000 is recorded in equity.

Dr. Equity	95,000	
Cr. Liability		95,000

To record the present value of the obligation to deliver 98,000 in one year, i.e. 95,000 as a liability.

31 December 2002

Dr. Interest expense	2,750	
Cr. Liability		2,750

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 2003

Dr. Interest expense	250	
Cr. Liability		250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver 98,000 in cash to Entity B in exchange for 95,000 worth of shares [95 x 1,000].

Dr. Liability	98,000	
Cr. Cash		98,000

To record the settlement of the option contra

Rationale

Alignment with paragraph 29 E

Comment Nr. 20

Paragraph A56

A56. The existence of multiple settlement alternatives generally does not affect the treatment of a written put option contract as described in (a)-(c) above. The accounting treatment is determined on the basis of the party that controls the settlement alternatives. If the counterparty has the right, among the different settlement alternatives, to require the exchange of a fixed amount of cash for a fixed number of the entity's own shares, the issuer recognises a liability for the obligation to deliver cash, as illustrated in (c) above. If the issuing entity has the right, among the different settlement alternatives, to require net share or net cash settlement, the issuer recognises a derivative liability, as illustrated in (a) and (b) above, unless it has an established practice of the exchange of a fixed amount of cash for a fixed number of the entity's own shares **and intends to settle the contract by exchanging a fixed number of its own equity instruments for a fixed amount of cash or other financial assets**, in which case it recognises a liability for the share redemption amount.

Rationale

Alignment with paragraph 29 E

Comment Nr. 21
Paragraph B22

B22. The Board decided to propose that IAS 32 should include guidance that addresses these issues. The objective of the proposed changes is to clarify the accounting treatment of derivatives on an entity's own equity instruments whose value changes in response to changes in the market price of the entity's own equity instruments. The proposed changes are based on the principle that only those derivative contracts that result in an exchange of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments (other than derivatives) should be accounted for directly in equity. For such derivatives, changes in fair value would not be recognised. All other derivatives that are indexed to the price of an entity's own equity instruments should be accounted for as derivative assets ~~or derivative liabilities~~ because they do not evidence a residual interest in the entity.

Rationale
Alignment with paragraph 29 E

Comment Nr. 22
Paragraph B27

B27. The following table provides an overview of the application of the proposed principle:

Table: Overview of the proposed accounting for derivatives indexed only to the value of the entity's own shares

Derivative contract	Settlement method				
	<i>Gross physical settlement</i>	<i>Net settlement (net cash or net shares)</i>	<i>Issuer choice (past practice of gross physical settlement)</i>	<i>Issuer choice (no past practice of gross physical settlement)</i>	<i>Counterparty choice</i>
Forward to buy	L	D	L	D	L
Forward to sell	E	D	E	D	D
Purchased call	E,L	D	E,L	D	D
Written call	E	D	E	D	D
Purchased put	E	D	E	D	D
Written put	E,L	D	E,L	D	L
Total return swap	-	D	-	-	-

D = Derivative asset/liability (net amount);
E = Equity;
L = Liability for the share redemption amount (gross amount).

Gross physical settlement means the exchange of a fixed amount of cash for a fixed number of the entity's own shares.

Net settlement means the exchange of either (a) a fixed amount of cash for a variable amount of cash equal to the fair value of a fixed number of the entity's own shares or (b) a variable number of the entity's own shares that have a value equal to a fixed amount of cash for a fixed number of the entity's own shares.

Issuer choice means that the reporting entity (the issuer of the shares) can require, among the different settlement alternatives, gross physical settlement.

Counterparty choice means that the counterparty to the derivative can require, among the different settlement alternatives, net settlement.

Rationale

Alignment with paragraph 29 E

Comments on IAS 39

Comment Nr. 23

Paragraph 10

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

Definition of a Derivative

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraph 6) with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or ~~similar other~~ variable (sometimes called the 'underlying');

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

(c) it is settled at a future date

Rationale:

The old term "similar variable" shall not be removed as the term "other variable" is extremely broad and encompass variables, which should not be underlying in derivatives, e.g. random figure (in which case the derivative is lottery) or commodity amount.

Comment Nr. 24

Paragraph 111

~~111. If there is objective evidence of impairment and it is probable that an entity will not be able to collect all amounts due (principal and interest) according to the contractual terms of loans, receivables, or held-to-maturity investments carried at amortised cost, an impairment or bad debt loss has occurred.~~ The amount of the ~~bad debt loss of loans, receivables, or held-to-maturity investments carried at amortised cost~~ is the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate

(recoverable amount). Cash flows relating to short-term receivables generally are not discounted. The carrying amount of the asset shall be reduced to its estimated recoverable amount either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss for the period.

Rationale:

There is always objective evidence of impairment and it is more or less probable (e.g. 5 %) that an entity will not be able to collect all amounts due (principal and interest) according to the contractual terms of loans, receivables, or held-to-maturity investments (even at the moment of origination of investment). The only exception is absolutely risk-free investment.

Comment Nr. 25
Paragraph 112

~~112. An entity first decides whether the financial asset shall be assessed for impairment individually or collectively. The transfer of the financial asset from a group of individually assessed financial assets to a group of collectively assessed assets and vice versa shall not be carried out as the financial asset is recognised. assesses whether objective evidence of impairment exists individually for financial assets that are individually significant and either individually or collectively for financial assets that are not individually significant. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics that are collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment or bad debt loss is or has been recognised are not included in a collective assessment of impairment.~~

113. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair-value measurement on financial assets that this Standard would otherwise measure at amortised cost. If the terms of a loan, receivable, or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. If a loan, receivable, or held-to-maturity investment has a variable interest rate, the discount rate for measuring recoverable amount pursuant to paragraph 111 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost based on an instrument's fair value using an observable market price. The estimation of the recoverable amount of a collateralised financial asset reflects the cash flows that may result from foreclosure, whether or not foreclosure is probable. If an asset is collateralised and foreclosure is probable, then the holder measures impairment based on the fair value of the collateral less costs for obtaining the collateral.

113A. For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtor's ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status, and other relevant factors).

~~113B. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.~~

~~113CB.~~ Expected cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and

historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in expected cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of changes in the probability of losses in the group and their magnitude). The methodology and assumptions used for estimating expected cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

113D. In discounting expected cash flows of a group of financial assets that are collectively evaluated for impairment, an entity uses a weighted average of the original effective interest rates of the assets in the group that is being assessed for impairment. To ensure that an impairment loss is not recognised immediately after initial recognition, the original effective interest rate for each asset in the group is computed as an expected rate based on the originally estimated cash flows. For example, if the original contractual effective interest rate for an asset is 12 per cent and the entity on initial recognition, based on past loss experience for assets with similar credit risk characteristics, determines that the discount rate that equates the initial carrying amount of the asset with the present value of the expected cash flows for the asset (considering expected losses and prepayments) is 10 per cent, then the original effective interest rate that should be used for the purposes of computing a discount rate for the group of assets to which the asset belongs is the expected rate of 10 per cent.

Rationale:

The proposed treatment of collectively assessed financial assets for impairment is illogical and inconsistent with the concept of risk included in the Basle Capital Accord. The primary idea of the concept of collectively assessment of financial asset, with similar credit risk characteristics that are collectively assessed for impairment, shall be the facilitation of the burden associated with individual assessment of a huge number of small financial assets.

According to the proposed paragraphs 112 – 113D the individually impaired financial asset shall be removed from a group of collectively assessed financial assets. Thus such a group of collectively assessed financial assets contains in any moment only financial assets, which are not impaired. Thus there is no need for any allowance against such a group of non-impaired financial assets. Such conclusion is against the primary idea of creating an allowance against a group of collectively assessed financial assets.

This conclusion is supported by the fact that allowance is calculated on the basis of historic loss of a group of collectively assessed financial assets. It is evident that the transfer of an impaired financial asset from a group of collectively assessed financial assets shall be accompanied by the transfer of a part of the allowance associated with such a group. Removing all impaired financial assets from a group of collectively assessed financial assets and associated parts of the allowance shall result in the allowance against portfolio being zero.

There is a conceptual mistake included in paragraphs 112 – 113D: Assets, liabilities and equity in financial statements shall be provided to the balance sheet date. Any asset shall be presented either at cost (corrected for impairment, if any) or at amortised cost (corrected for impairment, if any) or at fair value. Any possible decrease of the fair value of an asset in the future shall not be taken into account when assessing the allowance for impairment. Any such possible decrease of the fair value of an asset in the future is exactly the substance of “the risk” and “the risk” is addressed in the concept of Basle Capital Accord. Thus “risk” does not influence impairment and allowance. Regulated entities shall cover any credit risk and market risk by capital (tier 1, tier 2 or tier 3).

127. A hedged item can be a recognised asset or liability, an unrecognised firm commitment, an uncommitted but highly probable anticipated future transaction ('forecasted transaction'), or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, or forecasted transaction or (b) a group of assets, liabilities, firm commitments, or forecasted transactions with similar risk characteristics. ~~Unlike originated loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be~~ a hedged item with respect to risks from changes in **risk-free interest rate**, foreign currency exchange rates and credit risk.

Rationale:

There is no reason to exclude held-to-maturity investment from hedged items with respect to interest rate risk or prepayment risk. Even if there is intention to hold the investment until maturity, still such an investment can be hedged against interest rate risk. The following example demonstrates it.

The entity has the portfolio:

- **purchased 5-months zero-coupon bond designated as held-to-maturity investment (long interest rate position),**
- **issued 3-months zero-coupon bond (short interest rate position).**

The entity decided to hedge an interest rate risk associated with the portfolio by negotiating FRA 3x5 (receive floating payment and pay fix payment). The fair value of the portfolio including FRA develops during the first 3 months according to a straight line (fair value either decreases or is constant or increases). If there is a shift of yield curve up during the 3-months period, the entity will have positive cash flow from FRA, which insures refinancing the long interest rate position at the original interest rate for the next 2 months. If there is a shift of yield curve down during the 3-months period, the entity will have negative cash flow from FRA, which insures refinancing the long interest rate position at the original interest rate for the next 2 months. Thus the fair value of the portfolio without FRA (which already expired) develops during the next 2 months again according to the same straight line (fair value either decreases or is constant or increases). FRA has been used to hedge interest rate risk associated with held-to-maturity investment.