CEMLA ACCOUNTING COMMITTEE

TECHNICAL NOTE - FINANCIAL INSTRUMENTS

1) BACKGROUND

The first steps that lead to the current search for the harmonization of accounting criteria in central banks that are members of Cemla were taken in 1996. Since then, an on-going process has been developed to review the requirements to be satisfied in CB accountants, and this was done for several reasons. The first that might be indicated is the growing search of greater transparency and reliability in the CB financial statements, something that can be accomplished by adopting consistent accounting standards.

Besides Cemla's internal interest in this matter, the international community has emphasized the importance of the role of international standards in the strengthening of the international financial structure. At an international level, these standards strengthen transparency while permitting multilateral supervision because they help identify shortcomings, increase efficiency and discipline and make the global economy less vulnerable to crises.

In connection, the International Monetary Fund (IMF) and the World Bank (WB) have iuused the "*Reports of the Observance of Standards and Codes*" (ROSC), which show the observation levels of the standards selected that are relevant for the stability and development of the private and financial sectors. The WB was concerned about three component areas of the ROSC: (i) corporate governance (ii) accounting and auditing, and (iii) creditor rights and insolvency regimens. The IMF is interested in aspects concerning data disclosure and fiscal transparency.

It is not necessary to state the importance for the CB members of Cemla to pay attention to the announcements and recommendations made by these international entities.

In the III Meeting on Central Bank Accounting and Budgetary Aspects in November 1996, the subject of "International Accounting Standards" was raised for the first time by the Committee which considered the following benchmark aspects for the assessment of international reserves: a) the International Accounting Standards; b) the legal requirements governing central banks; c) factors that cause variations and d) the presentation of fluctuations in financial statements. Additionally, it was acknowledged that the central banks (CBs) should not blindly follow the standards, but should use them as guidelines together with generally accepted accounting principles. When there are laws about specific aspects, the laws shall prevail.

The subject was taken up again in the VIII Meeting in November 2002 where it was verified that because of the perception of risk distortion in financial statements in economies with high inflation, the IFRS should be observed with the application of adjustments when necessary. For the first time, a divergence between the International Accounting Standards and the Generally Accepted Accounting Principles (GAAP) was evidenced, notwithstanding agreements by the international accounting regulation bodies to unify them.

This aspect of the need to harmonize accounting procedures was given special emphasis in the IX Meeting held in October 2004 concerning the articles deemed to be delicate in their application to the central bank's accounting. It was concluded that:

(a) there is a trend among Cemla members to adopt the IFRS in their respective accounting systems;
(b) the IFRS do not do not include some transactions inherent to the BC;
(c) there is no consensus among the CBs regarding some IAS (7, 21, 32 and 39);
(d) the CBs should pay special attention to their application of the IAS: 11, 12, 14, 19, 20, 22, 24, 27, 28, 29, 31, 33, 34, 35 and 41.

On this occasion, the central banks analyzed their accounting and based on this, a request was made to draft a technical note justifying why certain IAS/IFRS are applied or not applied, and on relevant cases of disparity between the IFRS and the Criteria and the possible desirability of harmonizing the applicable aspects.

Furthermore, the scope of particular operations carried out by the CBs was identified in the report. After broad analysis, the committee later approved accounting criteria adapted to the registry of operations that had previously been identified. The criteria approved were accepted by the CB members of Cemla. In accordance with the above, it was recommended that CBs bear in mind the national legislation in effect and their distinct legal structures.

The criteria drafted and proposed are recommendations for the registry, evaluation and presentation of the financial statements of CB operations which do not try to establish binding guidelines because of the recognition of the wide divergence among the legislations applicable to each central bank. Nevertheless, an effort was made to promote, as far as possible, the unification of evaluation, registry and presentation of financial statements concerning the operations that are common to these CBs. Additionally, it was acknowledged that the problem for CB accountants lies at two levels: a) inconsistency among the criteria defined by the Committee and the IFRS; b) the inherent difficulty in implementing the IFRS in the CBs.

Based on a survey made with members, the standards that the central banks find most difficult to apply because of the specific nature of the CB operations and due to the legislation in effect in some countries were identified, together with those that prevent the full application of the IFRS.

An effort was made to show why CBs have difficulties in applying such standards by virtue of the reiterated recommendation by the International Monetary Fund that various Latin American and Caribbean CBs should use the IFRS as accounting criteria in their financial statements, and also the concern of the region's central banks and the Committee itself to adopt internationally standardized criteria that contribute to greater transparency and comparability of financial information.

In the meeting of July 2005, the Committee identified the IAS/IFRS that should be analyzed in greater depth to determine their applicability in central bank accounting, and concerning this, the central banks that follow such standards were asked to draft technical notes for a better understanding of their contents:

(a) IAS 7 – Argentina
(b) IAS 2 – Peru
(c) IAS 14 – Chile
(d) IAS 21 – Guatemala
(e) IAS 37 – Uruguay
(f) IAS 39 and IAS 32 – Brazil.

This technical note particularly refers to the disclosure and presentation of financial instrument operations covered by IAS 32, IAS 39 and IFRS 7.

2) SUMMARY – IFRS 7, IAS 32 and IAS 39

Definitions (§ 11)

Financial Instruments: A contract that gives rise to a financial asset or a financial liability in an entity or equity instrument in another entity.
Financial asset: any asset that may be:

(a) Cash;
(b) An equity instrument in another entity;
(c) A contractual right:
  - To receive cash or a financial asset of another entity, or
  - To swap financial assets or financial liabilities with another entity under potentially favorable conditions for the entity, or

(d) A contract that will or may be settled with equity instruments of the entity and which are:
  - A non-derivative for which the entity is or may be obliged to receive a variable number of equity instruments; or
  - A derivative that may or may not be settled in a way other than the exchange of a set amount of cash or other financial assets for a set number of equity instruments of the entity itself. To this end, the equity instruments of the entity do not include the instruments that are contracts for future receipt or delivery of equity instruments of the entity.

Financial Liability: Any liability that may be:

(a) A contractual obligation:
  - To deliver cash or a financial asset to another entity, or
  - To delivery financial assets or financial liabilities to another entity under potentially unfavorable conditions for the entity, or

(b) A contract that will or may be settled in the equity instruments of the entity.

Equity Instrument: Any contract that shows a residual interest in the assets of an entity after deducting all its liabilities.
A financial instrument is an asset instrument if and only if both of the following conditions are satisfied:

(a) the instrument does not include the contractual obligation to delivery cash or a financial asset for another entity, and
(b) if the instrument can or may be settled with an issuer's asset instrument, it is

- A non-derivative that does not include contractual obligation for the issuer to deliver a number of its own capital instruments; or
- A derivative that may only be settled by the issuer by exchanging a set amount of cash or other financial asset for a set number of its own equity instruments (§ 16).
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Fair value: is the amount for which an asset may be exchanged or a liability may be paid between parties knowledgeable of the matter and willing to negotiate in a free transaction.
Derivative: is a financial instrument or another contract within the scope of the Standard that has all of the three following characteristics:

(a) the value changes in response to alterations in the interest rate specified, in the financial instrument prices, in the commodities prices, the exchange rate, the price or rate index, the credit rating or credit index or another variable (sometimes called an underlying variable);
(b) that does not any net initial investment or a net investment that is much smaller that the value invested than would be required concerning other kinds of contracts that might be expected to present a similar response to the variations in market conditions; and
(c) which is settled on a future date.

The amortized cost of a financial asset or a financial liability is calculated by using the effective interest rate, which is:

(a) the amount of the financial asset or financial liability is measured on the date of the initial recognition;
(b) minus the principle payments;
(c) plus or minus the accrued amortization of any difference between the initial amount and the value of the balance; and
(d) minus any reduction (directly or by using a provision account) due to impairment or if not collectible.

The effective interest rate is the rate that exactly discounts the future cash flows estimated over the life of the financial instrument or, when appropriate, the net load amount of the financial asset or financial liability in a shorter period.

IFRS 7 - Financial Instruments: Breakdown (published on August 18, 2005 for compulsory adoption on January 1, 2007)

Purpose of IFRS 7

The purpose of this objective is to require entities to provide breakdowns in their financial statements that enable to users to assess:

(a) The relevance of financial instruments for the financial position and the performance of the entity; and
(b) The nature and scope of the risks arising from the financial instruments to which the entity is exposed during the fiscal year and on the date of the balance and how the entity manages such risks.

IFRS 7 substitutes IAS 30 and the breakdown requirements of IAS 32. The presentation requirements of IAS 32 are unchanged. All the breakdowns on financial instruments are thus joined in a single standard.

IFRS 7 Breakdown Requirements

The breakdown of the entity's financial instruments, when required, must be made by class of similar instruments (§ 6).

Information on the importance of financial instruments

Asset Balance

The breakdowns concerning the importance of financial instruments for the financial positions and the performance of an entity for each of the following categories (§§ 7 and 8) include:

(a) Financial assets valued at Fair Value through Profit and Loss (FVTPL) – separately show the instruments for negotiation and those designated in the initial recognition;
(b) Investments Held to Maturity;
(c) Loans and collectibles;
(d) Assets available for sale;
(e) Financial assets valued at reasonable result value – separately show the instruments maintained for negotiation and those designated in the initial recognition;
(f) Financial liabilities valued at amortized cost.

The entity's attachments on financial instruments shall include:

(a) Information on credit risk, market risk and changes in the fair values of the financial assets and liabilities designated to be fair value through profit and loss (§§ 9-10);
(b) Reclassification of fair value financial instruments for amortized cost or vice versa (§ 12);
(c) Attachments on discontinuance, including transfer of financial assets for the which the discontinuance is not permitted by IAS 39 (§ 13);
(d) Information (a) on financial assets offered in guarantee in liability operations and (b) financial and non-financial assets received in guarantee (§§ 14-15):
(e) Reconciliation of provision accounts for losses – for example, doubtful settlement loans – for each kind of financial asset (§ 16);
(f) Information on compound financial instruments with multiple embedded derivatives (§ 17);
(g) Breach of contract terms of loans granted (§§ 18-19).

Statement of Results and Net Assets

The following receipts, expenses, earnings and liabilities items must be disclosed (§ 20):

(a) Net earnings and losses:

- Financial assets measured at reasonable result value, separately showing those that were kept for negotiation and those designated in the initial recognition;
- Investments held to maturity;
- Assets available for sale;
- Financial liabilities measured at fair value through profit and loss, separately showing those that were kept for negotiation and those designated in the initial recognition;
- Financial liabilities measured at amortized cost.

(b) Receipts and expenses with interests for financial instruments that are not measured at fair value through profit and loss;
(c) Fees and other expenses;
(d) Amount of losses due to financial asset detriment;
(e) Receipts of interests on financial assets that deteriorated.
(f) Other attachments
(g) Accounting policies for financial instruments (§ 21);
(h) Information on hedge accounting (§ 22), including;

- Description of each kind of hedge, hedge instruments and fair value of these instruments, and the nature of the risks being covered;
- For the cash flow hedge, for the periods in which cash flow is expected, when it is expected that they will affect the result and the description of a foreseen transaction for which the accounting hedge was previously used, but which is expected to happen.

(i) c) If the earnings or loss in a hedge instrument, in a cash flow coverage, have been directly recognized in the Net Worth (NW), the following must be disclosed (§ 23);

- The amount was not recognized in the NW in the period;
- The amount was withdrawn from the NW and included in the period's results statement;
- The amount was withdrawn from the NW in the period and included in the initial cost or in another non-financial asset (or liability) carrying amount in a hedge operation foreseen as highly probable.

(j) For fair value hedge (§ 24):

- Information on changes in the fair value of a hedge instrument and the item hedged;
- The effectiveness of the hedge recognized in the results statement – separated from the cash flow hedge and the net investment in foreign operations hedge.

(k) Information on the fair values of each kind of financial asset and liability, together with (§ 25-30);

- Comparable carrying amounts;
- Description of how their fair value were determined;
- If the fair value cannot be accurately measured, provide detailed information on the financial instruments, including why the value cannot be accurately measured.

(l) Fair value disclosure values are not required when the carrying amount is a reasonable approximation of the fair value, such as, for example, collectibles and short-term commitments, or for instruments whose fair values cannot be accurately measured (§ 24).

Nature and extent of the risk exposure arising from financial instruments

Qualitative disclosures (§ 33)

Qualitative disclosures describe:

(a) Risk exposure for each kind of financial instrument;
(b) Management, policy and process objectives for risk management;
(c) Any alterations in (a) or (b) in previous periods.

Quantitative Disclosures

The Quantitative disclosures provide information about the extent of the entity's risk exposure, based on information furnished internally for the upper management. These disclosures include (§ 34):

a) Summarized quantitative data about exposure to each kind of risk on the balance date;
b) Disclosures about credit risk, liquidity risk and market risk as described in the following items;
c) Risk concentrations if not visible in (a) and (b).

Credit risk disclosures include (§§ 36-38):

a) Maximum exposure value (before deduction of guarantee values), description of the guarantees, information about the credit quality of the financial assets not matured and without detriment loss and information about the quality of financial asset credits that have been renegotiated (§ 36);
b) Analytical disclosures are required for matured assets or those that have suffered detriment loss (§ 37);
c) Information about credit guarantees or backups obtained or required (§ 38).

Liquidity risk disclosures include (§ 39):

a) Analysis of liability maturities;
b) Description of matters raised in risk management.

Disclosures about market risk – risk that the fair value or the future cash flow of a financial instrument will fluctuate due to changes in market prices and which include the interest rate risk, currency risk and other price risks (§§ 40-42) – include:

a) A sensitivity analysis of each kind of market risk to which the entity is exposed;
b) If an entity prepares a sensitivity analysis for management purposes that reveals interdependence of more than one market risk component (for example, combined interest rate and currency risk) the analysis must show this instead of a separate sensitivity risk for each kind of market risk.

IAS 32 – Financial Instruments: Presentation and Information to be Revealed (reviewed March 31, 2004 for compulsory adoption on January 1, 2005)

Scope

IAS 32 is applied to the presentation of all kinds of financial instruments (the information to be revealed was substituted by IFRS 7), with the following exceptions (§ 4):

a) Participation is subsidiaries, associates and joint ventures with accounting in accordance with IAS 27 – Consolidated and Separated Financial Statements, IAS 28 – Investments in Associates, IAS 31 – participation in joint ventures. Nevertheless, IAS 32 is applied to all the derivates referring to participation in subsidiaries, associates and joint ventures.
b) Rights and obligations of employees who have benefit plans (IAS 19).
c) Rights and obligations arising from security contracts.
d) Contingency contracts in a combined operation (IFRS 3).
e) Contracts that require payments based on climatic, geological or other physical variables (IAS 39).

IAS 32 is applied to contracts to buy or sell a non-financial asset that may be settled by net value in cash or in another financial instrument, except for contracts that were acquired and have been maintained for the receipt of delivery of a non-financial item according to the entity's expectation for purchase, sale or utilization requirements (§ 8).

Liability and Equity Instrument

The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form. The enterprise must make the decision at the time the instrument is initially recognized. The classification is not subsequently changed based on changed circumstances (§ 15).

One party may choose the form of instrument settlement

When a derived financial instrument gives one party the right to choose the form of liquidation (for example, the issuer or holder may choose liquidation by net value in cash or to swap stocks for cash), it is a financial asset or liability, except if all the alternative settlements imply that it must be considered as an equity instrument (§ 26).

Compound Financial Instruments

Some financial instruments - sometimes called compound instruments - have both a liability and an equity component from the issuer's perspective. In that case, IAS 32 requires that the component parts be accounted for and presented separately according to their substance based on the definitions of liability and equity. The split is made at issuance and is not revised for subsequent changes in market interest rates, share prices, or other event that changes the likelihood that the conversion option will be exercised (§ 28).

When the initial carrying amount of a compound financial instrument is required to be allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole, the amount separately determined for the liability component (§ 31).

Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported in the income statement. This means that dividend payments on preferred shares classified as liabilities are treated as expenses. On the other hand, distributions (such as dividends) to holders of a financial instrument classified as equity should be charged directly against equity, not against earnings (§ 35).

Treasury Shares

The cost of an entity's own equity instruments that it has reacquired (treasury shares) is deducted from net equity. Gain or loss is not recognized on the purchase, sale, issue, or cancellation of treasury shares. Treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received is recognized directly in equity (§ 33).

Offsetting

IAS 32 prescribes rules for the offsetting of financial assets and financial liabilities by net value. It specifies that a financial asset and a financial liability should be offset and the net amount reported when, and only when, an enterprise (§ 42):

(a) has a legally enforceable right to set off the amounts; and
(b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

IAS 39 – Financial Instruments: Recognition and Measurement (reviewed March 31, 2004 for compulsory adoption on January 1, 2005 and with corrections up to August 18, 2005)

Scope

IAS 39 deals with derivative or non-derivative financial instruments. Table I below gives a simplified description of what comes under the scope of IAS 39 and what does not.

The most important aspects of IAS 39 are:

Table I	
Outside the scope of IAS 39	**Within the scope of IAS 39**
(a) Investments in subsidiaries, associates and joint ventures (IAS 27, IAS 28 and IAS 31) (*); (b) Leasing rights and obligations (IAS 17) (*); (c) Employer's assets and liabilities concerning employee benefits (IAS 19); (d) Equity instruments issued by the reporting enterprise – shares, options or stock purchase guarantees and other financial instruments (*); (e) Insurance contract rights and obligations (as defined in IFRS 4) (*); (f) Contracts with contingent aspects in a combination of enterprises, barely in relation to the acquirer (IFRS 3); *(g)* Contracts between the acquiring and selling enterprise for future acquisition of another enterprise (acquired); *(h)* Loan agreements that cannot be settled in cash or by other financial instruments (IAS 37); *(i)* Financial instruments, contracts and obligations as covered by transactions with share-based payments (IFRS 2); *(j)* Financial guarantee supplier contracts (including letters of credit and other breach contracts) (IAS 37 and IAS 18); *(k)* Contracts that require payment in weather, geological or other physical variables (called exotic derivatives) (*);	(a) Debt instruments; (b) Equity instruments (no own shares); (c) Loans originated by the enterprise; (d) Debts reported by the enterprise; (e) Accounts payable and receivable arising from commercial activities: (f) Derivatives (that may or may not be part of hedge accounting.).
(*) Specific cases may have IAS 39 application, consequently, there is a need for a differential diagnosis for the above-mentioned items by comparison with the IAS 39 with the text of the standard in parentheses.	

a. Recognition (initial and subsequent) of financial instruments, when they must be accounted because of the value of the financial assets and liabilities;
b. Evaluation of financial instruments – registry value of load cost.

Categories of Financial Instruments

The main purposes of this standard is the definition of financial instruments in order to prescribe specific accounting treatment for them (recognition and evaluation), as well as the additional information disclosure items, (disclosures), which may be financial or not.

Categories – Classification

IAS 39 defines four categories of financial instruments, such as:

Financial asset or financial liability at fair value through profit or loss (FVTPL) is a financial asset or liability that has one of the following conditions:

a. it is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:
    i. acquired or incurred mainly with the purpose of sale or repurchase in the short term;
    ii. part of a portfolio of identifiable financial instruments that are jointly administered and for which there is evidence of a real recent administration pattern with lucrative purposes in the short term;
    iii. a derivative (except derivatives that are designated as hedge instruments).
b. It is designated in its initial recognition as a fair value profit and loss financial instrument, under the conditions specified by the standards:
    i. for embedded derivatives, except in the cases described, an entity may designate all to a hybrid (combined) contract as a fair value through profit and loss financial asset or a financial liability.
    ii. For other instruments when doing so leads to more relevant information because:
        - there is a significant elimination or reduction of an inconsistency in the initial recognition or measurement that would otherwise arise if another measurement base or profit and loss measurement had been used; or
        - because a group of financial assets or liabilities or both are valued and administered based on fair value, or investments, documents and information on this group is disclosed internally in the same base for the key executives of the administration (see IAS 24, Related Parts).

Investments held to maturity (HTM) are non-derivative financial assets with fixed or determinable payments and maturities for which the entity has the positive intention and condition to hold until maturity, which are not:

a. those which, in the initial recognition, the entity designates as a fair value profit and loss financial instrument (FVTPL);

b. those designated by the entity as available for sale (AFS);

c. those which make up the definition of loans and receivables.

Loans and Receivables (LR) are non-derivative financial assets with fixed or determinable payments that do not have a price reference in an active market, which are not:

(a) those that the entity intends to sell immediately or in the near future, which must be classified as held for trading and those that the entity designates as fair value through profit and loss in relation to the initial recognition;
(b) those designated by the entity at initial recognition designated as available for sale; and
(c) those which the bearer may not substantially recover all the initial investment that is not due to credit detriment and which may be classified as available for sale.

Financial assets available for sale (AFS) are non-derivative financial assets that are classified as available for sale or are not classified as:

(a) loans and collectible;
(b) investments held to maturity; or
(c) fair value through profit and loss financial assets.

The available for sale category is a "catch-all" category and may include various kinds of financial instruments.

Table II summarizes the categories and classification conditions.

<table>
<tr><th colspan="4">Table II
Classification of Financial Instruments – IAS 39</th></tr>
<tr><th colspan="2">Categories (based on facts and the entity's intention on the purchase date)</th><th>Administrative Intention</th><th>Administrative Intention</th></tr>
<tr><td rowspan="2">Fair value through profit and loss</td><td>Fair value through profit and loss</td><td>Applicable to financial instruments with active market and available listing.</td><td>Administration intention to peg financial instruments to market (fair value) from when certain specified conditions are satisfied.</td></tr>
<tr><td>Held for Trading</td><td>Intention to obtain gain in the short term by trading.</td><td>Derivative financial assets and liabilities are always considered as held for trading, except those that form part of the hedge.</td></tr>
<tr><td colspan="2">Held to Maturity</td><td>Held to Maturity</td><td>Positive intention and capacity (especially financial) to hold investment to maturity.</td></tr>
<tr><td colspan="2">Loans and Collectibles</td><td>Financial assets with fixed or determinable payments that are not listed on an active market.</td><td></td></tr>
<tr><td colspan="2">Available for Sale</td><td></td><td>Those that, on the date of acquisition, the entity intends to hold in the category, or
Those that were not classified in the other three categories.</td></tr>
</table>

Recognition and Evaluation

Initial Recognition

An entity may recognize a financial asset or liability in its balance sheet, even derivatives, only when contractual provisions of the instrument exist.

When a financial asset or liability is initially recognized (initial recognition), an entity must measure it by cost, which is the fair value of the payment delivered (asset) or received (liability) by it. The transaction costs must be included in the initial measurement.

Subsequent Recognition (evaluation)

From this point, the financial assets and liabilities have to be valued at fair value, maintained by the amortized cost (effective rate method) or may even be maintained by historic value cost, in accordance with the initial classification (Table III).

After the initial recognition, an entity must measure all the financial liabilities held for trading and derivate-liabilities by fair value, except for a derivative liability that is linked and must be settled by an equity instrument for which there is no listing available, whose fair value cannot be reliably measured and which must be measured by cost. Table IV below shows the classification and evaluation of financial liabilities.

<table>
<tr><th colspan="4">Table III
Evaluation of Financial Assets – IAS 39</th></tr>
<tr><th>Evaluation</th><th>Financial Instruments</th><th>Evaluation Type</th><th>Variations in Fair Value</th></tr>
<tr><td>Initial</td><td>All</td><td>Acquisition Cost (including transaction costs)</td><td>Not applicable</td></tr>
<tr><td rowspan="4">Subsequent</td><td>1. Fair value through profit and loss</td><td rowspan="2">Amortized cost (appropriations taken to the period's profit and loss) (effective interest rate method)
+
Fair Value
(transaction costs not included)</td><td>1. profit and loss of the period in which they arise</td></tr>
<tr><td>2. Available for Sale</td><td>2. Shown in NW account</td></tr>
<tr><td>3. Loans and collectibles;
4. Investments Held to Maturity;</td><td>Amortized cost
(effective interest rate method)</td><td>Not applicable</td></tr>
<tr><td>5. Any financial asset that does not have a listed price on an active market and whose fair value cannot be reliably measured.</td><td>Cost</td><td>Not applicable</td></tr>
</table>

Table IV			
Evaluation of Financial Liabilities – IAS 39			
Evaluation	Instruments	Evaluation Type	Variations in Fair Value
Initial	*All*	*Cost* (including transaction costs)	Not applicable
Subsequent	Liabilities for trading (does not include derivatives-liabilities tied to equity instruments)	*Fair Value* (without settlement or liability discontinuance cost)	profit and loss of the period in which they arise
	Others	*Amortized cost* (Effective Interest Rate)	Not applicable

Investments Held to Maturity – Contamination Rule

The Standard declares that when selling or reclassifying a more than insignificant part in relation to all the investments held to maturity, that do not refer to sales or the kinds of reclassification referred to in the standard, the entity shall observe:

(a) a period of two (2) compete financial periods as from the date of occurrence in which the company shall abstain from any assets in the category, if there are sales (or a sales option is exercised) or transfers of the financial instruments in question, except those foreseen.

(b) if the event occurs in relation to the significant part of the held to maturity investment portfolio, the other financial instruments in it must be reclassified if the entity used separate sub-portfolios (for example, denominated in different currencies).

Profits and Losses of the Fair Value through Profit and Loss

A gain or loss arising from a change in the fair value of a financial asset or liability that is not part of the hedging (paragraphs 89-102) must be recognized as follows (a summary if given in Table III):

(a) The profit or loss of a financial asset or liability classified as "fair value through profit and loss" must be recognized in the profit and loss of the period.

(b) The profit or loss of a financial asset that is "available for sale" must be directly recognized in the NW and appear in the DMPL. Exception is made for devaluation losses (paragraphs 67-70) and foreign exchange profits and losses (appendix A paragraph AG 83) until the financial asset is discontinued when the profits and losses accumulated in the NW must be transferred to the profit and loss. However, the interests calculated by using the effective interest rate method (paragraph 9) are recognized in the profit and loss (IAS 18, Receipts). Dividends on an equity instrument in the available for sale category are recognized in the profit and loss when the payment reception right is established (IAS 19).

For financial assets and liabilities accounted for at amortized cost (paragraphs 46-47), the profit or loss is recognized in the result when the financial asset or liability is discontinued or there is a loss of value (devaluation), as well as by the amortized cost method. The rule does not apply to the assets and liabilities that form part of a hedging operation (paragraphs 78-84, Appendix A paragraphs AG98-AG101 and paragraphs 89-102).

If an entity recognizes financial assets by using settlement date registry (paragraph 38 and Appendix A paragraphs AG53 and AG56), any change in the fair value of the asset acquired occurring during the period from the trading date to the settlement date is not recognized for assets marked by amortized cost or by cost, except for devaluation losses. For assets measured by fair value, however, the change in the fair value must be recognized in the profit and loss or in the NW, as applicable, according to paragraph 55.

Standard Sales and Purchase – Treatment

A sale or purchase of financial assets is defined as standard when its contract establishes that the delivery of the assets must be made within the term generally established by market standards or convention pertinent to such transaction. Although such sales and purchases entail a commitment that is similar on nature to a derivative, the Standard does not cover this commitment, which shall only come under IAS 32 – Financial Instrument – Disclosure. Consequently, this kind of contract must not be treated in accounting as a derivative financial instrument. Defined in these terms, a sale or purchase of financial assets may be recognized by using the both the accounting on the trading date and the settlement date.

Trading date accounting versus settlement date accounting

Trading date accounting refers to:

(a) the recognition of an asset to be received and the obligation to pay for it on the trading date;
(b) at the discontinuance of an asset that is sold and a recognition of a buyer's collectible for payment on the trading date.

Settlement date accounting refers to:

(a) the recognition of an asset, the day on which it is transferred to an entity; and

(b) the discontinuance of an asset, the day on which it is transferred by the entity.

The entity's option for one of the forms of accounting must be consistent for purchases and sales of financial assets that form part of the same category.

If an entity recognizes purchases of financial assets by using settlement date accounting, any change in the fair value of the asset to be received during the period from the date of the transaction and settlement, for assets calculated at fair value, must be recognized in the profit and loss or in the liquid assets, as applicable. Nevertheless, it is not recognized for assets accounted by cost or amortized cost.

Discontinuance of Financial Assets and Liabilities

Discontinuance is the removal of a financial asset or a financial liability previously recognized from the entity's balance sheet.

An entity may discontinue a financial asset, or part of it, only when it loses control of the contractual rights included in the financial asset (or part of it). An entity loses this control when realizing the rights and benefits specified in the contract, the rights expire or it waives them.

They must be included in the liquid gain or loss of the period, by discontinuance, of the difference between (a) the carrying amount of an asset (or part of it) transferred for third parties and (b) the total of earnings received or to be received and any prior adjustment made to reflect the fair value of assets that have been recognized in the liquid assets.

Complementary to the general rule, the standard describes special discontinuance situations, such as (i) discontinuance or part of a financial asset and (ii) discontinuance of a financial asset with the concomitant creation of a financial liability.

An entity must withdraw a financial asset (or part of it) from its net worth only when it is extinct, that is, when the obligation specified in the contract is satisfied, settled or expires. This happens when:

(a) the debtor settles a liability by paying a creditor, normally in money, other financial assets or goods or services; or

(b) the debtor is legally released from its primary obligation for the liability (or corresponding part), either by legal procedure or by the creditor.

Devaluation and Non-Collectability of Financial Assets

Key concepts to understand this section:

(a) Impairment loss of a financial instrument is the amount by which the estimated recoverable value exceeds its estimated book value;

(b) There must be objective evidence of the devaluation in order to make recognition of the loss, that is, the devaluation must not only be a transitory situation;

(c) Recognition of the devaluation in the results of the period in which it occurs;

(d) Possibility of loss reversion in the cases specified by the Standard.

On each balance date, an entity must determine whether there is objective evidence that a financial asset or groups of financial assets are devalued.

A financial asset or group of financial assets is devalued and devaluation losses are incurred if, and only if, there is objective evidence of loss as a result of one or more events that occur after the initial recognition of the asset (loss incidence) and these loss incidents have an impact on of future cash flows of the financial assets or group of financial assets that may be reliably estimated.

It may not be possible to identify the sole and exclusive event that caused the loss. On the contrary, the combined effect of various events may have caused the devaluation. Losses expected as a result of future events, no matter how probable they are, are not recognized.

Objective evidence that a financial asset or group of financial assets is devaluing includes observable data that comes to the knowledge of the holder of the asset about the following loss events:

(a) a significant financial difficulty in the receiver or person with the obligation to pay;

(b) breach of contract, such as failure to make payment, delays in the payment of interest or principal;

(c) concessions by the creditor to the debtor, for economic or legal reasons, related to the debtor's financial difficulties, conditions that the creditor would not consider under other circumstances;

(d) high probability that the issuer will require suspension of payments or undergo another form of financial reorganization;

(e) disappearance of this financial asset from an active market due to financial difficulties;

(f) observable data indicating a measurable decrease in the estimate of the future cash flow of a group of assets from the initial recognition of such assets, even though the decreases cannot yet be identified in the individual components of the group, including:

   i. adverse changes in the payment situation of the loan takers belonging to the same group (e.g., a growing number of payments in arrears or a rising number of credit card holders that have reached their limit and are paying the minimum monthly amount); or

   ii. local or national economic conditions that are correlated with defaults in the assets of a group (e.g., increase in the unemployment rate in the geographic area of the takers, decreases in the prices of real estate financing in the relevant area, decreases in the price of loans tied to the oil price for oil producers or adverse changes in the conditions of a given sector that affect the loan takers of a given group).

The Standard prescribes the procedures that are applicable for financial assets. The way to recognize this loss depends on the category of the financial instrument (see paragraphs 55 to 70 of IAS 39).

Hedging Operations Accounting

A firm commitment is an agreement that obliges the exchange of a defined amount of resources at a price specifies on given future date(s).

A foreseen transaction is a foreseen transaction, however, it does not constitute a commitment.

A hedge instrument is a allocate derivative or (only for exchange rate change risk hedge) or an allocated non-derivative financial asset, or an allocated non-derivative financial liability, whose fair value or cash flow are expected to neutralize the changes in the fair value or cash flows of a hedged item (see 72-77 and AG94/97).

A hedged item is an asset, liability, firm commitment or highly probable future transaction or external liquid investment operation that:

a. exposes the entity to the risk if changes in the fair value or changes in the future cash flows, and
b. is designated as having been hedge (paragraphs 78 to 84 of the Standard, paragraphs 98 to 101 of the Application Guidance).

The effectiveness of the hedge is the degree in which changes in the fair value or cash flows of a hedged item are compensated by changes in the fair value or cash flows of a hedge instrument.

There are three kinds of hedge relations:

a. Fair value hedge: a hedge against exposure to variations in the fair value or an asset or liability recognized in the balance sheet or of an unrecognized firm commitment, or of an identified portion of such asset, liability or firm commitment, which is attributable to a particular risk and may affect the profit and loss;
b. Cash flow hedge: a hedge against exposure to cash flow variations that:
   i. is attributable to a particular risk associated with a recognized asset or liability (such as the total or part of the futures interest payments of a debt with variable interest rates) or in relation a highly probable foreseen transaction and,
   ii. could affect the enterprise's profit and loss.
c. Liquid investment in a foreign operation hedge as defined by IAS 21.

The specific prescriptions are found in articles 85 to 102 of IAS 39.

Definition and Treatment of Embedded Derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a host contract – with the characteristic that part of the combined instrument's cash flow varies in a way that is similar to a sole derivative. An embedded derivative gives rise to some or all of the host contract cash flows. A derivative that is liked to a financial instrument but is contractually transferable independently of such instrument, or has a different counterpart to such instrument, is not an embedded derivative, but an independent financial instrument.

An embedded derivative must be separated from the host contract and accounted for as a derivative in accordance with the Standard if, and only if:

a. the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract;
b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
c. the entire instrument is not measured at fair value, with changes in fair value recognized in the income statement (that is, a derivative that is linked to a financial asset or financial liability at fair value through profit and loss is not separated).

If a derivative is embedded, the host contract must be accounted for (a) according to IAS 39 if it is still a financial instrument; and (b) in accordance with the appropriate IAS, if it is not a financial instrument. The Standard does not state whether an embedded derivative should be separately presented in the account demonstrations or not.

If an entity is not capable of reliably determining the fair value of an embedded derivative on the basis of its contractual characteristics (for example, because the embedded derivative is based on an equity instrument without available listing), the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the host contract, if both can be determined in accordance with the Standard. If the entity is not capable of determining the fair value of an embedded derivative by using this method, then the entire instrument is treated as Available-for-Sale.

3) DIFFICULTIES FOR CENTRAL BANKS

a) Financial Instruments – Categorization, Recognition and Measurement

Classification in Categories Defined in IAS 39

In general terms, central banks have at least two different portfolios; one as a result of monetary policy and the other for the administration of international reserves. The most common instruments that make up these portfolios are:

(a) Own issue certificates;
(b) Derivatives:
(c) Debt instruments denominated in local and foreign currency;
(d) Time deposits;
(e) Foreign currency.

The international accounting standard issued by the IASB determines that financial instruments must be classified according to one of the four categories defined in IAS 39: fair value through profit and loss – FVTPL (by investor allocation or by trading), held to maturity – HTM, loans and collectibles – LC and available for sale – AFS.

The debate about the classification of central bank portfolios involves the peculiarities of these institutions because the classification implicitly involves, as from the initial recognition, the institution's intentions concerning its financial instruments.

In principle, it is important to stress some aspects inherent to the portfolio of financial instruments to be used for the execution of monetary policy, which is mostly composed of government certificates:

(a) objective – it is only used for the execution of monetary policy, it is important to stress that the operations with this portfolio do not involve profit;
(b) operation – normally only used for committed operations (sale with a repurchase commitment and purchase with a resale commitment), carrying out definitive trading with certificates only in the eventuality of a permanent liquidity imbalance in the market:
(c) activity – in terms of the operation committed to be the most important operation, portfolio activity, with definitive purchases and sales before certificate maturity is small;
(d) size – normally elevated, in order to attend to two basic needs: a) be able to neutralize eventual speculative movement in the market; and b) cover a wide variety of certificate type that could attend to different market types;
(e) risk – normally the entire portfolio is made up of internal federal real property debt certificates, redeemable in national currency, with local government guarantee and therefore, without internal risk in the country.

Some considerations must be made concerning the classification of the portfolio to be used in the execution of monetary policy:

Assets and Liabilities at Fair Value through Profit and Loss

When a certificate is acquired, the central bank should not mark the intention as for use in short-term trading because the main objective of suing the paper is to function as collateral in a committed operation – in essence, a guarantee in loan certificates.

In the case of a free market, the financial transactions with a short-term effect cannot be entirely foreseen by the Monetary Authority that consequently cannot foresee conditions of liquidity imbalance and classify, in part, its portfolio as being for trading. Furthermore, if is did so, it would run two risks: first, not classifying the paper with the characteristics that will be demanded; second, informing the market that it will be trading short-term instruments with definitive operations, which would be like saying that the Monetary Authority expects liquidity problems in the short term. The only justification for valuing the use of the trading category in the internal certificates portfolio would be the hypothesis that record of the central bank's operations is used to demonstrate an intense and constant portfolio activity with definitive operations in the same fiscal period.

Loans and Collectibles

This category is mostly used for the classification of financial instruments that do not enjoy an active trading market. Given the operation characteristics of the central bank's mission, their use is marginal and certainly not applicable to the certificates to be used in the execution of monetary policy.

Held to Maturity

This category covers financial instruments for which the entity, on the date of their entry, has the clear intention and shows the capacity, mostly financial, to hold them to maturity. This is a rather restrictive category in reference to possible reclassifications because if this happens, for example, from the sale of a more than insignificant portion of the portfolio, it would imply the need to disclose the reasons that led to the change in the evaluation initially made (projection error, poor assessment of parameters, etc.), as well as oblige it to reclassify all the other items of the Available-for-Sale portfolio and the non-use, for a period of two entire and consecutive fiscal periods, of the "Held-to-Maturity" classification.

This category is inadequate for use in the central bank given its need to always be ready to make definitive sales and to regulate the market liquidity, which as mentioned before, is in terms of parameters that are not fully controllable by the Monetary Authority.

Available-for-Sale

Considering that the central bank does not possess a portfolio with the intention of actively and frequently trading it, because its action is reactive to the market and subjective to the control of liquidity, and it cannot mark the certificates that it will indeed hold to maturity, it is understood that the Available-for-Sale classification is, in principle, the most suitable for the classification of certificates belonging to the portfolio to be used in the execution of monetary policy.

This classification does not simply transpire from the exclusion of the above-mentioned classifications. It is important to note that the central bank must monitor its action needs, and may do so, depending on the current market situation. This procedure is rather compatible with the characteristics of the certificates registered in the Available-for-Sale category, in which an opportunity is awaited – if applicable, dictated by the market – to carry out trading.

In reference to the international reserves administration portfolio, other peculiarities are verified, in accordance with the following:

(a) objective – this portfolio oversees the: i) protection of international reserve assets; ii) maintenance of financial availability in volumes suitable for the attention to the country's external commitments; and iii) maximization of profit with a view to covering the cost of holding these reserves [1], in other words, a minimum while maintaining purchasing power;

(b) operation – almost all the operations available in the international market are carried out. However, the choice does not lie only in those offering high earnings, but in those that obey the risk policy adopted by the institution from the beginning;

(c) activity – this is subject to there being a high volume because the primary commitment is to the objectives defined above and adherence to the risk policy;

(d) size – defined in terms of the country's international availability needs;

(e) risk – normally much lower because central banks only trade with institutions that have the risk rating (AAA or AA by Moody's, for example).

Is summary, the profile of the international reserves instruments portfolio does not differ substantially from the portfolios of private financial institutions, because the intention and action of central banks is confused with them.

b) Certificate Loans and Certificates Received in Guarantee (Committed Operations, Repo and Reverse Repo)

The problem refers to the certificates received as guarantee: What should be done with the guarantee certificates that do not come under IAS 39? Are they placed as assets or liabilities?

c) Participation in International Financial Organizations

In order to classify the financial items in this category, note must be taken of how the participation was made, that is, the nature of the relationship between the investor and the investee.

According to IAS 28, *"An associate is an entity, including a non-incorporated entity, for example, a partnership, over which the investor has significant influence and which is neither a subsidiary nor an interest in a joint venture"*. Also according to the standard, in paragraph 6, it is said that if an investor directly or indirectly has 20% or more of the total voting power in an investee, such investor is assumed to have significant influence, unless there is formal proof to the contrary. According to IAS 28, this would be the power to influence an entity's financial and operation policies in order to obtain a benefit.

It is evident that the participation of the Cemla member countries in the larger International Financial Organizations (IFO), such as the International Monetary Fund (IMF) and the International Clearing Bank (ICB) is not significant. Consequently, IAS 39 and its specific categories must be observed for the classification of such items that are considered as equity financial instruments (not won shares).

d) Net Worth (NW)

The impact of classification in the measurement of financial instruments is shown in the following table:

<table>
<tr><th colspan="4">IMPACT OF CLASSIFICATION ON THE
MEASUREMENT OF FINANCIAL INSTRUMENTS</th></tr>
<tr><th>MEASURMENT</th><th>CLASSIFICATION OF FINANCIAL INSTRUMENT</th><th>TYPE OF MEASUREMENT</th><th>VARIATIONS IN FAIR VALUE</th></tr>
<tr><td>Initial</td><td>All</td><td>Acquisition Cost
(including transaction costs)</td><td>Not applicable</td></tr>
<tr><td rowspan="4">Subsequent</td><td>1. Assets and Liabilities at Fair Value through Profit and Loss</td><td rowspan="2">Appropriate amortized cost at profit and loss of period (effective interest rate method)
+
Fair Value</td><td>1. Profit and loss of the period in which they arise</td></tr>
<tr><td>2. Assets available for sale</td><td>2. Shown in NW item</td></tr>
<tr><td>3. Loans and Collectibles
4. Investments Held to Maturity</td><td>Amortized cost (effective interest rate method)</td><td>Not applicable</td></tr>
<tr><td>5. Other liabilities</td><td>Amortized cost (effective interest rate method)</td><td>Not applicable</td></tr>
</table>

The above table verifies that the decurrent profits and losses not made of the of the fair value assessment of financial instruments classified in the FVTPL category are registered in the period's profit and loss, while the assets classified in the AS category are directly sent to the NW.

In these situations there is the possibility of a central bank presenting a negative net worth that, although it does not hinder its operational activity, it should be carefully watched because:

(a) It does not clearly represent the central bank's financial position because the market marking value carried to Net Worth is a non-realized value;

(b) It could lead to misinterpretation with impact on the launching of government certificates aboard in the appraisal by the rating agencies of the country's risk and on the placement rates of National Treasury and financial system certificates, as well as cause problems in the approval of a balance under these conditions.

4) PROPOSED ACCOUNTING ALTERNATIVE OR ACCOUNTING CRITERION

a) Financial Instruments – Categorization, Recognition and Measurement

Classification of Financial Instruments Solutions

No difficulties are envisaged regarding the classification of the international reserves administration portfolio in accordance with the following:

(a) Debt certificates: must be classified in the FVTPL – for trading category because the central bank trades this paper in the short term with the intention of making a gain;

(b) Derivatives: must be classified in the FVTPL – for trading category, if not classified for hedge accounting.

(c) Time deposits: must be classified in the LC and HTM categories only when they are negotiable instruments in an active market and for which there is an intention to trade, when they must be classified in the FVTPL – for trading;

(d) Foreign currency: as a monetary asset is entered at original value and it is later converted for the functional currency of the balance sheet in accordance with the central bank's official exchange rate.

In reference to the portfolio of financial instruments to be used for the execution of monetary policy, which is mostly composed of national treasury issuance certificates, given the considerations presented above, it shall be considered as suitable for the following treatment:

(a) Own issue certificates: according to the standard, subsequent to the initial evaluation, an entity must measure all the liabilities held for trading and derivatives at fair value through profit and loss (FVTPL). All other liabilities must be valued by amortized cost.

(b) Debt certificates (normally certificates issued by the National Treasury): must be classified in the AS category with decurrent profits and losses of the market parking carried to the net worth;

(c) Derivative must be classified in the FVTPL category, except when they form part of a hedge element.

b) Certificate Loans and Certificates Received in Guarantee (Committed Operations, Repo and Reverse Repo)

Implementation of the IFRS

According to IAS 39 § 14, an entity must recognize a financial asset or liability only when they become a part of the contractual provisions of the instrument. Once the risks and benefits of the certificates loaned and the certificates received in guarantee remain with their respective counterparts, (IAS §§ 17-23 and Appendix A §§ AG34-AG52), the entity that receives these certificates must not recognize them in the balance sheet and the counterpart must not discontinue them.

A securities lending operation with receipt of guarantees in certificates must be accounted for by net value (differential between the rates). Thus, the certificates loaned must be separated in a certificates sub-account and guarantees received in certificates must not be recognized in the balance, but only registered in the accounts that control them.

This operation is characterized as a securities lending operation with receipt of guarantees in certificates.

Thus, the profit and loss of the operation must be registered by net value, additionally, the assets and liabilities referring to the certificates loaned and guarantees received in certificates must not be recognized in the balance sheet, but only in the compensation accounts.

Considering the accounting of the central banks and ICB analyzed, a check is made that there is no divergence of criteria concerning what is determined by the IFRS.

c) Participation in International Financial Organizations

IAS 39 defines four categories of financial instruments:

(i) at fair value through profit and loss (FVTPL) (as such and held for trading);

(ii) investments Held to Maturity (HTM);

(iii) Loans and Collectibles (LC); and

(iv) Available for Sale (AS).

Investments may not be classified in IFO as fair value through profit and loss, primarily because most of the CBs do not have the intention to realize them in the short term. Additionally, there is no evidence of short-term gain behavior.

Neither can they be classified as investments held to maturity because there is no maturity. The separation is only made at the request of the entity investing and there is verification that most of the CBs do not intend to break away from the IFO. The “having maturity” condition is also present in the “loans and collectibles” category, consequently, only the “available for sale” category remains.

Once the category is defined, its characteristics must be understood for accounting and presentation. Initially all the categories are registered by acquisition cost. After the initial registry, the subsequent accounting in the AS category is made by adding the amortized cost to the fair value, with the appropriations carried to the period's profit and loss. The fair value variations are evidenced in the net worth item. The AS must be valued at fair value and if this cannot be reliably calculated, the valuation must be made by cost. In the case of BIS, the Equity Equivalence Method is considered as measurement of value, that is, the fair value is the value at which the organization repurchases the shares. Concerning the IMF, the fair value is the value of the shares – valued in DES – that are updated by the value of the US dollar. However, if it is not possible to state the fair value, the assets registered must be entered at cost in local currency, but, with this it is impossible to make exchange rate adjustments.

d) Net Worth (NW)

Discussion on Negative Net Worth

The negative net worth in central banks does not mean a real problem if the economic situation, which is the most important aspect to be valued and which does not shift in terms of how accounting is presented, is clearly evidenced and described.

It should also be noted that the occurrence of a negative net worth is closely related to the central bank's capital structure, its capitalization system, distribution and hedging of profit and loss, pursuant to the legislation if effect. The solutions for the issue of negative net worth are therefore connected to the revision of legislation on capital and the central banks' profit and loss, with consideration of the question of transferring non-realized profit and loss.

This issue is being debated in the leading international central bank forums (IMF, BIS, CEMLA and BCE). Some recently published texts could help in understanding the issue and its implications, for example, "The Role of Central Bank Revisited", Bindseil, Manzanares and Weller, European Central Bank, September 2004, and even, "Central Bank Capital" Central Bank Capital Study Group, BIS, April 2005.

5) CONCLUSION

Based on the understanding that the objective of accounting is to structure financial and equity information to be used by those who have an interest in the entity (the users), a unified and widely-known technical standard helps in accounting's main purpose.

In this respect, the standards issued by the International Accounting Standards Board – IASB, because of their renowned quality, seek the objective of having an accounting language that is easily understood in the country and abroad and whose importance is emphasized by the current globalization process.

Considering that the IFRS is a set of good accounting standards, the decision by central banks whether to adopt them or not, implies the following:

a) Adoption – there are some implications whose effects must be dealt with (it being understood that the origin is the adoption of good accounting procedures), for example, the eventuality of a net worth with a negative balance and the transfer of profits and losses not made;

b) Non-adoption – this procedure does not eliminate the generating fact of accounting.

Central banks have very specific operations that deserve differentiated treatment, as in the case of gold and the cash flow status. The benefits of adopting an international standard include the possibility of solving a central bank's problems with the support of the IFRS, with the firm decision to adopt and discuss the improvements that must be introduced in order to attend to the users of the financial information in our financial statements with the IASD.