GROUP OF THIRTY

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All members of the Working Group and Steering Committee served in their personal capacities. The views expressed in this report do not necessarily reflect the views or policies of their respective institutions, nor does publication of the report by the Group of Thirty imply an endorsement of the views expressed herein.

Copies of this report are available for $40 from:

Group of Thirty
1990 M Street, N.W., Suite 450
Washington, DC 20036
Tel: (202) 331-2472 · Fax: (202) 785-9423

WWW – http://www.group30.org · E-mail – info@group30.org

Enhancing Public Confidence in Financial Reporting

Group of Thirty©
Washington, DC 2003

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>>> FOREWORD

FROM TIME TO TIME the Group of Thirty pursues thorny issues of public policy and financial best practice by means of a special study group. This study was launched after considerable discussion, with full recognition of unresolved and highly contentious issues surrounding accounting theory and practice. The intricacies of accounting are not standard fare for the Group, but it has become clear that the complex issues involved cannot be resolved without participation of those with a variety of perspectives and experience. Furthermore bridging the gaps in perception and analysis among practitioners, regulators and the investing public is proving exceedingly difficult. The failure thus far to resolve key issues, like the application of fair value accounting to financial instruments, provided the impetus for this G30 study.

Gerald Corrigan volunteered to take on this difficult challenge and set about recruiting the impressive array of talent that eventually joined him in this enterprise. Although he has claimed on numerous occasions that he has found the process of learning these issues and seeking consensus to be intellectually stimulating, even fun, we are aware of the amount of hard work that has gone into the process. The Group of Thirty owes him a special debt of gratitude for his efforts, and thanks Douglas Flint for joining Jerry as co-chair. We appreciate the many others — professional accountants, bankers and financial experts — who devoted so much intellectual energy and time to completing the final report.

The report is a thorough and thoughtful assessment of difficult issues. It should make an important contribution to the continuing debate on accounting standards. It also makes important recommendations on Best Practice and Enhanced Disclosure. Consequently the report is an important educational tool for those interested in understanding the complexities of the debate over accounting issues and a guide for financial firms in reviewing internal controls and preparing public reports. While the report does not purport to solve the thorniest issues surrounding fair value accounting, it offers a balance of views and interests among the public and private sector and technical experts on these issues.

This is an area in which principles matter, and where clarity and honesty of presentation are essential. Yet it would be foolish to pretend that it is not an area in which political judgment and expression play a legitimate role. Pursuing an honest and open dialogue, involving the parties at interest, offers the best chance that rational analysis will carry the day and politics will be held at bay. We commend the study to those pursuing sensible resolution of the accounting challenges in the hope that it will contribute to a successful outcome in this vital policy area.

PAUL A. VOLCKER
Chairman of the Trustees
Group of Thirty

JACOB A. FRENKEL
Chairman
Group of Thirty

>>> ACKNOWLEDGEMENTS

The Group of Thirty would like to thank all those who contributed to the success of this project. Thanks is due first to the project co-chairs: Gerald Corrigan, who took a rough idea discussed at a G30 plenary meeting and turned it into a going concern, and Douglas Flint, who agreed to join him in pursuing a thoughtful and balanced approach to these complex and contentious issues. The co-chairmen were joined in the effort by a Working Group (Exhibit 1) that spent countless hours debating and framing issues, developing an industry survey, drafting working papers and generally powering the project agenda. Their contribution would be difficult to quantify.

The Group also wishes to thank the project Steering Committee, listed on page vi, which provided high-level guidance throughout the project and itself devoted considerable energy to considering issues, reviewing papers and approving recommendations.

In addition to those directly involved in committee work, there were a number of other advisors to the project including: Jan Brockmeijer of De Nederlandsche Bank; Tony Cope and Jim Leisenring of the International Accounting Standards Board; Gerald Edwards of the US Federal Reserve Board; Howard Smith of AIG; and Larry Smith of the US Financial Accounting Standards Board. Others played supporting roles at meetings, in conducting the survey or in drafting and editing the report. These include:

Trish Coughlin, Kristy Robinson and Mark Allen of Goldman Sachs and Ian Michael of the Bank of England. The most labor intensive portions of the project were the comparisons of accounting systems and the survey of industry practice pursued with the help of Deloitte and PricewaterhouseCoopers. At Deloitte, we would like to thank Paul Gallagher, Sandeep Gupta, Shinya Iwasaki, Shigeo Ogi, and Hiroyuki Sono, with additional input from Al Hazard, Thomas Omberg, George Simeone and Robert Walsh. At PricewaterhouseCoopers, thanks is due to Mark Batten, Nigel Dealey and Kirstin Doody.

Finally, we would like to thank Goldman Sachs, HSBC and JPMorgan Chase for their hospitality in hosting meetings of the Steering Committee. We also thank Gillian Davies of HSBC and Lucille DePaulis of JPMorgan Chase for organizing those events, and especially Manar Zaher of Goldman Sachs whose unstinting efforts throughout the project helped ensure that the trains always ran on time.

EXHIBIT I: WORKING GROUP

PRINCIPALS

E. Gerald Corrigan
Managing Director, Goldman Sachs

Douglas Flint
Group Finance Director, HSBC Holdings

Jim Johnson
Partner, Deloitte

Phil Rivett
Partner, PricewaterhouseCoopers

David Sidwell
CFO, Investment Bank, JPMorgan Chase

Sarah Smith
Chief Accounting Officer, Goldman Sachs

John Walsh
Executive Director, Group of Thirty

SENIOR ASSOCIATES

Giovanna Acquilano
Vice President, JPMorgan Chase

A. Scott Baret
Partner, Deloitte

Andrew Hubacker
*Senior Manager, Deloitte **

Matthew Schroeder
Managing Director, Accounting Policy, Goldman Sachs

J. Douglas Summa
Director, PricewaterhouseCoopers

Shannon Warren
Managing Director, Accounting Policies, JPMorgan Chase

* Andrew Hubacker participated in the project as a representative of Deloitte, but took a position with a new firm prior to the conclusion of the study.

EXHIBIT 2: STEERING COMMITTEE

E. Gerald Corrigan
Managing Director
Goldman Sachs

H. Rodgin Cohen
Chairman
Sullivan & Cromwell

Jonathan Francis
Senior Vice President
Putnam Investments, Inc.

Timothy Howard
Vice Chairman & CFO
Fannie Mae

Walter Kielholz
Chairman
Credit Suisse

Phil Rivett
Partner
PricewaterhouseCoopers

Sarah Smith
Chief Accounting Officer
Goldman Sachs

Douglas Flint
Group Finance Director
HSBC Holdings

Tom de Swaan
Member of the Managing Board
ABN AMRO Bank

Gerard Gil
Chief Accounting Officer
BNP Paribas

Jim Johnson
Partner
Deloitte

Robin Monro-Davies
Fitch Ratings

David H. Sidwell
CFO, Investment Bank
JP Morgan Chase

John G. Walsh
Executive Director
Group of Thirty

OFFICIAL OBSERVERS

Susan Bies
Member of the Board of Governors
Federal Reserve Board

Mauro Grande
Director, Financial Stability and Supervision
European Central Bank

Jenifer Minke-Girard
Associate Chief Accountant
US Securities and Exchange Commission

Alastair Clark
Executive Director
Bank of England

Robert H. Herz
Chairman
Financial Accounting Standards Board

Andrew Sheng
Chairman
Securities and Futures Commission, Hong Kong

Note: Consistent with G30 practice, the official observers in this project attended the meetings of the Steering Committee and shared their individual views on the subject matter under discussion. However, they are not members of the Steering Committee and, as such, any views attributed to the Committee may not necessarily reflect their individual views and under no circumstances are they intended to represent the views of the observers' employer institutions.

>>> OVERVIEW

At its plenary meeting held at the Federal Reserve Bank of New York in December 2002, the Group of Thirty commissioned the formation of a Working Group to look into a range of issues relating to accounting policies and practices. The catalyst for this initiative was the emergence of a relatively small, but alarming, number of corporate scandals and related restatements of financial results which, in many cases, seemed to have their roots in failures in accounting policies and practices. At the same time, sharp differences of opinion were very much in evidence regarding future directions of accounting standards and practice, especially relating to the issue of the extent to which "fair value" accounting should be the generalized norm for future accounting standards. The fair value debate was — and is — particularly sharp as it relates to its application to certain classes of financial instruments, notably loans and advances made by banks, and various classes of liabilities.

Following its traditional methods of operation, in the early weeks of 2003, the leadership of the Group of Thirty designated a Working Group, chaired by E. Gerald Corrigan, Managing Director, Goldman Sachs & Co., and Douglas Flint, Group Finance Director, HSBC Holdings Plc, to undertake the project. In short order and consistent with G30 practice, a project Steering Committee was named made up of a diverse cross section of industry leaders and accounting professionals, together with a group of official observers including accounting standard-setters and regulatory officials. The members of the Working Group, the Steering Committee and the official observers are contained in Exhibits 1 and 2.

The initial mandate of the Working Group and its Steering Committee was aimed at seeking consensus regarding the use of fair value for the recognition and valuation of financial instruments commonly used by internationally active banks and investment banks.[1] Implicit in that mandate was, of course, the related subject of achieving a higher degree of harmonization in cross-border accounting standards.

Almost from the very outset of the project, it became clear that the initial goal of seeking consensus regarding the use of fair value was much too narrow and, as a practical matter, was not achievable. This early conclusion was shaped by three considerations as follows:

- **FIRST;** within both the Working Group and the Steering Committee there was an early consensus that the core problem in most of the headline corporate scandals was much more a matter of serious breakdowns in corporate governance and control as well as failures in disclosure practice than it was a matter of systemic flaws in accounting standards. That is not to say there were not shortcomings — or worse — in the application of accounting policies and their effective oversight by boards of directors, senior management and internal or external auditors. Nor is it to say that there were not cases in which disclosure practices were flawed. But, it is to say that systematic disregard for the most basic elements of governance and control, misrepresentations of information and alleged fraud were the common ingredients in most high profile cases.

  This conclusion on the part of the Working Group and the Steering Committee produced a major shift in the focus of the project in the direction of (1) efforts to strengthen corporate governance and control fundamentals and (2) initiatives aimed at enhancing the effectiveness of disclosure policies and practices.

- **SECOND;** for the reasons discussed in greater detail on pages 2 and 3, it also became obvious early in the project, that it would be impossible to reach

[1] Beacause the focus of the project was limited to financial instruments commonly used by internationally active banks and investment banks, this report does not cover the larger question of accounting standards for other financial and non-financial industry groupings.

consensus within either the Working Group or the Steering Committee regarding the extent and manner to which fair value should be the general standard for measurement of financial instruments. Indeed, the Steering Committee, like the population of interested parties more generally, was sharply divided into roughly three camps as discussed below on the question of whether fair value should be the general approach for accounting standards for financial instruments. While consensus could not be reached on the fair value question, the Steering Committee was able to come to broad agreement as to the primary barriers standing in the way of achieving that broader consensus and on ways in which those barriers might be reduced, as discussed on pages 2 through 5. Central to that broad agreement is the recognition that the choice of the accounting model comes down to what is best, not what is perfect, since perfection is not realistically within reach.

- **THIRD;** early on in the deliberations of the Steering Committee, it also became obvious that philosophical and practical tensions regarding the application of both accounting and disclosure practices were very real. For example, while there is unanimous agreement that the application of accounting techniques — regardless of the model — requires judgment, there is also unanimous agreement that such applications require standards and transparency. Obviously, there is a point at which the need for judgment and the pursuit of consistent application and interpretation of accounting standards can be in fundamental conflict with each other. This conflict is at the heart of the debate over the so-called "principles" versus "rules" approaches to accounting standards. Unfortunately, a number of factors — including elements of skepticism about the extent to which a principles-based framework for accounting standards can be achieved, inherent complexities, litigation risk, and fear of regulatory sanction — may be tilting the scales of that debate in the direction of more rules and fewer principles. This potential tilt, ironically, is being intensified by preparers and auditors of financial statements (and their lawyers) seeking more specific guidance and clarity from accounting standard-setters and regulators.

These tensions between philosophy and practicality pose a particularly sharp dilemma in the current setting in which the scandals of the past are, understandably, generating pressures to create a "no-flaw" framework for accounting and disclosures. Because such a "no-flaw" world is not within reach, the Report's focus on best practices for governance and control and more effective disclosure are seen by the Steering Committee as central to the needed effort to reduce the tensions between philosophy and practice, while at the same time helping to create a framework that will enhance public confidence in financial reporting. In turn, reducing such tensions will work in the direction of striking a more reasonable balance between principles and rules than now seems to be emerging.

FUTURE DIRECTIONS FOR ACCOUNTING POLICY

While the Steering Committee was not able to reach consensus on a near-term approach to the generalized application of fair value to financial instruments, there was agreement that further efforts were needed to narrow the debate about accounting models and to find common ground which could facilitate greater harmonization of accounting standards while striking a better balance between principles and rules. Movement in that direction must begin with a realistic understanding of the starting point around which the debate about alternative accounting models is being framed.

At the risk of considerable oversimplification, that starting point centers on three sharply differing viewpoints about accounting standards, each of which have proponents on the Steering Committee. These competing viewpoints are summarized as follows:

- **FIRST;** the view broadly associated with banks and many bank regulators is that some financial instruments, particularly the book of loans carried by banks (especially loans to consumers and small businesses) are not suited to fair valuation and the traditional approach — historical cost less provision for incurred impairment — should be maintained. The Basel Committee and the US Federal Reserve Board have cautioned against a move to comprehensive fair valuation without resolving significant implementation issues or providing rigorous guidance on valuation of such financial instruments.

  This view opposing fair value accounting for bank loans is based on three assertions: first; the relevance

of historical cost valuations to the lend-and-hold-to-maturity philosophy that has characterized bank lending for decades; second, the practical difficulty of valuing loans when most do not have readily observable prices; and third, potentially perverse incentives, especially a short-term orientation to risk taking, that could result from fear of greater volatility in reported profits. It is argued that this last factor could have important systemic implications for the functioning of banking systems and economic performance more generally.

- **SECOND;** the view broadly associated with large US securities firms is that fair value accounting should be the standard for most financial instruments. This view is based on the belief that fair valuation is significantly more relevant than historical cost for financial instruments and is sufficiently reliable if appropriate policies, governance, controls and disclosure are in place. Further and importantly, fair value has been standard practice among US securities firms for many years, without adverse consequences, and those firms believe that its use has encouraged a disciplined approach to risk management that, if more broadly applied, could engender greater market discipline and greater financial stability.

- **THIRD;** the view of the US Financial Accounting Standards Board (FASB) that fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives. However, FASB (and the International Accounting Standards Board, or IASB), as well as the community of regulators recognize that there are difficult issues associated with the application of fair value accounting, with an important issue being reliability, particularly with respect to instruments for which there is little or no direct price visibility.

Deliberations by the Steering Committee and other participants reflected the division of views among these camps, since participants included bankers, investment bankers, official observers and representatives of a number of countries. The principal implication of this division of views is that a mixed system of accounting, involving fair value for some instruments and historical cost or accrual accounting for others, is likely to continue for some time, although it is the Committee's conviction that the application of best practices and enhanced disclosure requirements to those instruments that are marked to fair value today will bolster confidence in the reliability of the fair value approach.

Yet the Committee recognizes that an eventual consensus is needed on the critical issue of accounting model. However, even when such consensus is reached, the pressure for detailed rules that increasingly characterize accounting standards and practice may intensify, thus increasing the risk that the system could be more difficult to administer or, worse, pushing the envelope of practice to the point where misjudgments will be made, thus generating pressures for even more detailed rules. More importantly, the Committee is also mindful that in an increasingly international framework of business and finance, a much higher degree of convergence in national systems of accounting is badly needed.

Although a clear plan for the future evolution of accounting policy remains elusive, many and possibly most observers believe that over time fair value will play a larger role in accounting for financial instruments. Even if its role were not to expand at all, more definitive agreement on the application of fair value as it is presently used is needed. These are thorny issues that will only be resolved through open dialog among the interested parties. It is the Steering Committee's belief that if that dialog is to be effective, it must embrace the following key considerations.

- **FIRST;** given the complexity of many of today's products and structures, **fair value accounting — or for that matter any accounting model — cannot eliminate the need for informed judgment**, applied by market participants experienced in accounting theory and practice, quantitative methodologies, financial theory and knowledge of markets. As accounting principles and related measurement techniques are further developed, the role of informed judgment must be part of the picture.

- **SECOND;** **there can be no fail-safe system of accounting that will prevent honest misjudgments much less banish fraud**. Standard-setters, regulators, supervisors and other users of financial statements must, unfortunately, recognize that no set

of revised rules or procedures can prevent abuse or eliminate even spectacular cases of fraud. When such cases occur, great care must be exercised to ensure that the industry, regulators, legislators and law enforcement officials make every reasonable effort to deal with them on a case-by-case basis. It is entirely appropriate that supervisors, regulators and standard-setters apply lessons learned from individual cases in framing policy and practice but, where possible, they should avoid unnecessary changes in the rules. That being said, most observers believe that the capacity of authorities to respond effectively to accounting-related transgressions would be facilitated in a setting of a more principlesbased approach to accounting standards.

With these considerations as prerequisites, resolution of even the most challenging issues should be achievable

EXHIBIT 3: RECOMMENDED BEST PRACTICES REGARDING GOVERNANCE, CONTROL, PRICE VERIFICATION AND AUDIT PRACTICES

GOVERNANCE

1. A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors or the audit committee.
2. A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.
3. Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside the risk taking functions.
4. Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk mangement and independent price verification functions are performed to the highest standards.

CONTROL

5. Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.
6. For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board-level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (e.g., value-at-risk, etc).
7. There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.
8. An appropriately qualified and experienced independent price verification (IPV) unit should be responsible for the fair values used in the financial statements.
9. There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.
10. Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.
11. There should be procedures for the timely review of highly structured, complex trades independent of the persons responsible for their design and execution.
12. For institutions using hedge accounting, the documentation, valuation and control requirements should be managed by financial control.

PRICE VERIFICATION PROCEDURES

13. Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verifi-

EXHIBIT 3, CONTINUED

cation results to the board of directors or the audit committee.

14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification differences and valuation adjustments should be distributed throughout senior management and, where fair value is a critical component of reported results, to the board of directors or the audit committee.
15. In addition to a rigorous monthly IPV process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

AUDIT

16. Internal audit departments should review at least annually the independent price verification procedures and control processes.
17. External audit should devote considerable resources to reviewing the control environment, including the price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.

over time. Discussions in the Steering Committee demonstrate that knowledgeable people on all sides of the present debate recognize the need for greater convergence in accounting standards. What is needed is a prompt and systematic effort to pursue such convergence in a spirit of good will. The Steering Committee believes that such a dialog is of enormous importance, and should initially focus on the critical questions of definition and scope.

- The *definition* of fair value is a topic that generates misunderstanding on two fronts: a semantic objection to the normative connotation of "fair value," and the more practical problem of measurement, including the question of the unit of account for fair valuation. Despite years of discussion, a common understanding of how fair value should be measured remains elusive. For example, some believe "price x quantity" in an active market provides the most objective and reliable result; hence, fair value. Others argue that in many circumstances without appropriate adjustments — as for example to reflect concentrations — price x quantity — by itself — may be inappropriate or just plain wrong. These issues become further complicated for instruments for which there is no directly observable price. In the past many financial statement preparers relied on guidance given in the 1993 Group of Thirty Report "Derivatives: Practices and Principles" which, while it was directed towards risk management, had become, in the absence of other specific guidance, a yardstick guiding the accounting for derivatives and trading books at fair value. However, the view of standard-setters (i.e., the FASB and the IASB) is that following the guidance in the 1993 G30 Report can yield idiosyncratic results which in certain circumstances can raise the potential for abuse.
- As to the *scope* of application, there will have to be agreement on which financial instruments, portfolios of financial instruments and/or business activities should be measured at fair value in financial statements. However, progress on this front will only be possible if there is a meeting of the minds on the questions of fair value definition and measurement as discussed above.

While an early consensus on the issues discussed above is unlikely, the need for progress is already widely recognized. In the United States, FASB has acknowledged the need to address questions of definition and has launched a project entitled 'Fair Value Measurement.' The IASB is similarly engaged. Projects focused on the fair value agenda are now under way under the auspices of the Financial Stability Forum, the International Association of Insurance Supervisors and the Accounting Task Force of the Basel Committee on Banking Supervision. There

is also work under way within Europe among accounting standard-setters and regulators. Such initiatives by regulators, standard-setters and practitioners are applauded by the Steering Committee which views them as essential building blocks for eventual consensus. And, for the same reasons that it commissioned the present study, the Group of Thirty remains committed to promoting consensus on these contentious issues.

Bridging the gaps in this area will not be easy, not least because the pursuit of dialog and consensus must not come at the expense of fundamental principles that are essential to the discipline of accounting standards and processes. Recognizing the complexity of the issues and the number of interested parties involved in this debate, the Steering Committee recommends a focused dialog between standard-setters and industry with participation, as appropriate, from the Group of Thirty, aimed at resolving issues of definition and measurement in the near term, and eventually scope of coverage. While it is not possible for the Committee to specify in detail a process for dialog, the concept echoes the Basel Committee's recommendation to the standard-setters to form a mixed panel of experts representing preparers and users of financial statements as well as auditors, regulators and the accounting standard-setters themselves. Whatever form it takes, the dialog should be pursued as a matter of urgency.

The Steering Committee further believes that achieving greater understanding of the fair value measurement process will be aided by the presentation of qualitative information in plain language that links the application of fair value accounting to the risk management process and the business model more generally. Such disclosure can help readers understand why a particular accounting model is most appropriate for the instruments and the business model in question. The Committee recommends that recent progress in this area be accelerated by building on the Best Practices and Disclosure Principles articulated in chapters 2 and 3 of this Report.

Taken together, and as outlined in the Report Summary which follows, the Steering Committee's recommendations represent a rich menu of actions that it believes are essential building blocks for the related goals of (1) *Enhancing Public Confidence in Financial Reporting;* (2) paving the way toward a more reasonable balance between informed and disciplined judgment and detailed specification in the world of financial reporting; and (3) facilitating much needed progress toward international convergence in accounting standards. Achieving these goals will not be easy, but in a context of widespread adherence to the recommended Best Practices and Disclosure Principles, building consensus on accounting standards may not be quite as formidable as would seem to be the case. Indeed, current US GAAP articulated by FASB and current international standards articulated by IASB, which constitute the starting point, have much more in common than is often recognized.

To illustrate this, Appendix 1 of this report provides a high level and plain language comparison between US GAAP and International Accounting Standards. (Appendix II adds a comparison between US GAAP and Japanese GAAP.) The comparison between US GAAP and IAS is intended to provide readers who are not close to the technicalities of accounting practice with a digestible overview of the two approaches in order to build a broader appreciation of the enormous complexity and difficulty associated with accounting policy and practice. While Appendix 1 points out areas such as hedge accounting and accounting for securitizations in which there are important differences, its central message is that the two approaches are not as widely divergent as is often assumed. This is an important finding given all that is at stake in achieving greater consensus and harmonization in accounting standards.

REPORT SUMMARY

The body of this report consists of three chapters and four related appendices. Each chapter is briefly described below with particular attention to the recommendations contained in chapters 2 and 3.

Chapter 1, entitled "Analytical Framework for Accounting Systems" consists primarily of a description of the goals of accounting standards and the main criteria for evaluating various accounting models and standards. Perhaps the most important aspect of Chapter 1 is the stress it places on both the micro *and* macro policy goals that should be inherent in accounting policy and practice. Indeed, the discussion of the macro policy goals makes the point that the effectiveness of accounting standards and practice are absolutely central to broad policy goals of economic growth, the optimal allocation of savings and investment, and financial stability.

Chapter 2 of the Report, which is entitled "Best Practices for Valuation of Financial Instruments," takes as its point of departure that the core problem in most of the

EXHIBIT 4: RECOMMENDED PRINCIPLES FOR MORE EFFECTIVE PUBLIC DISCLOSURE IN FINANCIAL STATEMENTS

1. Public disclosures should reflect information that is consistent with management's approach to risk management.
2. Public disclosures should focus on how risk within a firm changes over time.
3. Public disclosure should be responsive to changes in internal practices.
4. Public disclosures should be properly balanced between quantitative and qualitative information.
5. Public disclosures should include a plain language description of the business model, management's objectives and strategy, the risk and risk mitigation traits of the business and the ebbs and flows of the business dynamics over time.
6. Public disclosures — both quantitative and qualitative — should be consistent with and cross referenced to relevant accounting policies and, for example, to those policies which are considered "critical accounting policies," as discussed, for example, in relevant SEC guidance.
7. Public disclosures should include a written statement of each institution's governance policies broadly consistent with the best practices regarding governance practices as outlined in Part I of the Best Practices for Governance.
8. Public disclosure requirements need continuing reevaluation to ensure that they remain relevant and beneficial to users.

headline corporate scandals was much more a matter of serious breakdowns in corporate governance and control than it was a matter of systematic flaws in accounting standards. In other words, enhancing public confidence in financial reporting must start with insisting on a more systematic and rigorous framework of governance and control within which accounting standards are applied rather than seeking the impossible — namely accounting standards that can somehow prevent mismanagement, abuse or fraud.

In order to assist the process of developing a statement of best practices regarding (1) governance; (2) internal control; (3) price verification; and (4) internal and external audit as they relate to the preparation and/or audit of financial statements using fair value, a comprehensive survey of 13 major internationally active banks and investment banks was conducted. The survey methodology and detailed results are contained in Appendix 3 while the resulting statement of Best Practices is set forth in Chapter 2 and summarized in Exhibit 3. While the practices set forth are only a subset of an overall management and control framework, they should be viewed as complementary. In the text of Chapter 2, each of the Best Practices listed in Exhibit 3 is supplemented by inclusion of more specific and detailed lists of particulars associated with each individual Best Practice.

While Chapter 2 emphasizes that the primary focus of the survey was application of fair value accounting, the Steering Committee believes many of the Best Practices are not specific to fair valuation and thus have broader relevance. The Steering Committee therefore *recommends* that:

All major banks and investment banks evaluate their current practices against the relevant Best Practices and that the results of this review process should be reported to the Board of Directors or its Audit Committee.

This statement of Best Practices is not seen as a panacea or a fail-safe mechanism that will ensure that honest misjudgments, abuse or even fraud will never again occur in the application of accounting policies. Obviously, there can be no such assurance. However, the Steering Committee is confident that rigorous adherence to these Best Practices will go some considerable distance in minimizing the risk that incidents of the nature and scale that have recently occurred will be repeated. Thus, this framework of Best Practices is seen as a fundamental building block to the goal of restoring broad-based public confidence in financial reporting.

The third and final chapter in the report is devoted to "The Role of More Effective Public Disclosure." This chapter has both descriptive and normative components. It begins with a discussion of the theoretical underpinnings of why public disclosure is universally seen as critical to the workings of market discipline in the financial arena. It goes on to observe that the precise manner in which disclosures influence the behavior of financial market participants is not always clear, involving, as it does, the ambiguities of be-

havioral economics. The chapter then examines a number of areas in which there are issues or potential issues that may be impeding the effectiveness of disclosure policy and practice. Six areas of such potential concerns are identified and discussed. They are: 1) Information Overload; (2) Imperfect Information Filters; (3) The Quest for Comparability; (4) The Limits of Quantification; (5) More is Not Necessarily Better; and (6) Litigation Risk.

Taking account of these six factors and the extended pipeline of additional disclosure requirements that are newly issued or are under consideration in official and quasi-official circles (see Appendix 4), Chapter 3 recommends that movement towards more effective public disclosure by regulators, standard-setters and individual financial institutions should be guided by eight principles. These principles are presented in Exhibit 4. The Steering Committee believes that these eight guiding principles for disclosure policy and practice constitute a rigorous framework which will materially help in getting the "right" information to the "right" people at the "right" time. These principles, when combined with the 17 Best Practices relating to governance and control, should make a valuable and durable contribution to the central objective of this project; namely, *Enhancing Public Confidence in Financial Reporting*.

>>> CHAPTER 1: ANALYTICAL FRAMEWORK FOR ACCOUNTING SYSTEMS

High-profile financial scandals have dominated the headlines for much of the last two years. Whether the result has been outright bankruptcy or massive restatement of prior financial results, the magnitude of these problems has given rise to a widely held view that there must be something very wrong with accounting standards and practices and/or in the manner in which such polices and practices are administered and audited.

It was in this context that the Group of Thirty commissioned a study to examine one critical issue in the presentation of financial results for financial institutions, with specific focus on commercial and investment banks: the application of fair value accounting to financial instruments. The specific mandate from the Group was to identify and examine key issues and potential areas of consensus regarding the relevance and reliability of fair value accounting for financial transactions common to banks and securities firms. As discussed in the Overview, there was an early consensus that the fair value objective was too narrow and the report should examine a wider range of issues.

In considering how to approach its work, the Steering Committee made a number of important judgments at the outset. First, in the high-profile cases of financial misrepresentation gaining so much media attention, the essential problem was not systemic flaws in accounting standards, but serious breakdowns in governance and control and/or outright fraud. This is not to deny that there were cases in which aggressive accounting practices were pursued or disclosure practices were flawed, but the number of prosecutions being brought for fraud suggest strongly that accounting practices may have been an instrument of misdeeds but not their cause. Thus governance and control issues should be examined as an essential component of the project.

Second, the Committee agreed that no system of accounting, of official regulation and supervision, or of public disclosure can provide anything approaching fail-safe protection against fraud. Still, public policy and private actions — including those directed at accounting policy and practice, disclosure practices and official oversight — must be framed in a manner that seeks to sustain the broad-based discipline that is needed to avoid the cumulative and self-reinforcing erosion of business practices that characterized the bubble years of the late 1990's. It was in the interest of promoting a disciplined approach that the Committee considered principles to guide disclosure and accounting policy choices for the future.

Finally, the Committee agreed that any analysis of accounting policy and practice must start with agreement on the fundamental goals and essential characteristics of an effective system of accounting for financial institutions.

ACCOUNTING GOALS AT THE MACRO AND MICRO LEVELS

From the broadest public policy perspective, the reliability and integrity of accounting systems can be seen as serving two broad goals, one of which is *micro* in nature and the other of which has a distinctly *macro* focus. In other words, judging the reliability and integrity of accounting policy and practice requires both a microscope and a telescope.

At the micro level, accounting data are designed to provide reliable and relevant information as to the economic and financial condition of individual business entities and to do so for multiple and varied constituencies. Users of accounting data begin with the managers of such entities but the primary constituencies are external users including current and prospective investors and creditors, rating agencies, regulators, the media and the investing public at large. Because these constituencies have differing needs — particularly as they relate to judgments as to comparative performance and prospects — the resulting necessity for accounting data to serve multiple masters creates an enormous tension between the need demand for clarity on the one hand and detail on the other. This situation is

further complicated by the manner in which information is disseminated to these constituencies by various filters of information, themselves under enormous pressure to produce "instant analysis" of highly complex subject matter.

Turning to the telescope, the reliability and integrity of accounting practices clearly play a crucial role in the capital formation process, influencing both the manner in which savings are mobilized and the manner in which such savings — through the financial intermediation process — are allocated across different investment projects. To the extent that accounting practices provide systematically misleading information, it is very clear that both savings and investment can be misdirected to less efficient uses to the detriment of long-term productivity and economic growth prospects.

In macro policy terms there are also questions whether the choice of accounting model directly increases or decreases (1) financial market volatility; (2) pro-cyclical behavior in the credit extension process; (3) "prior restraint" in the financial intermediation process generally; and (4) overall financial stability. There is also the question whether accounting standard-setters should even care about the answers to these questions. Indeed, historically the standard-setters have taken the view that their mandate does not (and should not) extend to these macro issues. While that may not be an unreasonable position for the standard-setters to take, concern about the possible impact of accounting rules on these stability questions is nonetheless real.

In other words, the reliability and integrity of accounting practices have profoundly important implications for economic well-being on a broad scale. Thus, in macro terms, the effectiveness of accounting policy and practice relates directly to the broad policy goals of economic growth and financial stability. However, policy makers, practitioners and the public at large must recognize that accounting — like virtually all instruments of public policy — is at least as much an art as it is a science. Indeed, regardless of the accounting model, the application of accounting polices must — day by day — come to grip with far more grey than either black or white. Judgments, close calls and informed subjectivity are the rules, not the exceptions. Thus, the choice of the accounting model comes down to what is best, not what is perfect since perfection is not realistically within reach.

EVALUATING ACCOUNTING MODELS

In almost any discussion of the desirable qualities of financial statements, and the accounting standards and practices that govern their preparation, there is one essential quality of such statements that is invariably cited and that quality is "integrity." The frequency with which that single word is invoked is readily understandable, but because integrity is one of those great intangibles, it has different meaning to different people, and giving it operational definition is difficult.

In dictionary definitions, three other words are used to help capture the essence of integrity: "soundness," "incorruptibility," and "completeness." Since the essence of integrity is reasonably captured in these words, any criteria used to evaluate alternate accounting policies should, as a matter of common sense, be easily identified with these words. However, because the choices involved are both difficult and inherently subjective, any criteria must also have operational content such that choices can be made between accounting policies with a high degree of discipline.

In the interest of promoting consensus around difficult choices, the Steering Committee has embraced five evaluation criteria for accounting policies and systems. Although they were developed without reference to other policy pronouncements, the criteria described below bear a striking similarity to FASB's statement of financial accounting concepts No. 2 "Qualitative Characteristics of Accounting Information."

1) **CONSISTENCY.** The operational significance of the consistency doctrine essentially requires the administration or application of accounting policies by individual entities to be characterized over time by harmony, regularity and freedom from variation as reinforced by appropriate disclosure policy and internal documentation procedures. A more difficult aspect of the consistency criterion is the extent to which it should require precise — if not identical — comparability across firms. This issue is discussed further below.

2) **NEUTRALITY.** The key concept associated with the neutrality criterion is the proposition that accounting policies should inform various constituencies in an unbiased manner that does not tilt the decision-making process of these constituencies in any direction. In particular, accounting policies that meet the neutrality requirement should yield financial statements that reasonably approximate economic reality. Absent that neutral link to economic reality, there

is much greater risk that financial statements will undermine the effectiveness of the process through which markets allocate savings and investment.

3) **RELIABILITY.** The reliability criterion relates to the discipline in accounting policy and practice that provides a very high degree of assurance that the application of such policies and practices to similar situations over time will yield the same result in such successive applications. Looked at in this light, for financial instruments the reliability factor is especially important to the independent price verification process and the various disciplines such as back testing that are associated with that process.

4) **RELEVANCE.** The relevance criterion relates to whether the data captured in financial statements are the "right" information and whether these data can stand the ex-post test or challenge as to material omission and/or misstatement as well as provide a reasonable basis for ex-ante judgments for future performance.

5) **UNDERSTANDABILITY.** The understandability criterion is straightforward in concept but very elusive in practice, primarily because of the multiple-constituency problem discussed earlier. Clearly, the understandability criterion can only be achieved in the context of effective disclosure and transparency. However, even allowing for the very best in terms of transparency and disclosure, there are no accounting policies and practices that can provide even remote assurance that today's high octane financial and economic transactions can be grasped even by fairly sophisticated market participants. Moreover, when this criterion is extended to the politically charged subject of small investors or rank-and-file employees, the dilemma becomes much more acute. Thus effective application of this criterion — especially for less sophisticated market participants — rests more with governance and disclosure than it does with the ability of market participants to directly understand financial statements.

For the most part, the five evaluation criteria discussed above are complementary and mutually reinforcing. However, the criteria also give rise to certain subtle tensions and potential trade-offs. As an example, it would be convenient if appropriate valuation procedures were reduced to the simple product of price (P) times quantity (Q). However, even when P is readily observable (which is often not the case), the product of P times Q may not yield the relevant value in every circumstance.

As another example, there can be trade-offs between the relevance and consistency factors. That is, the consistency and relevance criterion should not necessarily be construed to mean that practices are applied, or must be applied, by every institution in an identical fashion that would produce identical results so as to, for example, facilitate cross-company comparisons. Clearly, such a mechanical approach raises the risk of a collision between consistency and relevance since pursuit of mechanical comparability could prevent institutions from developing more sophisticated valuation approaches which would clearly be more relevant even if less comparable.

There can also be fundamental conflict, especially in the valuation of instruments and portfolios for which prices are not available from the *Wall Street Journal* or *Financial Times*. These tensions between evaluation criterion bring into sharp focus the fact that a necessary (but not sufficient) condition to bring about improvements in the manner in which accounting policy and practice can better satisfy their macro and micro goals is more effective public disclosure — especially of a qualitative nature. These tensions also illustrate that at the end of the day, the choice of the preferred accounting policy framework must give important weight to the approach which best contributes to managerial discipline, which may not necessarily be consistent with managerial intent.

>>> CHAPTER 2: BEST PRACTICES FOR VALUATION OF FINANCIAL INSTRUMENTS

Governance, Control, Price Verification and Audit Practices

Because of the early consensus within both the Working Group and Steering Committee about the critical importance of governance and control, it was decided to undertake an industry survey of practices for ensuring the objectivity, consistency and integrity of valuation and accounting procedures for financial instruments. The survey results would be used to identify and examine key issues and potential areas of consensus related to use of fair value accounting for financial instruments. The objective of the survey was to be the development of a statement of best practice in these areas.

The survey explored practices relating to valuation of financial instruments at a group of large, internationally active banks and securities firms. Deloitte and PricewaterhouseCoopers agreed to conduct the survey on behalf of the Group of Thirty. The questions in the survey addressed the nature and extent of the involvement of the board of directors, audit committees, senior management and other management groups, the controls over model development and inputs, the frequency and nature of price verification procedures and the extent of internal and external audit involvement.

The survey was completed by thirteen of the largest banking and securities institutions in the United Sates and Western Europe, comprising Bear Stearns, BNP Paribas, Citigroup, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Lehman Brothers, HSBC, JPMorgan Chase, Merrill Lynch, Morgan Stanley, The Royal Bank of Scotland and UBS. These institutions represented all aspects of the banking industry — commercial, retail and mortgage banking as well as investment banking. The results of the survey were then analyzed for each institution to establish the best practices adopted. From this analysis, a preliminary list of Best Practices was prepared and, following a process of review and revision, was approved by the Steering Committee. These Best Practices are set out below. A more detailed report, analyzing the results of the survey, is included as Appendix 3. It provides greater context regarding how the procedures and processes operated in practice and the range of practices identified by the survey.

The Best Practices are derived from all the institutions taking part in the survey together with input from members of the Steering Committee reflecting their experience in managing and regulating major financial institutions. The degree of compliance with the recommendations clearly depends on the precise procedures adopted by the institution and the nature of its activities. Certain of the Best Practices may well be less appropriate or important for some institutions.

All the institutions taking part in the survey had significant levels of financial instruments held at fair value and for some (e.g., such as the investment banks) it was a seen as a critical accounting policy in the determination of their results. For others such as the commercial banks, it was less critical to their results, but nevertheless a similar degree of rigor was applied to the determination of fair value.

The survey from which the Best Practices in this report are derived focused on fair value of financial instruments. However, a number of the Practices are not specific to fair value and have much wider application. In particular, the Best Practices relating to governance and control are applicable for much of the day-to-day operation of a financial institution albeit as part of a much larger process that institutions will adopt in relation to all aspects of governance and control. While the Best Practices relating to price verification procedures focus on financial instruments held at fair value, they are relevant to all financial instruments where it is necessary to undertake valuation procedures. The Best Practices set forth below are only a subset of an overall management and control framework, but they should be viewed as complementary.

This report recommends, in the first instance, that all major banks and investment banks should evaluate their current practices against the Best Practices suggested in this report. The results of this evaluation should be report-

ed to the board of directors or the audit committee. Where financial instruments are held at fair value, any departures from the Best Practices should be reviewed critically to determine what actions, if any, are required. All the recommendations must be assessed in relation to the nature of activities, structure, governance and control arrangements and operations of an institution.

Although the first step in adopting these Best Practices is aimed at major institutions, ultimately it is recommended that all large financial institutions should undertake this evaluation and report. In making this proposal, the Committee recognizes that smaller financial institutions, especially those in less developed and emerging markets, may have difficulty adopting these Best Practices immediately. Some time may be required to marshal resources, train staff and gain the experience necessary to achieve these benchmarks. While this reality is recognized, the Committee encourages the widest possible application of the Best Practices as soon as practicable.

By way of clarification, the terms board of directors, audit committee and senior management are used in the Best Practices to indicate the different levels of oversight, decision making, authority and reporting lines that typically exist in a financial institution. The precise nature of these various groups will vary depending on the institution and, in particular, the legal framework within which it is governed. Whatever the legal framework similar levels of authority, decision making and reporting lines will exist in all financial institutions. The terms financial control and risk management are used to indicate the groups in an institution responsible for:

- Financial control, accounting and preparation of financial and management information.
- Independent risk control and assessment but not risk taking.
- Product control, including procedures such as position reconciliation, price checking and daily profit verification.

BEST PRACTICES

Governance

1. ***A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors or the audit committee.***
   - The board of directors or the audit committee should approve a high-level framework for accounting and valuation.
   - The board of directors or the audit committee should review the governance structure regularly to ensure it remains appropriate especially if major acquisitions, disposals or business changes have occurred.
   - All significant changes to accounting and valuation policies should be reported to the board of directors or the audit committee.
   - Design of the detailed accounting/valuation methodologies should be the responsibility of a senior management group reporting to the CFO or its equivalent.
   - The escalation process to senior management for various valuation oversight topics should encompass all high-risk areas and be based on judgment and/or discrete financial thresholds but in all cases should be documented.
   - Financial control and risk management must be fully independent of the risk taking businesses.

2. ***A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.***
   - Membership should include representation from market risk management, credit risk management, financial control/product control groups, senior business management, tax and legal.
   - Day-to-day responsibility for oversight should be a combination of financial control and risk management.
   - Information consistent with that produced by financial control and risk management for senior management should be provided periodically to the board of directors or the audit committee.
   - Proper and complete documentation should be prepared and reviewed by senior management and, where relevant, the Board of Directors or the audit committee for all processes involved in the determination and verification of fair values.

3. ***Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside of, and fully independent of, the risk taking functions.***

   - Risk takers, under the supervision of senior risk-taking management are responsible for providing prices/market values for all financial instruments held at fair value.
   - Financial control (the function responsible for the preparation of the financial statements) is responsible for reviewing (in conjunction with other control functions such as risk management) the fair values and ensuring adherence to the institution's policies and relevant accounting standards.
   - Ultimate responsibility for the determination of the value included in the financial statements should be in financial control.
   - Documentation should be prepared for policies and processes related to independent price verification.

4. ***Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk management and independent price verification functions are performed to the highest standards.***

Control

5. ***Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.***

   - A risk management committee should establish more detailed limits in consultation with business heads and senior management.
   - A range of risk measures should be used as well as reasonableness tests
   - For market risk, value-at-risk, stress testing and scenario analysis should be used.
   - Credit risk should be measured based upon current mark-to-market as well as on the basis of future potential exposure.
   - Other measures, such as notional limits and present value of a basis point should be used, particularly for items not measured on a fair value basis.

6. ***For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board-level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (e.g., value-at-risk, etc).***

7. ***There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.***

   - The initial identification of risk, control and valuation issues for new transaction types and markets should be the responsibility of the risk taking businesses.
   - The ultimate responsibility for New Product Approval, including the risk measurement, control and valuation procedures for such new products, should reside with a senior management grouping including representation from all relevant control and infrastructure groups (e.g., compliance, legal, internal audit (in an independent advisory role), financial control, risk management, tax, operations, technology, etc).

8. ***An appropriately qualified and experienced independent price verification (IPV) unit should be responsible for the fair values used in the financial statements.***

   - The IPV group should be part of financial control.
   - The members of the IPV group should be appropriately experienced (e.g., product controllers, risk managers, valuation experts, qualified accountants, etc.)

and should have significant "on the job" experience as well as specialist training.

- Risk takers, under the supervision of senior risk taking management, are responsible for providing prices/market values for all financial instruments held at fair value.
- Financial control (the function responsible for the preparation of the financial statements) is responsible for reviewing (in conjunction with other control functions) the fair values and ensuring adherence to the institution's policies and relevant accounting standards.
- IPV groups should work closely with risk management, product control groups and those involved in the new product approval process (see above).
- The IPV group should seek input from risk taking units.
- Where fair value is a critical component of reported results IPV groups should have access to dedicated quantitative professionals within financial control or risk management to deal with complex price verification issues.

9. ***There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.***
   - Especially where fair value is a critical component of reported results, considerable man-hours should be dedicated to model verification by appropriately qualified staff.
   - This Model Verification Group should be within financial control or market risk management.

10. ***Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.***
    - A report should be prepared covering significant assumptions and model limitations. This report should be used to focus the independent price verification processes, as well as being the basis for limits setting and valuation adjustments.
    - Trading on models that have not been fully validated, or reviewed, should be subject to specific and rigorous limitations and senior management approval.
    - The inventory should include each model's review status, date of last review, limitations on its use and a scheduled re-review date.
    - Institutions should have a formal process for ensuring models remain up to date.

11. ***There should be procedures for the timely review of highly structured, complex trades independent of the persons responsible for their design and execution.***
    - Such transactions should include unusually large trades, those with a significant profit at inception and/or transactions that raise questions about tax, accounting or suitability policies.
    - This review should be undertaken by a similar group to that for the New Product Approval, often with more involvement of technical people such as those in the Model Verification Group.

12. ***For institutions using hedge accounting, the documentation, valuation and control requirements should be managed by financial control.***

Price verification procedures

13. ***Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.***
    - Prices and valuation parameters for liquid markets should be independently verified using external market data such as stock exchanges and other external sources of prices.
    - Remaining parameters should be verified by way of broker quotes and consensus-pricing sources supported by market data and technical analysis to ensure that all inventory positions are verified for reasonableness.
    - These prices/inputs should all be requested and received directly by the IPV group.
    - The reports to senior management, board or audit committee should identify the 'quality' of prices used to determine fair value for each type of asset or liability.

- Other ad-hoc procedures including collateral reconciliations to position value, a review of similar recent transactions and early termination analysis should be undertaken.
- Consideration should be given to undertaking unscheduled, mid-month, detailed price verification. At a minimum this unscheduled verification should be performed if the result of other work identifies a potential difficulty and must be completed by people independent of the transaction execution.

14. ***An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification differences and valuation adjustments should be distributed throughout senior management and, where fair value is a critical component of reported results, to the board of directors or the audit committee.***

- Valuation adjustments for credit, bid/offer, liquidity and model uncertainty should be made on a consistent and systematic basis. Adjustments for servicing or administration are considered inappropriate by certain accounting frameworks and financial institutions.
- Valuation adjustments for early termination, customer unwind, funding and hedging should be considered, as appropriate, to determine fair value.
- Market and credit risk management groups should provide assistance in the determination of valuation adjustments.
- Valuation adjustments must be rigorously reviewed by the independent group to ensure that appropriate fair values are being adopted in accordance with GAAP.

15. ***In addition to a rigorous monthly IPV process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.***

- This process should involve an analysis of results by reference to movements in market prices and indices, transactions, independent risk analysis and other information.
- For non-traded financial assets and liabilities the independent pricing process should be subject to similar procedures on whatever periodic basis is used to prepare profit and loss accounts and reported on a timely basis to senior management.

Audit

16. ***Internal audit departments should review at least annually the independent price verification procedures and control processes.***

- Review of the IPV process should include the policies and procedures as well as the treatment and escalation of exceptions.
- Internal audit staff involved in such work should be experienced and attend both internal and external training similar to that received by the IPV group.
- The head of internal audit should report the results of their testing to the audit committee regularly (and where fair value is significant to reported performance, frequently) on the scope and results of price verification.

17. ***External audit should devote considerable resources to reviewing the control environment, including price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.***

>>> CHAPTER 3: THE ROLE OF MORE EFFECTIVE PUBLIC DISCLOSURE

Based on its review of the recent history of corporate scandals and large-scale re-statements of financial results, the Steering Committee recognized that one of the key building blocks for the future centers on a more effective framework of public disclosure of information relating to the quality and integrity of financial statements and related information. Indeed, as discussed below, effective public disclosure is central to market discipline in that it is the vehicle that permits investors, creditors and other market participants to make the informed decisions that must lie at the very foundation of the process of mobilizing savings and allocating such savings to their best possible uses.

The following discussion of more effective public disclosure and the articulation of the recommended eight principles that should guide future public disclosure policy are importantly based upon three starting propositions which are broadly shared by the Steering Committee. Those propositions are as follows:

- **FIRST;** enhanced and more effective public disclosure is not a substitute for sound accounting applied in a rigorous, disciplined and consistent manner.
- **SECOND;** in the realm of disclosure practice, more is not necessarily consistent with better in that more data and words can further complicate the already challenging task of absorbing and comprehending the vast amount of information currently disclosed by many companies.
- **THIRD;** disclosure, particularly as it applies to financial statements and the information surrounding financial statements brings to the surface a dilemma, the horns of which seem to sharpen almost daily. That is, while practitioners intellectually embrace a principles-based approach to accounting standards, in practice they are often the ones who insist on detailed rules which are seen as necessary to guard against reputational and litigation risks.

These propositions are elements of reality which must be taken into account in efforts to work toward more effective public disclosure. While they are obstacles, they are not barriers in a setting in which there is universal agreement that more effective public disclosure is central to the goals of greater market discipline and the restoration of public confidence in financial statements and corporate behavior generally. With the above in mind, the analysis that follows addresses the following issues:

- **FIRST;** the theoretical underpinnings of the role of public disclosure in contributing to market discipline, along with some of the factors identified by the Steering Committee which have an important bearing on the effectiveness of disclosure practices.
- **SECOND;** the likely directions of near-term changes in officially mandated disclosure requirements, which are provided in brief overview;
- **THIRD;** a recommended set of principles that should guide future public disclosure practices for financial instruments and/or institutions will be presented.

Before proceeding with this discussion, there is one basic point of distinction which should be made clear. Namely, while all public companies in all jurisdictions are subject to certain public disclosure requirements, regulated financial institutions, in particular, are also subject to certain regulatory reporting requirements. While much of the information and data that are the subject of regulatory reporting requirements is also subject to public disclosure, some such information is provided to regulators under strict rules of confidentiality. Indeed, in some instances, information provided to supervisors and regulators may not,

as a matter of law, be disclosed to the public. Bank examination materials in the United States and bank secrecy laws in Germany are cases in point. This feature of regulatory reporting requirements is central to the ability of regulators to perform their duties in a manner consistent with their basic responsibilities to foster financial stability. Since public disclosure and regulatory reporting requirements are not always differentiated, it should be stressed that the focus of this report is strictly limited to public disclosure and not to confidential regulatory requirements.

THE EFFECTIVENESS OF PUBLIC DISCLOSURE PRACTICES

The following discussion of the effectiveness of public disclosure is framed primarily from the vantage point of institutional suppliers and users of such information who are the members of the G30 Steering Committee. As such, it does not directly reflect the point of view of "retail" users of such information.

The fundamental goal of public disclosure policy is simple and straightforward and reduces to a single word, namely discipline. That is, effective public disclosure is aimed at creating a framework in which the (1) discipline of the marketplace plays the major role in determining the manner in which savings and investments are allocated among competing uses; and (2) risks are distributed among different agents in a manner that best promotes economic growth, rising standards of living and financial stability. Effective public disclosure works its discipline on both sides of the savings/investment equation. That is, for investors, creditors, and other stakeholders, effective public disclosure provides the information that helps such entities and individuals to channel their financial resources to the enterprises that will provide investors and creditors returns in keeping with their respective tolerance for risk while at the same time contributing to the optimal allocation of capital. Having said that, all jurisdictions recognize that small and unsophisticated investors and depositors need special protections since these market participants cannot reasonably be expected to understand much of the information that is subject to public disclosure. There is also the need to satisfy the information needs of other parties (such as employees) who rely on public reports to assess the relative merits of organizations.

On the other side of the equation, effective public disclosure provides the discipline for those seeking to raise capital to provide potential and existing creditors and investors with accurate and reliable information — both quantitative and qualitative — describing their business enterprise and its financial conditions, with the knowledge that if material information is not disclosed or is not disclosed properly the commercial viability of the company can ultimately be called into question.

The Steering Committee is strongly and unanimously of the view that effective public disclosure policy is central to the working of the financial system and the economy at large. Indeed, sound and well-managed institutions — financial and non-financial alike — should be the champions of effective disclosure policy since well-managed institutions stand to be the major beneficiaries of effective disclosure. That is, to the extent that information disclosed is (1) reliable; (2) consistent with economic reality; (3) comprehensible; (4) informative of risk profiles and risk management; (5) descriptive of valuation practices, and (6) consistent with GAAP, it will reward the sound, prudent and well-managed institutions and penalize the less effective institutions. In point of fact, there can be no doubt that over time disclosure policy and practice has played a critically constructive role in helping the marketplace sort out corporate winners and losers, even if it is true that no such framework is fail-safe, in the face of rapidly changing economic and financial conditions and occasional efforts to mislead or deceive.

In today's setting of greatly heightened complexity and speed, the challenge of shaping effective disclosure policy is daunting, especially when it is recognized that disclosure, by its nature, is intended to influence behavior in a context in which our understanding of behavioral economics is limited at best.

Notwithstanding those limitations, and given the role of the discipline associated with effective public disclosure, it *must* follow that if public disclosure is to be *effective,* it must influence behavior in a constructive manner. Indeed, the virtually universal recognition of the case for enhanced public disclosure ultimately rests on the proposition that such disclosure will influence behavior in ways that enhance the mobilization of savings, the allocation of capital, and the stability of the financial system.

Looked at in this light, the central issue about public disclosure is not its critical role but rather how can it be better framed in order to achieve maximum assurances that it will change behavior in the desired directions. However,

such desirable results can be elusive since enhanced public disclosure — unless designed and executed with great care — can easily be subject to the law of unintended consequences. The risks associated with the law of unintended consequences in this context fall into three major categories, all of which relate to the behavioral phenomena. They are:

- **FIRST;** *and by far of greatest importance,* enhanced disclosure policies could prove to be ineffective meaning that there is little or no obvious change in behavior resulting from the added disclosure. The absence of changed behavior could occur if the added disclosures were seen by the marketplace as adding details but not yielding fundamentally different assessments of the creditworthiness, soundness, and financial performance of individual firms. The same result could occur if the marketplace concluded that the added information was either so stale or ambiguous as to provide little basis for fundamentally different assessments of individual firms. Importantly, if the enhanced disclosures were to prove ineffective, that would mean that the costs associated with the effort would produce little or no benefit. This would be most unfortunate because the direct and opportunity costs for some individual firms associated with the systems needed to develop and support the enhanced disclosure framework can easily run into the millions of dollars.

- **SECOND;** the enhanced disclosure practices could prove to be either *misunderstood* because of their complexity or *misleading* because of their lack of transparency. In either case, the induced changes in behavior could result in some combination of (1) misguided investment and credit decisions; (2) misallocation of credit and capital; and (3) mispricing of capital or credit.

  Unfortunately, in the cases of misleading disclosure, the adverse consequences caused by such disclosures may not be recognized by the marketplace until well after the fact. Indeed, in an extreme case such as Enron it seems clear that misleading (if not fraudulent) disclosures were not recognized until long after investors and creditors were already incurring massive losses.

- **THIRD,** there is also the admittedly more remote risk that enhanced disclosure *could* have the unintended effect of distorting competition. Some believe that this could occur because the disclosures have the de facto effect of compromising proprietary information of individual firms in ways that undercut the competitive edge of the most innovative and creative institutions. As another possible example, efforts to achieve comparability of information across firms by requiring all firms to use exactly the same models for disclosing value at risk or potential credit exposures risk metrics could gravitate toward the universal use of the least common denominator approach thereby frustrating more conservative or informative proprietary approaches.

These risks arising from the law of unintended consequences as associated with enhanced disclosure cannot and should not stand in the way of prudent initiatives to foster changes in behavior that will serve the cause of market discipline. However, their nature and potential consequences serve as a forceful reminder that the agenda for the future regarding more effective public disclosure must be approached with caution. In that spirit of caution, there follows a brief description of a number of specific issues and concerns with regard to disclosure policies and practices that have been raised by financial practitioners and others.

1) **INFORMATION OVERLOAD.** The absolute magnitude and complexity of information disclosed by all large financial institutions can border on the unintelligible for even sophisticated investors and creditors. Annual reports alone can be a hundred or more pages which cannot easily be absorbed and digested without many hours of effort by sophisticated investors. Less sophisticated investors are severely constrained in their ability to make reasoned assessments of the information. The information overload problem is amplified to the extent that new disclosure requirements are often layered onto existing requirements in ways that can add to confusion and complexity. In other words, while the objective of disclosure is to inform, the result may sometimes be to overwhelm and to confuse.

2) **IMPERFECT INFORMATION FILTERS.** Even sophisticated investors and creditors, but especially small investors and creditors, often have neither the time nor the ability to wade through the enormous volume of complex information that is publicly avail-

able to assist the credit and investment decision making process. Thus, in varying degrees, their behavior is shaped by the information they receive in digested format from the news media and from various individuals and entities whose job it is to provide insight and analysis to facilitate the investment and credit decision making process.

Even under the best of circumstances *and motivation,* the pressures on those who provide such information filters in this day of instant analysis and instant communication are enormous. Indeed, the competitive pressures to produce the quickest and the most pointed analysis are unyielding. The corresponding pressures on corporations to shape their disclosures in a manner that anticipates the issues of the day for journalists and analysts — to say nothing of satisfying market earnings expectations to the nearest penny — only serve to further complicate the inherently complicated task of full and fair disclosure.

Unfortunately, the evidence is overwhelming that "market demand" for instant analysis has captured the day, sometimes at the expense of clarity, precision, and thoroughness. This flaw in the disclosure process will not be remedied easily so long as the marketplace puts such a large premium on instant analysis.

3) **THE QUEST FOR COMPARABILITY.** Quite naturally, creditors, investors, analysts and other market observers are pre-occupied with making comparisons among firms, especially those firms that are engaged in broadly similar activities. Given that natural interest, regulators and accounting standard-setters have had a reasonable degree of success in shaping disclosure requirements in ways that facilitate such comparisons as, for example, in basic financial statements. There are, however, limits as to the extent to which comparability can be achieved. That is, even when the grouping of "comparable" firms is quite small, achieving disclosure comparability in some *areas* is difficult.

For example, there is a very small number of globally active banks and investment banks which at first glance would seem to be at least roughly comparable institutions. In fact they differ considerably in the nature of their business as well as their business models, their geographical footprint, their accounting regimes and their regulatory environment. Thus, even when it would seem that comparability in disclosure can be reasonably approximated — say with regard to potential credit exposures or value-at-risk measures of market risk — seemingly small technical differences in the methodologies used to compute such information can have material implications that impair the extent to which the resulting data is in fact comparable.

That is not to say that comparative data have no value but it is to say that the interpretation of such information must be approached with great care and with a detailed understanding of the businesses being compared. That is, such information cannot be viewed in a vacuum that does not take account of many other factors including risk management capabilities, the nature of the activities and the business model itself.

4) **THE LIMITS OF QUANTIFICATION.** All too often, elements of thinking about effective disclosure policy fall victim to the myth that quantification and still more data *will themselves deliver enhanced discipline.* Obviously there is more than a grain of truth to that proposition as illustrated most plainly by the unquestioned value of basic financial statements. However, quantification and data, by their nature, have limitations as illustrated by the frequency and magnitude of revisions in our most important economic statistics and the manner in which financial market behavior sometimes reacts to such data and their revisions.

In the arena of public disclosure for financial institutions, extensive reliance is placed on a blend of both quantitative and qualitative disclosures. Yet, there are many informed observers who believe that the balance between qualitative and quantitative is tilted far too heavily toward the latter. One consequence of this tilt is that disclosure practices sometimes fail to articulate in plain language the basic characteristics of the business model, the intent of management and the ebbs and flows of the business dynamics over time.

5) **MORE IS NOT NECESSARILY BETTER.** In the current environment the case for still further enhancements to public disclosure is compelling. Yet, it does not fol-

low that simply adding to the already costly burden of disclosure requirements will necessarily mean that market discipline and the allocation of savings and investment will be improved. Indeed, achieving those goals probably brings with it the need to take a fresh look at ways in which disclosure requirements can be streamlined and at ways in which existing requirements are scaled back as new requirements are put in place. This fresh assessment of costs and benefits is particularly timely in the light of the many new disclosure requirements that are under consideration, as discussed below.

6) **LITIGATION RISK.** In the United States in particular, but in other jurisdictions as well, litigation risk represents a significant complication to disclosure practice. This complication arises in at least two ways: First, litigation risk tempers the willingness of businesses and their lawyers to provide plain, easily readable language to describe their business activities, risks and performance; and second, litigation risk and other factors sometimes force standard-setters and regulators to go to great lengths to prescribe detailed rules and standards designed to anticipate virtually every technical or legal issue that might arise. This pressure for prescription militates against moving toward a principles-based framework of accounting standards. At the same time, some hold the view that principles-based accounting standards would serve to better align the incentives of preparers and auditors with those of investors, with a resultant increase in the informativeness of financial statements. This suggests that a principles-based framework could result in fewer meritorious cases brought against preparers and auditors and a consequent overall reduction in litigation costs and damages. In the meantime, however, litigation risk amplifies tensions between the accounting standard-setters on the one hand and the practitioners on the other in seeking to strike the right balance between enlightened disclosure and overly prescriptive rules.

DISCLOSURE REQUIREMENTS: LOOKING FORWARD

Not surprisingly, in the wake of the recent history of corporate scandals and failures in governance and disclosure, there is an almost universal call for further enhancements in disclosure requirements. As a result, regulatory bodies and accounting standard-setters have many pending changes and/or additions to disclosure requirements in the pipeline. (An inventory of some of the more important changes is contained in Appendix 4.)

Given the magnitude and scale of these pending changes — to say nothing of the costs associated with their implementation — a concerted joint effort by the public and private sectors will be needed to ensure that such changes are designed and implemented in a manner that is (1) cost-effective; (2) consistent with the goals of effective disclosure policy; and (3) well coordinated across regulatory jurisdictions and national boundaries. There is, thankfully, an established track record of official and private sector cooperation to harmonize initiatives aimed at enhanced disclosure — often on a voluntary basis.

One recent illustration of new disclosures that are importantly improving transparency can be seen in the financial services' industry response to the SEC's push for better disclosure of critical accounting policies. Specifically, the annual reports of many internationally active banks and investment banks now include qualitative and quantitative information on the methods used to value financial instruments despite the fact that final rules have not been issued by the SEC. These new disclosures include information about financial instruments with little or no price transparency — an area of increasing importance to practitioners, regulators and standard-setters.

The Steering Committee believes that in both form and substance this illustration of cooperative efforts aimed at enhanced disclosures serves the best interest of the involved institutions, the regulatory community and financial markets generally. More broadly, the Steering Committee also believes that looking forward the task of moving toward a framework of both enhanced and enlightened public disclosure will be well served by a set of broadly accepted principles that should guide that effort.

RECOMMENDED PRINCIPLES FOR FUTURE DISCLOSURE REQUIREMENTS

In the aftermath of the market meltdown associated with the Russian crisis and the Long Term Capital Management collapse in late 1998, there were multiple public sector/private sector initiatives aimed at better understanding what happened, why it happened and what steps could be taken to minimize the risks of future systemic market failures of this kind. One important element of such efforts was

aimed at enhanced public disclosure. Those efforts initially were spearheaded by the work of the Counterparty Risk Management Policy Group and an Official Working Group chaired by Peter Fisher of the US Treasury. The final public sector-private sector consensus regarding enhanced public disclosure emerged from a private sector Working Group, chaired by Walter Shipley (then CEO of Chase Manhattan Corporation) as encouraged by the Federal Reserve Board, the O.C.C. and the SEC.

In January 2001, the Shipley Working Group recommended a number of specific enhancements to public disclosure, many of which have been implemented. More importantly, the Shipley Group also recommended four principles that "should be the centerpiece of any effort to enhance public disclosure." These principles are as follows:

1. ***Public disclosure should reflect information that is consistent with management's approach to risk management.*** There should be as strong a link as possible between the framework relied upon by senior management to evaluate the risks and returns of the business and the information that is disclosed. Such a linkage provides insight into management practice, financial performance and risk discipline. Such a linkage also helps ensure that the information disclosed will be meaningful. At the same time, the information that is disclosed needs to be easily understood, non-proprietary and based on a mature risk framework. As such, the information may not be as detailed as the information that senior management uses to evaluate risk.

2. ***Public disclosure should focus on how risk within a firm changes over time.*** While comparable data across firms are conceptually appealing, they are difficult to achieve, as noted above. Because risk information is based on inherently imprecise estimations, having frequent information to relate the earnings volatility of a business over time to the estimates will be the best way for a user to assess the quality of those estimates.

3. ***Public disclosure should be responsive to changes in internal practices.*** Maintaining continuous and comparable prior period data is less important than having the best currently available view of a firm's risk profile. We expect the pace of innovation and modifications to risk management and measurement practices to be rapid and believe the changes should be reflected as quickly as possible in public disclosures. A discussion of material changes in risk management and how those changes may affect the trend in disclosed information should accompany significant changes.

4. ***Public disclosures should be properly balanced between quantitative and qualitative information.*** Best practice disclosures incorporate clear and informative discussions about a firm's risk management processes. Such disclosures would include defining the various risk factors, discussing the framework for the management of each risk factor (responsible groups, committees, types of limits, etc.) and describing the main elements of risk assessment, including key metrics. These qualitative disclosures combined with quantitative information around each risk factor and the performance of risk estimates are aimed at providing a well-balanced view of the firm's overall risk profile.

Because the Shipley principles were formulated in response to the market melt-down of 1998, they are importantly framed around risk management related issues as pertains largely to market and credit risk. Nonetheless, they remain highly relevant to the general subject of enhanced public disclosure. However, given the events since January 2001, the Steering Committee believes that the original Shipley principles should be supplemented by four additional principles. They are discussed below:

5. ***Public disclosures should include a plain language description of the business model, management's objectives and strategy, the risk and risk mitigation traits of the business and the ebbs and flows of the business dynamics over time.*** Such information is the foundation upon which investors, creditors, analysts, rating agencies, and the media can better understand and interpret the information — quantitative and qualitative — that is disclosed.

6. ***Public disclosures — both quantitative and qualitative — should be consistent with and cross referenced to relevant accounting policies and, for example, to those policies which are considered "critical accounting policies"*** as discussed, for example, in relevant SEC guidance.

7. ***Public disclosures should include a written statement of each institution's governance policies broadly***

consistent with the Best Practices for Governance. Such disclosures regarding governance should be made by all large banks and investment banks regardless of the extent to which such institutions use fair value accounting.

8. ***Public disclosure requirements need continuing re-evaluation to ensure that they remain relevant and beneficial to users.*** Clarity and effectiveness will be improved by systematic and coordinated efforts to keep polices and practices current and to remove obsolete information and requirements.

The Steering Committee believes that the four Shipley principles, when combined with the four supplemental principles outlined above, constitute a rigorous and comprehensive set of principles that should guide future disclosure policies and practices and that these principles will work to improve the effectiveness of disclosure policy and practice.

>>> APPENDIX 1

Comparison of Financial Instruments Accounting Standards: US GAAP and IAS

INTRODUCTION

Making informed choices about accounting policy frameworks requires a clear understanding of present accounting arrangements and how major systems compare. To that end, the following analysis broadly compares accounting standards applicable to financial instruments as promulgated by standard-setters in the United States (the Financial Accounting Standards Board, or FASB) and internationally (the International Accounting Standards Board, or IASB). It is not an understatement to assert that any broad expansion in the use of fair value accounting for financial institutions would ultimately require the support and concurrence of one (but probably both) of these bodies. In reading this analysis, some broad observations should be kept in mind:

- The FASB and the IASB dedicate considerable time and resources to accounting issues related to aspects of financial instrument accounting. Accordingly, guidance is subject to frequent developments and, from time to time, ongoing refinements and modifications. In some cases, the changes are in respect to narrow technical fixes; in other cases, the changes may be more significant.
- Although this analysis focuses on areas where the standards promulgated by the two standard-setters differ, it is clear that the overall approach taken to date is similar, resulting in standards that are more alike than many recognize. Further, both standard-setters have endorsed the need for convergence between their two sets of standards and have active projects to accomplish that goal. Certain areas of difference are highlighted below. These differences are not necessarily the focus of convergence efforts; indeed, it is possible that greater divergence could result as financial instrument accounting standards evolve.
- Securitization accounting currently represents an area where certain similar transactions would be accounted for differently under the two regimes. As a general rule, off-balance-sheet sale accounting is more frequently achieved under US GAAP today than under international standards. Both standard-setters have active agenda projects that encompass securitization accounting and it is possible the disparity will not continue or at least not continue to the same degree.
- Currently, derivative and hedge accounting principles are similar, although significant technical differences apply — including an explicit prescription in US GAAP (also under consideration by the IASB) that limits revenue recognition on certain complex derivative instruments. The IASB (but not the FASB) is considering permitting financial institutions to hedge a portfolio of interest-bearing assets and liabilities under conditions that would be prohibited under current IASB and FASB standards.

Financial instruments accounting under Japanese GAAP is not included in this comparison, but significant details related to financial instruments accounting pursuant to GAAP in Japan are provided in Appendix 2 of this report. This comparative analysis was current in August 2003 but changes are ongoing so some descriptions may be outdated.

THE ISSUES

The financial accounting and reporting issues associated with financial instruments are best summarized in the context of a few simple, yet fundamental, questions. These questions include the following:

- What financial assets or liabilities should be recognized in the balance sheet, and how should those recognized financial instruments be initially measured?
- Should financial instruments be remeasured on a periodic basis, and if so, how often, what should the basis

for remeasurement be, and where in the financial statements should changes in value upon remeasurement be reported?

- If the objective of the initial and subsequent measurements of financial instruments in the financial statements is fair value, what does fair value mean, and how should fair value be estimated — especially in the absence of transparent and liquid markets for the instrument being valued?
- If financial assets are not accounted for entirely on a fair value basis (with changes in fair value included in current income), when should declines in their value be recognized as a loss?
- When should a financial asset or liability be removed, or derecognized, from the financial statements, and how should any resulting gain or loss from derecognition be reported in the financial statements? For example, when financial assets are "sold," do the terms of the transaction suggest financing rather than sale treatment?

These are issues that accounting standard-setters in the United States and internationally have struggled with for many years, and continue to struggle with. Accounting standards that have been issued to date attempt to address one or more of these fundamental questions, with the objectives of achieving some consistency in practice amongst different enterprises (to facilitate comparisons) and providing relevant, reliable, and useful information to financial statement users. When comparing the current financial accounting requirements for financial instruments in the United States with International Financial Reporting Standards (IFRS), it is helpful to bear these fundamental questions in mind, as key differences will largely relate back to them.

ACCOUNTING STANDARD SETTING

United States generally accepted accounting principles (US GAAP) are primarily established by an independent organization, the Financial Accounting Standards Board. Since 1973, the FASB has been designated in the United States as the organization in the private sector for establishing standards of financial accounting and reporting. The standards established by the FASB are officially recognized as authoritative by the US Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA). Although the SEC has the statutory authority, under US law, to establish financial accounting and reporting standards for publicly held companies, the SEC has historically relied on the expertise and resources of the private sector, including the FASB, in carrying out this mandate. Other groups are also involved in establishing accounting principles in the United States, including the Emerging Issues Task Force (EITF), which typically deals with narrow, emerging issues and whose conclusions must be ratified by the FASB; and a committee of the AICPA (AcSEC) which generally addresses industry-specific accounting and financial reporting issues,[1] and whose guidance is subject to FASB clearance.

International Financial Reporting Standards (IFRS) are currently set by the International Accounting Standards Board. The IASB is an independent, privately funded accounting standard setter based in London. Board members come from nine countries and have a variety of functional backgrounds. The IASB assumed the duties of its predecessor, the International Accounting Standards Committee (IASC), following a restructuring of the IASC that was completed in April 2001. Standards published by the IASB are referred to as IFRS and incorporate the extant International Accounting Standards (IAS) issued by the IASC. The body of these standards are collectively referred to herein as IAS. The IASB has no authority to require compliance with its accounting standards; however, many countries require that the financial statements of publicly held companies be prepared in accordance with IFRS. Additionally, the European Commission has required that all European Union companies listed on a regulated market prepare their consolidated financial statements in accordance with EU-adopted IAS beginning in 2005. Interpretations of IFRS are developed and issued by the International Financial Reporting Interpretations Committee (IFRIC) (formerly known as the Standing Interpretations Committee under

[1] In November 2002, in cooperation with the FASB, the AICPA committee agreed to focus its efforts solely on the development of industry-specific accounting and auditing guides and to no longer issue general purpose statements of position. Therefore, the accounting standard setting activities of this committee will be further limited in the future.

the IASC structure), which is similar to the FASB's EITF in the United States.

COMPARISON OF US GAAP AND IAS

What follows is a high-level summary and analysis of some of the differences between the accounting requirements for financial instruments under US GAAP and IAS. This high-level summary is then supported by additional, more detailed analysis of differences that may arise from the application of US GAAP versus IAS for financial instruments. Overall, financial instruments accounting standards and practices are very similar in many respects under these different accounting regimes and broad-based differences may be subtle.[2] However, many of the specific details of these standards, including the related interpretive guidance, such as the wording of the standards, definitions of critical terms used in the standards and special exceptions or exemptions for certain types of instruments or transactions, vary considerably. Therefore, this summary is not intended to reveal all instances in which the accounting for financial instruments differs under US GAAP and IAS. Rather, it addresses the more important areas in which US GAAP and IAS differ with respect to financial instruments accounting.

While this summary focuses primarily on differences, recent effort toward convergence of accounting standards deserve some mention. The FASB and IASB have made some limited progress toward their stated goal of convergence of their financial accounting standards. Both boards have put into place procedures and mechanisms for achieving the ultimate goal of narrowing or eliminating the substantive differences between US GAAP and IAS. Therefore, some of the differences that are discussed herein may be eliminated in the near term.

GENERAL NATURE OF STANDARDS

One of the most notable differences between US GAAP and IAS is in the sheer magnitude and volume of the actual standards themselves. Although subject to extensive additional interpretive guidance, international standards for financial instruments accounting are largely contained in two comprehensive standards, IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement. US GAAP for financial instruments, alternatively, has developed over the years through the issuance of accounting standards that typically address a narrow issue (such as disclosures about the fair value of financial instruments) or a particular type of financial instrument (such as investment securities or derivatives). In addition, in the United States, authoritative accounting standards are issued by a number of different groups. The result has been the development of an accounting framework for financial instruments in the United States of standards and pronouncements that more broadly address a specific fundamental accounting or disclosure issue coupled with a variety of standards dealing with issues related to specific instruments and transactions.[3] These observations are not intended to infer that one set of standards is more "rules-based" or "principles-based" than the other. In fact, many of the accounting rules and principles in US GAAP and IAS are the same, as evidenced by the overall similarity between the financial instruments accounting standards when they are compared. The more concise nature of IAS 32 and IAS 39 is, at least in part, attributable to the fact these international accounting standards were more recently issued and are currently less frequently applied, and were developed with all of the existing US accounting standards as their foundation.

FAIR VALUE DEFINED[4]

Fair value is defined, generally, as the amount at which a financial instrument could be purchased or sold in a current transaction between willing parties, other than in a forced sale context. This definition is relatively consistent between US and international accounting standards. However, significant differences may arise in the application of this definition. For example, the staff of the FASB has

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2 One of the reasons for this similarity is that current IAS for financial instruments were largely developed based on the existing accounting requirements in US GAAP. However, given the recent establishment of the new IASB structure, the potential exists for divergence of the standards in the future, despite the stated intent of the FASB and IASB to substantially reduce or eliminate significant differences, as discussed herein.

3 For example, the US accounting standards for derivative financial instruments alone, including all of the related interpretations, likely encompass more written pages of accounting and reporting requirements than IAS 32, IAS 39, and all of the related interpretations of these standards, which provide guidance on accounting for the entire population of financial instruments, of which derivatives are a sub-set, combined.

4 The FASB currently has a project on its agenda which could result in significant changes to the conceptual definition of fair value, and the application of this definition to various types of financial instruments, under US GAAP. The project, which was added to the FASB's agenda in April 2003, is intended to codify and improve existing guidance for measuring fair value (for all assets and liabilities required to be measured at fair value, including certain financial instruments).

recently made clear its views about the hierarchy of fair value information in the context of complex derivatives.[5] Quoted market prices in active markets are deemed to be the best source of fair value information, and, according to the FASB staff, fair value information obtained from specialized techniques, such as valuation models, that incorporate information that is not observable in the marketplace should not be used to override the transaction price for a financial instrument. Although a similar preclusion does not currently exist under IAS, the IASB has recently tentatively agreed on a similar fair value hierarchy and the revised international standards are likely to incorporate similar language.

To illustrate, assume a dealer and a corporate counterparty enter into a complex derivative. No cash or other assets are exchanged at the outset of the contract. Assume that there is no active market for the complex derivative as a single instrument. The dealer's internal models indicate that its best estimate of fair value on the launch date is $5 million. According to the FASB staff guidance, if data incorporated in the dealer's model is not based on observable market data, the dealer should initially value the derivative at zero because the initial transaction price of zero "trumps" the dealer's best estimate of fair value. Prior to this FASB staff guidance, the dealer would likely have recognized a $5 million trading asset and revenue (or some portion thereof) at the contract's launch date.

Another valuation difference between the standards relates to the issue of block discounts or premiums. If an entity holds a large position in a security, the economic fair value of the total position may be less (or could be more) than the product of the number of units held and the quoted market price per unit (the block discount or premium) due to the illiquidity or other characteristic of the position relative to the trading volume. In determining the fair value of an unrestricted security with a quoted price in an active market, IAS requires that the fair value be measured based upon the product of the number of trading units held and the market price per unit and no recognition should be given to the block discount or premium. Generally, the requirements under US GAAP are the same — adjusting the value of a holding in a marketable security to reflect an estimate of this discount or premium is generally prohibited. However, in the US an adjustment is permitted, as a specialized industry accounting practice, by brokers and dealers in securities and investment companies.

RECOGNITION AND MEASUREMENT

Classification[6]

Under IAS, all financial assets are to be classified upon origination or acquisition into one of four categories: originated loans and receivables, held-to-maturity (HTM) investments, available-for-sale (AFS) financial assets, and financial assets held for trading. For HTM, AFS, and trading assets, the appropriate category depends on the investor's intent with regard to its investing strategy and perhaps on its ability to hold the asset until its maturity. Originated loans and HTM investments are carried in the financial statements at amortized cost, whereas AFS and trading financial assets are recorded at fair value. Changes in fair value for trading assets are recorded through the income statement, and changes in the fair value of AFS financial assets are recorded through equity until realized (although an entity following current IAS may make an accounting policy election to report changes in the fair value of AFS financial assets through income).

The HTM, AFS, and trading classification scheme for purposes of the subsequent measurement of financial instruments, while very similar to IAS, applies only to certain securities under US GAAP. Securities, a defined term under US GAAP, include all debt securities and only equity securities with readily determinable fair values. While the accounting for the HTM, AFS, and trading classifications of financial instruments is substantially the same under IAS and US GAAP, the IAS framework more broadly applies to all financial assets, and not just a sub-set of this larger population. Therefore, differences in accounting for certain financial instruments, such as purchased loans and investments in private equity securities generally accounted for at amortized cost under US GAAP, may exist under these two

[5] EITF Issue No. 02-03, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities, footnote 3.

[6] Security dealers hold inventory positions at fair value, as do investment companies and the investment company subsidiaries of commercial banks. Except for the discussion of trading portfolios, much of this section is especially relevant for the lending and investing businesses of commercial banks.

accounting regimes.[7] In addition, IAS provides little guidance on determining amortized cost, whereas US GAAP includes extensive guidance. Therefore, differences could exist in the accounting for certain financial instruments at amortized cost under these two sets of standards.

The IASB has undertaken a project to improve its accounting and disclosure standards for financial instruments and is currently proposing an alternative whereby entities could designate any financial instrument, asset *or liability* (including originated loans and receivables), as held-for-trading, irrespective of the actual intention regarding its holding or use, and to report all changes in the fair value of these financial instruments through income. This alternative has been proposed as it is viewed by many as eliminating the conceptual and practical issues associated with the current "mixed-attribute" model, whereby some financial instruments are carried at fair value and others at amortized cost. Standards setters in the United States have recently made clear their view that fair values for financial instruments provide more relevant and understandable information for financial statement users. The FASB has also expressed its ultimate goal of requiring that all financial instruments and related assets and liabilities be measured at fair value. However, the US effort has, to date, not progressed as far as the international effort.

Impairments

IAS and US GAAP provide similar guidance related to the recognition of impairment losses on originated loans and receivables. For other financial assets, the timing of impairment loss recognition and the measurement of that loss may differ under the two sets of standards. A financial asset is deemed impaired, requiring recognition of an impairment loss, under current IAS if its carrying amount is greater than its estimated recoverable amount, and evidence must be evaluated at each balance sheet date to determine whether financial assets are impaired. In contrast, for investment securities classified as HTM or AFS under US GAAP, an impairment exists when fair value has declined below amortized cost basis, but an impairment is only recognized when it is deemed to be "other than temporary." For example, an other-than-temporary impairment shall be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition. The differing standards for recognition of an impairment loss for investment securities under IAS and US GAAP could cause differences in the timing of recognition of an impairment loss. However, a proposed amendment to the relevant standard under IAS could move the timing of the recognition of an impairment loss closer to the US model.

In terms of measurement, IAS and US GAAP differ in two significant respects. First, IAS requires that an impairment of an HTM investment be measured based upon the difference between the asset's carrying amount and the present value of expected future cash flows, discounted at the instrument's original effective interest rate. US GAAP treats receivable (e.g., bank loans) impairments similarly. On the other hand, an impairment of a security (including an HTM security) under US GAAP is measured based on the difference between the security's amortized cost basis and its fair value (a fair value calculation would be based on current market interest rates, as opposed to the security's original effective interest rate). Second, for financial assets carried at amortized cost under IAS, if in a subsequent period after an impairment loss has been recognized the impairment loss decreases (that is, the impaired asset recovers its value), the reversal must be recognized in the income statement, provided that the reversal can be objectively related to an event occurring after the loss was recognized (for example, an improvement in the financial asset issuer's credit rating). For AFS financial assets, if after an impairment loss has been recognized the fair value or recoverable amount of the financial asset increases, and the increase can be objectively related to an event occurring after the loss was recognized, the loss must be reversed under IAS and recognized in the income statement. However, the IASB has recently tentatively decided that reversals of impairment losses on equity instruments classified as AFS should not be recognized through the income statement, as is the prohibition under US GAAP. Impairment losses for investment securities under US GAAP establish a new cost basis. Under US GAAP, it is as if the impaired security is sold for cash, which is immediately reinvested in the security (at fair value), establishing a new cost basis.

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[7] One should note the potentially anomalous outcome of the classification schemes of both US GAAP and IAS. For example, a bank that holds an identical government security in its trading, AFS and HTM portfolios will account for each identical holding differently at the same time.

DERIVATIVES AND HEDGING

Derivatives are financial instruments that derive their cash flows, and hence their value, by incorporating in their terms references to other financial instruments or financial or non-financial indexes (e.g., spot oil prices). Both US GAAP and IAS are largely similar (though not identical in all technical respects); in fact the IAS standard was largely derived from US guidance. However, US guidance is much more detailed and prescriptive. Accounting for derivatives is among the most difficult areas in financial reporting.

When a contract is a derivative, it must be recorded on the balance sheet as an asset or a liability at its current fair value. Changes in fair value are recorded in income unless the derivative is designated and effective as a hedge in cash flow hedge strategies. In these instances changes in the value of the derivative are excluded from income until the hedged transaction occurs or affects income. The objective of hedge accounting can be summarized as neutralizing the impact on income, to the extent that the hedge is effective, of the consequences of the hedged risk.

Derivatives in a hedging relationship are used to offset the risk profile of designated assets, liabilities, firm commitments or probable forecasted, although not committed, transactions. The common risks in financial instruments are interest rate, credit, market and foreign currency. The accounting standards are largely designed to closely link the derivative to the position being hedged (via specific documentation requirements) and to ensure that the derivative is expected to be, and has achieved, high effectiveness in altering the risk profile of the hedged item. Note that neither IAS nor US GAAP requires that a derivative reduce the hedger's exposure to the risk, only that it effectively offset changes in the fair value or cash flows of the hedged item. It is possible that a hedger would utilize derivatives to alter risk profiles but not to account for the derivative as a hedge either because (1) the derivative was not sufficiently effective in altering the risk profile or (2) the hedger did not document the derivative as a hedge.[8] There are a number of differences in the detailed rules on hedge accounting between IAS and US GAAP, which may increase as a result of the IASB's recent tentative decisions in its IAS 32 and IAS 39 improvements project.[9] These differences can result in hedge accounting being achieved under one regime but denied under the other.

Embedded derivative instruments are terms within contracts that do not in their entirety meet the definition of derivative instruments that affect the cash flows or fair value of other exchanges required by the contracts in a manner similar to derivative instruments. Both US GAAP and IAS require certain derivatives embedded within other contracts to be separated from the "host" contracts and accounted for at fair value in the financial statements. The accounting requirements for embedded derivatives were included in the relevant US and international accounting standards in order to prevent entities from circumventing the accounting requirements for derivatives by including a derivative within a non-derivative contract. However, the result is a substantial amount of effort being required to search for and isolate embedded derivatives in a wide range of common traditional contracts under both US GAAP and IAS.

DISTINGUISHING BETWEEN LIABILITIES AND EQUITY

Under IAS, the critical feature that differentiates, for the instrument's issuer, a financial liability from an equity instrument is the existence of a contractual obligation requiring the issuer to deliver cash or another financial instrument to the holder on potentially unfavorable terms. Mandatorily redeemable preferred stock would be classified by the issuer as a liability under IAS. A recently issued US GAAP accounting standard requires that certain mandatorily redeemable financial instruments be classified as liabilities.[10] However, under current US GAAP, including the rules of the SEC, mandatorily redeemable instruments that do not meet the narrow definition provided in this accounting standard may be classified either as permanent equity (non-public companies only), or "mezzanine" equity (between the liabilities and equity section of the balance sheet). For

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[8] Some institutions previously adopting hedge accounting have concluded that the benefits of hedge accounting are outweighed by the cost of meeting the accounting requirements.

[9] As part of the IAS 39 improvements project, in late August 2003, the IASB published proposals that, if adopted, would enable fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk (referred to as "macro hedging"). If these proposals are adopted, differences between the hedge accounting rules under IAS and US GAAP will increase.

[10] Specifically, a financial instrument that embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring assets at a specified or determinable date, or based on an event certain to occur.

example, a financial instrument that is redeemable at the holder's option upon the occurrence of an event that is highly likely, but not certain, to occur would be classified as a financial liability under IAS, but may be classified as a liability or mezzanine equity under US GAAP. If an instrument is classified as a liability, it will generally yield interest expense. In contrast, the dividends paid on mezzanine equity are generally excluded as an expense in determining net income although they reduce both earnings available to common shareholders and earnings per share.

The recently issued US accounting standard also requires that certain freestanding financial instruments be classified as liabilities.[11] These include obligations to purchase the issuer's equity shares by transferring assets, and certain obligations to issue a variable number of the issuer's equity shares. The guidance in IAS is similar in many respects, but certain types of freestanding financial instruments that are classified as liabilities under US GAAP may be classified as liabilities or equity under IAS, depending on the settlement mechanism.

Compound instruments contain characteristics of both liabilities and equity. Another significant difference between US GAAP and IAS relates to the accounting under each set of standards by the issuer of compound financial instruments. For purposes of initial recognition in the financial statements, IAS requires that compound instruments be separated into their liability and equity components, whereas current US GAAP does not permit separation. A common example of a compound financial instrument is convertible debt. IAS requires that the proceeds from the issuance of convertible debt be allocated to the liability and equity components of the instrument and that these components be separately classified and accounted for as such. Current US accounting standards generally do not require the proceeds from the issuance of convertible debt to be allocated to the liability and equity components. Instead, the entire instrument is treated as debt. The allocation process under IAS generally results in higher interest expense when compared to the low coupon generally associated with convertible debt recognized under US GAAP.

It should be noted that the FASB currently has a project on its agenda to broadly address the accounting for financial instruments with characteristics of liabilities, equity, or both. The culmination of the first phase of this project resulted in the issuance of the accounting guidance discussed above that addresses certain freestanding financial instruments. The IASB's project to amend IAS 32 and IAS 39 includes proposals which would provide more detailed guidance on measuring the liability and equity components of compound instruments, and would address the classification of derivatives based on an entity's own shares. Further convergence between US GAAP and IAS may ultimately result from these projects.

DERECOGNITION OF FINANCIAL ASSETS

Derecognition is a technical accounting term meaning that a previously recognized financial asset no longer continues to be carried in the financial statements. Assets are derecognized when they are sold, exchanged, assigned, transferred or contributed if the disposal transaction meets criteria for derecognition established by the relevant standards. While the accounting is not controversial when the transferor relinquishes control and the transferee obtains the risks and rewards of ownership of the transferred assets (e.g., an investor sells a bond into the market), the derecognition criteria are needed for certain transactions where it is not clear whether the sale is, in reality, a financing collateralized by the transferred financial asset (no derecognition). The latter is best illustrated by most repurchase agreements and security lending transactions and certain structured sale transactions such as certain securitizations.

Standards for the derecognition of financial assets under US GAAP focus on control over financial assets, or components of financial assets. For example, control is not relinquished over many financial assets if (1) the transferor has an option or an obligation to reacquire them in the future or (2) the transferee is not free to pledge or sell the assets. Therefore, even though a transferor may retain important risks and rewards of ownership of transferred financial assets or components thereof, if the transferor surrenders control of the financial assets, they are derecognized in accordance with US GAAP, regardless of the risks retained. The derecognition standards under IAS include elements of the US control model, but are based more on the perceived economic substance of control and include elements of a risks and rewards model. Therefore, certain

[11] Freestanding financial instruments are those that are entered into separately from other financial instruments, or are entered into in conjunction with some other transaction and are legally detachable and separately exercisable.

transactions in which control, but not risks and rewards of ownership, of financial assets has been relinquished by the transferor will be accounted for as sales under US GAAP but as secured borrowings under IAS.[12]

One of the criteria that must be met for a transferor to derecognize a financial asset under US GAAP is that the financial asset be legally isolated from the transferor (in other words, put presumptively beyond the reach of the transferor and its creditors, even in the event of the transferor's bankruptcy). As the IAS derecognition criteria are based on the economic substance of control, as opposed to legal distinctions, legal isolation of the transferred financial asset, or a portion thereof, from the transferor is not a requirement for sale accounting (derecognition) under IAS. Therefore, transfers of financial assets or portions of financial assets are conducted through legally separate securitization vehicles under US GAAP in order to achieve sale accounting. Under IAS, using legally separate vehicles will probably not achieve sale accounting due to the economic substance tests. However, under IAS, portions of financial assets can be sold, resulting in derecognition or sale accounting, without securitization, provided that the derecognition criteria for the portion of the financial asset sold have otherwise been met.

Another substantial difference between IAS and US GAAP in the area of derecognition of financial assets relates to a special type of entity to which financial assets are often transferred in securitizations, referred to as a qualifying special purpose entity (QSPE). Under US GAAP, if financial assets are transferred to a QSPE, which must satisfy a number of tests designed to limit its activities and to render the entity essentially a repository holding the assets on behalf of third-party investors,[13] the assets can be derecognized by the transferor, despite the fact that the transferee (the QSPE) may be limited from taking advantage of its ownership of the assets (that is, the transferee's control over the transferred assets is limited). IAS provides no similar exception for transfers of financial assets to special purpose entities with limited permissible activities. IAS only accepts that control of a financial asset transferred to these types of entities has been surrendered by the transferor if either the entity itself or the holders of its beneficial interests have the ability to obtain substantially all of the benefits of the transferred asset.

Because of its mixed model, which contains elements of a control model combined with a risks and rewards component, current IAS related to the derecognition of financial assets has inherent conflicts and has been difficult to apply in practice. The IASB is reconsidering the current derecognition guidance in IAS and intends to make the derecognition model more consistent and operational but with an increased focus on the transfer of risks and rewards. This may increase the divergence of IAS from US GAAP.

CONSOLIDATION OF SPECIAL PURPOSE ENTITIES

When a parent consolidates a subsidiary, the subsidiary's assets and liabilities are included in the consolidated financial statements of the parent. This outcome is especially relevant to securitizations of financial assets. For example, if a securitizer wishes to achieve off-balance-sheet treatment, it must (1) meet the derecognition standards discussed in the previous section and (2) transfer the assets to an entity that it does not include in its consolidated financial statements. Securitizations involve so-called special purpose entities (SPEs) whose accounting "parent," if any, is difficult to discern under traditional consolidation standards.

Under US GAAP, a transferor of a financial asset to a QSPE may not consolidate the vehicle. However, many securitization transactions involve SPEs that fail to meet the extensive tests to be a QSPE (or that are intentionally structured to fail these tests). Recently, the FASB issued an interpretation designed to (1) distinguish between entities, including SPEs, that should be consolidated under traditional accounting standards, and (2) define variable interest entities, including SPEs, that require a unique accounting analysis to determine if any single holder of a financial interest in the entity is its accounting parent. The analysis is based on ascertaining whether any single holder

[12] The US standard indirectly incorporates some consideration of a risks and rewards model because it requires that the sold assets be legally isolated from the transferor, including isolation from the transferor's creditors under an assumption of the transferor's bankruptcy. Lawyers consider whether the transferor's retention of risks and rewards is too excessive to permit a conclusion that the assets have been isolated. However, careful transaction structuring can often mitigate this impediment. As discussed below in "Consolidation of Special Purpose Vehicles" US accounting rules have been modified so that off-balance-sheet financing vehicles will be consolidated when appropriate. These rules respond to concerns that transaction structuring has sometimes, in the past, resulted in inappropriate off-balance-sheet accounting results.

[13] The FASB recently issued an exposure draft of a proposed amendment to the US accounting standard for transfers of financial assets. If adopted as proposed, further restrictions will be placed on the already limited powers of QSPEs in order for them to be "qualifying."

has exposure to a majority of the expected losses of the entity and, if not, whether any single holder has exposure to a majority of the expected residual benefits of the entity. The expected outcomes approach is complex and requires an evaluation of probability-weighted scenarios in order to make the required evaluations.

The IAS framework for consolidation of SPEs is set forth in an interpretation of the IAS consolidation standard, and requires a sponsoring entity or beneficiary of an SPE to consolidate the entity if the substance of the relationship between the entities indicates control over the SPE. Indicators of control include (from the perspective of the enterprise that is evaluating the need to consolidate the SPE): (1) if the SPE conducts its activities on behalf of the enterprise, (2) if the enterprise has the decision making power or other rights to obtain the majority of the benefits of the SPE's activities, (3) the enterprise has rights to obtain the majority of the benefits of the SPE, or (4) the enterprise retains the majority of the residual ownership risks of the SPE. In general, the IAS requirements for consolidation of an SPE are broader than those under US GAAP and capture more SPEs for consolidation.

OFFSETTING FINANCIAL ASSETS AND LIABILITIES

Financial assets and liabilities can only be offset in the balance sheet if certain criteria are met. These criteria, which focus primarily on the legal right of set off and the parties' intent to set off, are relatively consistent between US GAAP and IAS. However, US GAAP provides exceptions to these criteria for fair value amounts related to derivatives executed under a master netting arrangement, and for certain repurchase and reverse repurchase agreements, provided that certain conditions regarding the settlement of these agreements are met. The master netting arrangement exception does not exist under IAS, as settling net under these arrangements typically occurs only in the event of default or in other circumstances not expected to arise in the normal course of business. In addition, IAS allows, in rare circumstances, offsetting in three-party arrangements, provided that certain conditions are met, whereas US GAAP only permits offsetting amounts in two-party arrangements.

EXHIBIT 5: A COMPARISON OF US GAAP AND IAS

CATEGORY	US GAAP	IAS
General	Several standards, with a larger volume of guidance, dealing with specific types of instruments, transactions and activities.	Two broad accounting standards, subject to extensive interpretation, addressing disclosure, recognition, measurement, and derecognition for most financial assets and liabilities (excludes lease receivables, for example)
Distinguishing between liabilities and equity	Guidance recently issued addressing certain freestanding instruments ■ Written puts and forward purchase contracts on an entity's own shares classified as liabilities, regardless of settlement ■ Narrowly defined mandatorily redeemable financial instruments classified as liabilities	Guidance based on the substance of the instrument ■ Physically settled or net share settled written puts and forward purchase contracts based on an entity's own shares classified as equity ■ More redeemable financial instruments classified as liabilities than under US GAAP
Compound instruments	■ Separation not permitted ■ Example – convertible debt recorded entirely as debt (except for "in-the-money" conversion options at issuance)	■ Separation required ■ Example – proceeds from convertible debt issuances allocated to liability and equity components
Offsetting financial assets and liabilities	■ Standard based on legal rights and intent ■ Exceptions for master netting arrangements and repurchase agreements ■ Three-party arrangements not permissible	■ Standard based on legal rights and intent ■ No exception for master netting arrangements ■ Three-party arrangements permitted in rare circumstances
Subsequent recognition and measurement	■ HTM, trading and AFS classifications applicable only to debt securities and marketable equity securities (not originated loans and receivables or private equity investments) ■ Unrealized gains/losses on AFS securities reported as a separate component of equity ■ Tainting rules apply to sales of HTM securities prior to maturity	■ HTM, trading and AFS classifications apply to all financial assets (except originated loans and receivables) ■ Unrealized gains/losses on AFS assets can be reported currently through income as an accounting policy election ■ Tainting rules apply to sales of HTM assets prior to maturity
Impairment	■ Loans – based on probability that a loss has been incurred; losses recorded through valuation allowances ■ Loans – impairment measured based on present value of expected cash flows discounted at loan's original effective rate ■ AFS and HTM securities – impairment exists when amortized cost exceeds fair value; impairment recorded when other than temporary ■ AFS and HTM securities – impairment measured based on difference between cost basis and fair value ■ AFS and HTM securities – impairment establishes new cost basis which cannot be written up	■ Loans and HTM investments – impairment recorded when probable that the entity will not be able to collect contractual cash flows; losses recorded through valuation allowances ■ Loans and HTM investments – impairment measured based on present value of expected cash flows discounted at original effective rate ■ AFS assets – same triggering event for recognition as loans and HTM investments ■ AFS assets – impairment measured based on difference between cost basis and fair value ■ HTM and AFS assets – subsequent recoveries in value after impairment can be recognized if attributable to discrete events
Derecognition of financial assets	■ Control model – risks and rewards of ownership secondary and impact may be mitigated via structuring ■ Legal isolation of transferred assets required for sale accounting ■ Consolidation exception for QSPEs	■ Mixed model – equal prominence of elements of control and risks and rewards (model based on economic substance of control) ■ Legal isolation of transferred assets not required for sale accounting ■ No QSPE exception – SPE or holder of beneficial interests must have ability to obtain substantially all of the benefits of the transferred assets

EXHIBIT 5 CONTINUED

CATEGORY	US GAAP	IAS
Consolidation of SPEs	■ Typically requires evaluation of the outcomes of probability-weighted scenarios to determine if a single party has exposure to a majority of the downside or upside of an entity's activities ■ Entities subject to this evaluation are those that have insufficient equity at risk to absorb expected losses without additional subordinated financial support	■ Consolidation of SPEs based on the substance of the relationship between an entity and an SPE, with indicators of control (broader standard)
Derivatives	■ Definition: must have underlying, notional amount (or payment provision), small initial net investment, and net settlement ■ Derivatives embedded in other contracts that are not derivatives or carried at fair value must be separated if not clearly and closely related to the host ■ Large volume of interpretive guidance, including scope exceptions and special carve-outs	■ Definition: must have underlying (causing changes in value), small initial net investment, and settlement at a future date; net settlement not an explicit requirement ■ Derivatives embedded in other contracts that are not derivatives or carried at fair value must be separated if not closely related to the host ■ Less detailed and prescriptive guidance compared to US GAAP
Hedging	■ Specified portions of risks can be hedged (no partial-term hedging) ■ Hedges of firm commitments accounted for as fair value hedges ■ Hedging a portfolio of dissimilar assets or liabilities generally not possible (portion of the risk in the portfolio cannot be hedged)	■ Risks associated with portions of cash flows or fair value of a financial asset or liability can be hedged (partial-term hedging permitted) ■ Hedges of firm commitments accounted for as cash flow hedges ■ Hedging a portfolio of dissimilar assets or liabilities can be accomplished, since a similar risk in the dissimilar portfolio can be designated as the hedged item
Definition of fair value	■ Block discounts permitted only as a specialized industry practice	■ Block discounts precluded

>>> APPENDIX 2

Financial Instruments Accounting Standards under Japanese GAAP

INTRODUCTION

The high-level comparison of accounting standards in Appendix 1 is focused on US GAAP and IAS financial instruments accounting and does not include a comparison with Japanese Generally Accepted Accounting Principles (GAAP). However, the Steering Committee recognized the importance of Japanese GAAP and requested the working group to assemble detailed information under two headings: *Financial Asset and Liability: Initial and Subsequent Recognition and Measurement*; and *Derecognition of Financial Instruments, Financial Statement Presentation, and Disclosure*.

THE ISSUES

The financial accounting and reporting issues associated with financial instruments are best summarized in the context of a few simple, yet fundamental, questions. These questions include the following:

- What financial assets or liabilities should be recognized in the balance sheet, and how should those recognized financial instruments be initially measured?
- Should financial instruments be remeasured on a periodic basis, and if so, how often, what should the basis for remeasurement be, and where in the financial statements should changes in value upon remeasurement be reported?
- If the objective of the initial and subsequent measurements of financial instruments in the financial statements is fair value, what does fair value mean, and how should fair value be estimated — especially in the absence of transparent and liquid markets for the instrument being valued?
- If financial assets are not accounted for entirely on a fair value basis (with changes in fair value included in current income), when should declines in their value be recognized as a realized loss?
- When should a financial asset or liability be removed, or derecognized, from the financial statements, and how should any resulting gain or loss from derecognition be reported in the financial statements? For example, when financial assets are "sold," do the terms of the transaction suggest financing rather than sale treatment?

These are issues that accounting standard-setters in the United States and internationally have struggled with for many years, and continue to struggle with. Accounting standards that have been issued to date attempt to address one or more of these fundamental questions, with the objectives of achieving some consistency in practice amongst different enterprises (to facilitate comparisons) and providing relevant, reliable, and useful information to financial statement users.

EXHIBIT 6: FINANCIAL INSTRUMENTS ACCOUNTING UNDER JAPANESE GAAP

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets[1]	Originated loans and receivables	Loans receivable not held for sale	*Kinyu Shohin ni kakaru Kaikei Kijyun* ("Accounting Standard for Financial Instruments" issued by Business Accounting Deliberation Council) *Kaikei Seido Iinkai Hokoku Dai 14-go "Kinyu Shohin Kaikei ni kansuru Jitsumu Shishin"* (Accounting Committee Report No. 14 "Practical Guidelines Concerning Accounting for Financial Instruments" issued by The Japanese Institute of Certified Public Accountants (JICPA))	Amortized cost	■ Interest income accrued as earned ■ Amortization of premiums or discounts recorded as yield adjustments using the "interest method" or the "straight line" method. ■ Impairment is recorded as a valuation allowance when it is probable that the creditor will be unable to collect all amounts contractually due. ■ As an alternative, a loan valuation allowance for bankrupt companies is permitted to be charged off against such loan. ■ Valuation allowance for loans receivable shall be established based on three classifications of loans receivable as follows: ▶ Normal loan – loans receivable from a debtor without significant problem. Loss is accrued based on a reasonable estimate considering historical loss on loans with similar credit grade and other relevant factors. ▶ Doubtful loan – loan receivable from a debtor which is experiencing a significant problem and is expected to continue to have a significant problem, but which is not bankrupt. Loss is accrued either by the discounted cash flow method or by estimating the uncollectible amount by referring to the loan principle, third party guarantee, collateral and relevant financial condition of the borrower. ▶ Bankrupt loan – loans receivable from a debtor that is legally or substantially bankrupt. Loss is accrued by estimating the uncollectible amount by referring to the loan principal, third party guarantee, collateral and relevant financial condition of the borrower.	■ Japanese GAAP generally does not distinguish between originated loans and purchased loans for purposes of subsequent recognition. However, purchased loans in the form of commercial paper and other securitized loans are often accounted for as investments in securities or trading securities.

[1] "Accounting Standard for Financial Instruments" defines financial assets as cash, deposits, receivables including notes receivable, accounts receivable and loans, securities including equity securities such as stocks and bonds, net receivables arising from derivatives including forwards, futures, options, swaps and similar transactions. In addition, Accounting Committee Report No. 14 explains the characteristics of financial assets as follows: a financial asset is defined as cash, evidence of an ownership interest in an entity or a contract that conveys to an entity the contractual right to receive cash or other financial assets from another entity or to exchange other financial instruments on potentially favorable terms with another entity.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets	Originated loans and receivables	Loans receivable held for sale	Same as above.	Amortized cost	■ Generally accounted for the same as loans not held for sale. ■ When decision to sell specific loans is made and the sales price is known or reasonably estimable, expected losses may be accrued as a part of a valuation allowance. ■ Report No.4 of Ad Hoc Committee for Audits of Banks issued by JICPA, applicable to audits of banks, allows expected losses on marketable (yet doubtful) loans to accrue based on market value as a valuation allowance.	■ No concept of loan held for sale exists under Japanese GAAP except for trading loans.
		Accounts receivable	Same as above.	Amortized cost	■ Estimated losses from uncollectible receivables recorded when probable and reasonably estimable. ■ Valuation allowance for accounts receivable shall be established based on three classification of accounts receivable, which are the same as loans receivable (see classifications above).	
	Held-to-maturity invest-ments (HTM)	Debt securities[2]	Same as above.	Amortized cost	■ Interest income, including amortization of premium or discount, reported in income as earned ■ Realized gains and losses reported through earnings ■ Impairment loss on HTM with readily determinable fair value is recorded through earnings, establishing a new cost basis when the fair value declines significantly (unless it is expected that the fair value of securities recovers). ■ Impairment loss on HTM without readily determinable fair value is recorded as a valuation allowance in the same manner as a loan receivable; that is, when it is probable that the issuer will be unable to redeem all amounts contractually due.	■ Under Japanese GAAP, the HTM, AFS and trading classifications are only applicable to financial assets that are treated as securities. No equivalent classification scheme exists for different types of financial assets. As such, under Japanese GAAP, different accounting standards address the accounting for other types of financial assets. ■ A concept of debt securities without readily determinable fair value exists under Japanese GAAP.

[2] Securities are defined by the Securities Exchange Law of Japan. In addition, other similar instruments with active markets are treated as securities for accounting purpose.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets	Available-for-sale invest-ments (AFS)[3]	Debt securities with readily determin-able fair value	Same as above.	Fair value	■ Changes in fair value (unrealized gains and losses) are reported as a separate component of shareholders' equity on a net-of-tax basis. As an alternative, it is permitted to report unrealized losses in earnings, while unrealized gains are still reported as a separate component of shareholders' equity. ■ Interest income and realized gains and losses are included in earnings. ■ Impairment losses are recorded through earnings, establishing a new cost basis, when fair value declines significantly (unless it is expected that fair value of securities recovers).	■ No concept of comprehensive income exists under Japanese GAAP. ■ As a matter of terminology, "available-for-sale" is not used in Japanese GAAP. Rather, securities other than HTM, trading, and equity investments in subsidiaries and affiliated companies are collectively referred to as "other securities" regardless of readily determinable market price. ■ Decline in fair value of or over 50% of the cost is considered as "significant decline." Decline in fair value less than 30% is generally NOT considered as a "significant decline."

[3] Marketable equity securities and non-marketable equity securities: When issuing companies pay dividends through the disposals of other capital surplus available for dividends, the shareholders shall in principle deduct the carrying value of equity securities by the amount of dividends. When the shareholders cannot determine that the dividends are made through disposals of unappropriated retained earnings or other capital surplus at the time of dividends, the shareholders may record dividend income through earnings. After that, if it is known that the dividends were made through the disposals of other capital stock, the shareholders shall adjust the dividends as appropriate.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets	Available-for-sale investments	Debt securities without readily determinable fair value	Same as above.	Amortized cost	■ Interest income and realized gains and losses included in earnings. ■ Impairment loss is recorded as a valuation allowance same as loan receivable when it is probable that the issuer will be unable to redeem all amounts contractually due.	■ As a matter of terminology, "available-for-sale" is not used in Japanese GAAP. Rather, securities other than HTM, trading, and equity investments in subsidiaries and affiliated companies are collectively referred to as "other securities" regardless of readily determinable market price. ■ A concept of debt securities without fair value exists under Japanese GAAP.
		Marketable equity securities	Same as above.	Fair value	■ Same as AFS debt securities with readily determinable fair value except for the second item regarding interest income. ■ Dividend income recorded through earnings on the day before the stock becomes ex-dividend, or on the day when dividends are resolved or declared by a body entitled for such action.	■ Same as AFS debt securities with readily determinable fair value.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets	Available-for-sale investments	Non-marketable equity securities	Same as above.	Cost	■ Dividend income recorded through earnings on the day when dividends are resolved or declared by a body entitled for such action. ■ Impairment loss is recorded through earnings, establishing a new cost basis, when economic value declines significantly due to deterioration of issuers' financial condition.	■ As a matter of terminology, "available-for-sale" is not used in Japanese GAAP. Rather, securities other than HTM, trading , and equity investments in subsidiaries and affiliated companies are collectively referred to as "other securities" regardless of readily determinable market price.
	Trading invest-ments	Debt securities	Same as above.	Fair value	■ Changes in fair value (unrealized gains and losses) reported through earnings	
		Marketable equity securities	Same as above.	Fair value	■ Same as trading debt securities	
		Non-marketable equity securities	Same as above.	Not applicable.	Not applicable.	■ It is out of consideration to classify non-marketable equity securities as trading securities under Japanese GAAP, since "trading securities" are defined as securities held for obtaining gain from short-term stock price fluctuation and by repetition of purchase and sale.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial assets	Trading investments	Derivatives (purchased options, purchased warrants, futures, forwards, swaps)	"Accounting Standards for Financial Instruments" Accounting Committee Report No. 14 Gaika-date Torihiki-to Kaikei Shori Kijun ("Accounting Standard for Foreign Currency Transactions" issued by Business Accounting Deliberation Council) *Kaikei Seido Iinkai Hokoku Dai 4 go "Gaika-date Torihiki-to no Kaikei Shori ni kansuru Jitsumu Shishin"* (Accounting Committee Report No. 4 "Practical Guidance for Accounting for Foreign Currency Transactions (Interim Report)" issued by JICPA)	Fair value	■ Changes in fair value reported through earnings, with certain exceptions (hedge accounting). ■ Fair value hedges – gain or loss on the derivative is recognized through earnings along with an offsetting loss or gain on the hedged item attributable to the risk being hedged. Such fair value hedge accounting is permitted only for AFS securities. ■ Deferral hedges – derivative's gain or loss is entirely deferred as asset or liability, and reclassified to earnings when the hedged transaction or account balance affects earnings. ■ Hedge accounting by a "synthetic" approach. Under certain circumstances, it is permitted to translate foreign currency denominated monetary assets or liabilities by forward exchange rate when foreign currency exposure of such assets or liabilities are hedged by foreign exchange forward contracts. ■ Hedges of foreign currency exposure of investments in a foreign subsidiary – gain or loss is reported in a separate component of shareholders' equity as part of the cumulative translation adjustment. ■ Hedge accounting by matched swap method. Accrual accounting based on combined interest rates of original assets/debt and interest rate swaps are permitted under certain circumstances when interest rate swaps are used to alter interest receipt/payment of hedged assets or liabilities.	■ Although included under the "trading" category, financial assets that meet the definition of derivatives are not subject to the HTM, AFS and trading classification scheme under Japanese GAAP, and are accounted for as derivatives. Only financial assets that are securities are to be classified into HTM, trading, and other securities categories. ■ The provisions of Accounting Committee Report No. 14 also require that derivatives embedded in other contracts be separated from the "host" contract and accounted for separately as derivatives under certain circumstances. ■ Basis adjustment as a result of hedge accounting is required for certain hedges of probable forecasted transactions that are likely to occur. ■ Hedge accounting by a "synthetic" approach is permitted for an indefinite transition period by the Opinion Concerning the Establishment of Accounting Standard for Financial Instruments issued by Business Accounting Deliberation Council.

EXHIBIT 6 CONTINUED

PART 1: FINANCIAL ASSETS & LIABILITIES: INITIAL AND SUBSEQUENT RECOGNITION AND MEASUREMENT – JAPANESE GAAP, CONTINUED

Financial Instrument	Category	Example	Applicable Accounting Standard	Balance Sheet Measurement Subsequent to Initial Recognition	Income Statement Recognition & Presentation	Other Comments
Financial liabilities[4]	Trading liabilities	Derivatives (written options, written warrants, futures, forwards, swaps)	Same as above.	Fair value	Same as above.	■ Under Japanese GAAP, there is no designation of financial liabilities as trading except for certain financial institutions. Japanese GAAP has specific accounting requirements for derivatives (they are either recorded as liabilities or assets), which must be measured at fair value in the balance sheet.
	Other financial liabilities	Notes payable	"Accounting Standards for Financial Instruments" Accounting Committee Report No. 14	Contractual principal amount of debt	■ Interest expense recognized as incurred (including amortization of discount or premium). ■ No clear authoritative guidance exists, but even when upfront interest is paid out from gross proceeds for issuing note, such interest payment is generally recorded as prepaid expense (not a deduction from liability), which is to be amortized by straight-line method over the term of note.	
		Accounts payable	Same as above.	Contractual principal amount of debt	■ Typically short-term (less than one year), and no interest expense.	
		Bonds	Same as above.	Contractual principal amount of debt	■ Interest expense recognized as incurred (including amortization of discount or premium). ■ Bonds issued under or over par are to be recorded at par and discount or premium is recorded as asset or liability. Such discount or premium is to be amortized by straight-line method over the term of bond.	■ Commercial Code Enforcement Regulations of Japan require bond discount to be expensed by the same or greater amount than periodic amortization by straight-line method over the term of bond.

[4] "Accounting Standard for Financial Instruments" defines financial liability as payable including note payable, account payable, borrowing and bond issued, and net payable arising from derivatives. In addition, Accounting Committee Report No. 14 explains characteristics of financial liability as follows: a financial liability is defined as a contractual obligation for an entity to deliver financial assets/liabilities to another entity or to exchange financial assets/liabilities on potentially unfavorable terms with another entity.

EXHIBIT 6 CONTINUED

PART 2: DERECOGNITION OF FINANCIAL INSTRUMENTS: FINANCIAL STATEMENT PRESENTATION, AND DISCLOSURE: JAPANESE GAAP

Item	Category	Applicable Accounting Standard	Accounting or Disclosures Required	Other Explanatory Comments
Derecognition	Financial assets	*Kinyu Shohin ni kakaru Kaikei Kijyun* ("Accounting Standard for Financial Instruments" issued by Business Accounting Deliberation Council) *Kaikei Seido Iinkai Hokoku Dai 14 go "Kinyu Shohin Kaikei ni kansuru Jitsumu Shishin"* (Accounting Committee Report No. 14 "Practical Guidelines Concerning Accounting for Financial Instruments" issued by The Japanese Institute of Certified Public Accountants)	■ Financial assets derecognized when 1) the underlying right is exercised, 2) the underlying right is lost, or 3) control over the right is transferred to others. ■ Control over right is deemed to have been transferred to others (accounted for as a sale of financial assets) when all of the following three criteria are met: ▶ Assets must be legally isolated from the transferor. ▶ Transferee(s) must be able to exercise the transferred right directly or indirectly. In case transferee is a special purpose entity (SPE), owner(s) of securities issued by the SPE is considered to be a transferee. ▶ Transferor must not have the right and obligation to repurchase the transferred assets. ■ SPE is defined as an entity which meets the following two criteria: ▶ The entity is incorporated for the purpose of transfering cash flows from the transferred assets to beneficial interest holders of the vehicle; ▶ The entity is properly managed for the purpose. ■ Transfers that fail the sale criteria are accounted for as secured borrowings with pledge of collateral.	■ Generally, financial component approach is used to account for transfer of financial assets. ■ No concept of qualifying special purpose entities (such as those defined in SFAS No. 140) is provided in Japanese GAAP. Securitization vehicles are not consolidated when 1) the transfer price is appropriate, 2) the vehicle is incorporated for the purpose of transfer cash flows from the transferred assets to beneficial interest holders of the vehicle, 3) the vehicle is properly managed for the purpose set out in 2), and 4) the company have never transferred any assets or liabilities except for financial assets to the vehicle and transfer of financial assets to the vehicle have met criteria for derecognition of financial assets.. ■ Loan participation, which technically does not meet the derecognition criteria, is permitted to be accounted for as sale in case substantial risk and reward is transferred from original lender to the participants. The Opinion Concerning the Establishment of Accounting Standard permits this treatment for existing and new transactions for an indefinite transition period for financial instruments, as defined by the Business Accounting Deliberation Council.
	Liabilities (including financial liabilities)	Same as above.	■ Liabilities (including financial liabilities) derecognized when: ▶ The debtor pays the creditor and is relieved of its obligation; ▶ The obligation extinguishes; or ▶ The debtor is legally released from being the primary obligor under the liability	■ Debt assumption, which technically does not meet the derecognition criteria, is permitted to be accounted for as settlement of liabilities in certain cases. The Opinion Concerning the Establishment of Accounting Standard permits this treatment for an indefinite transition period for financial instruments as defined by the Business Accounting Deliberation Council.

EXHIBIT 6 CONTINUED

PART 2: DERECOGNITION OF FINANCIAL INSTRUMENTS: FINANCIAL STATEMENT PRESENTATION, AND DISCLOSURE: JAPANESE GAAP, CONTINUED

Item	Category	Applicable Accounting Standard	Accounting or Disclosures Required	Other Explanatory Comments
Presentation	Offsetting financial assets and liabilities	Accounting Committee Report No. 14	■ Financial assets and liabilities are permitted to be offset when all of the three conditions are met: ▶ Each of two parties owes the other determinable amounts; ▶ The right of setoff is enforceable at law and the reporting party has an ability to setoff; ▶ The reporting party intends to set off.	■ Fair value amounts for derivatives executed with the same counterparty under a master netting arrangement may be offset to the extent covered by the agreement.
Required disclosures	Terms, conditions, and accounting policies	Zaimushohyo-to no Yogo Yoshiki oyobi Sakusei Hoho ni kansuru Kisoku (The cabinet ordinance "Regulations Concerning Terminology, Forms and Preparation Methods of Financial Statements") Renketsu Zaimushohyo no Yogo Yoshiki oyobi Sakusei Hoho ni kansuru Kisoku (The cabinet ordinance "Regulations Concerning Terminology, Forms and Preparation Methods of Consolidated Financial Statements)	■ Disclosure of significant accounting policies for financial instruments, in particular, valuation of securities, methods of establishing valuation allowance and hedge accounting.	■ Disclosure requirements for annual report (Yukashoken Hokokusho) that is filed with the regional finance bureaus of the Ministry of Finance and available to general public are set forth in a few government ordinances, an equivalent of SEC regulation S-X in the United States. ■ Commercial Code of Japan also requires certain disclosures in annual report (Shoho Keisan Shorui) for shareholders and creditors.
	Interest rate risk	Same as above.	■ Certain qualitative information regarding market risk and credit risk of derivative transactions is to be disclosed. Such disclosures include; ▶ Nature of risk; ▶ Risk management policy, procedures, and organization to control such risks Further, maturity information regarding debt securities and derivatives is required.	■ No specific disclosure of quantified interest rate risk exposure such as those measured by Value at Risk (VaR) is required.
	Credit risk	Same as above.	See above.	■ No specific disclosure is required regarding concentration of credit risks.

EXHIBIT 6 CONTINUED

PART 2: DERECOGNITION OF FINANCIAL INSTRUMENTS: FINANCIAL STATEMENT PRESENTATION, AND DISCLOSURE: JAPANESE GAAP, CONTINUED

Item	Category	Applicable Accounting Standard	Accounting or Disclosures Required	Other Explanatory Comments
Required disclosures	Fair values of financial instruments	Same as above.	■ Investments into securities. ■ Derivatives.	■ No disclosure requirements of fair value of financial instruments except for investments into securities and derivatives. ■ As an alternative, derivatives accounted for as hedging instruments are permitted to be excluded from fair value disclosure.
	Investment securities	Same as above.	■ Sales of HTM (the cost of securities sold, the proceeds from sales and the realized gains or losses and the reason for sales, by the type of debt security). ■ Sales of AFS (the cost of securities sold, the proceeds from sales and the gross realized gains and the gross realized losses). ■ Securities not revaluated by fair value. ■ The transfer of securities between categories of investments (the reason for the transfer is to be disclosed for debt securities transferred from the held-to-maturity category).	
	Transfers of financial assets	Same as above.	Not applicable.	■ There is no comprehensive disclosure requirement for transfer of financial assets, such as those required under SFAS No. 140.
	Hedges	Same as above.	■ Methods of hedge accounting. ■ Hedging instruments and hedged transactions. ■ Policy for hedging activities. ■ Method to measure hedge effectiveness.	

>>> APPENDIX 3

Survey of Best Practices for Valuation of Financial Instruments: Description of Findings

INTRODUCTION

The Group of Thirty commissioned a survey of best practice for ensuring the objectivity, consistency and integrity of valuation and accounting procedures for financial instruments. The purpose of the survey was to provide insights and develop a statement of Best Practices focused on governance, control, price verification procedures and audit as applied to the valuation of financial instruments. The survey participants included large, internationally active banks and securities firms.

The questions in the survey address:

- The nature and extent of the involvement of the board of directors, audit committees, executive management and other groups in the determination and approval of fair values.
- The controls over valuation models used for fair values and their development and input parameters.
- The frequency and nature of price and parameter verification procedures.
- The extent of internal and external audit involvement.

A copy of the survey questionnaire is attached as Exhibit 7 at the end of this appendix.

BACKGROUND

Thirteen of the largest banking and securities institutions in Western Europe and the United States agreed to participate in the survey, which was undertaken between April and July 2003. These institutions represented all aspects of the banking industry — commercial, retail and mortgage banking as well as investment banking. The institutions were sent the survey questionnaire, which formed the basis of the interview conducted by Deloitte and/or PricewaterhouseCoopers. These interviews were generally held with senior management in areas of finance, risk management and internal audit and typically lasted between 2 and 3 hours. The responses of the individual institutions were non-attributed and form the basis of this report and from which best practices were proposed to the Steering Committee. The identified Best Practices were then presented to the Steering Committee.

The participating institutions were Bear Stearns, BNP Paribas, Citigroup, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Lehman Brothers, HSBC, JPMorgan Chase, Merrill Lynch, Morgan Stanley, The Royal Bank of Scotland and UBS. The G30 is grateful to them for their open and frank responses in the interviews and to the questionnaire. The institutions were asked to describe how extensively they used fair values in their financial statements. All the institutions taking part in the survey had significant levels of financial instruments held at fair value and for some (e.g., the investment banks) it was seen as a critical accounting policy in the determination of their results. For others, such as the commercial and retail banks, it was much less critical to their results, but nevertheless a similar degree of rigor was applied to the determination of fair value.

In this report the terms board of directors, audit committee and senior management are used to indicate the different governance and decision-making levels that typically exist in a financial institution. The precise nature of these groups will vary depending on the institution and in particular the legal arrangements in the jurisdiction of the institution. Consequently, these terms will require interpretation in line with local custom and legal requirements. However, whatever the legal framework, similar levels of authority, decision making and reporting lines will exist. The terms financial control, risk management and product control are used to indicate the groups in an institution responsible for:

- Financial control, accounting and preparation of the financial statements and management information.

- Independent risk control and assessment but not risk taking.
- Product control, including procedures such as position reconciliation, price checking and daily profit verification.

The Best Practices are set out in Chapter 2.

OVERVIEW OF FINDINGS

The survey from which the Best Practices were derived was focused on the valuation processes and controls over financial instruments carried at fair value. While many of the Best Practices are specific to fair value, a number of the Best Practices have much wider application. In particular, the Best Practices relating to governance and control are applicable across all operations of a financial institution, albeit as part of a much larger process that the institution will adopt in relation to all aspects of governance and control. A crucial element of the governance is the 'tone at the top' of the organization. This sets the ethical and cultural characteristics and drives behavior within the organization.

Most organizations encouraged both formal and informal oversight responsibilities for valuation policies and procedures. The survey responses indicated that an institution's formal and informal oversight responsibilities were directly influenced by an acknowledged regulatory framework (either existing or legacy), the organization's culture, accepted industry practices, product type and management intent. Many institutions described a deliberate escalation process to senior management for various valuation oversight topics.

There was considerable consensus among the survey participants on areas of best practice and in particular the need for proper governance arrangements over all areas involved in the process of valuation and price verification. The need for those involved in the control procedures to be independent of those responsible for risk taking was stressed by all the institutions. In almost all cases it was financial control, and ultimately the CFO, that had the final oversight on fair values, usually after consultation with the respective risk management departments.

The investment banks and the trading and treasury activities of the commercial banks devote considerable time and effort to ensure that valuation methodologies, models and results are appropriate and well documented. This includes having a high degree of senior management and appropriate Board of Director oversight, highly educated resources in the process — in most cases having an independent group focused on verifying fair value. This group will typically include skilled quantitative experts. The governance structures are designed to encourage independence throughout the process of verifying fair value. While the Best Practices relating to price verification procedures focus on financial instruments held at fair value, they are relevant to all financial instruments where it is necessary to undertake valuation procedures.

The survey participants minimized differences between management reporting inclusive of risk information and financial statements prepared in accordance with GAAP. For trading books and other financial assets held at fair value, there was agreement that the fair values used in external financial statements and in management reporting including risk information should, as far as practicable, be the same. Any differences should be well documented and approved by senior management and appropriate board-level committees and, where appropriate and significant, disclosed in the financial statements. The same practice of approval and documentation should be sought for other financial assets and liabilities to the extent that risk oversight/management reporting is not based on GAAP principles.

Several institutions pointed out, however, that a recent change in accounting rules in the US Emerging Issues Task Force Issue 02-03: Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities ('EITF 02-03') impacted the accounting for certain types of derivative instruments. Under EITF 02-03, unrealized gains and losses on origination of a derivative instrument should not be recognized in the income statement unless the fair value of that instrument was obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable market transactions or based on a valuation technique incorporating observable market data. Such adjustments are seen by some practitioners as having the potential to reduce the level of control of these transactions.

The control procedures over fair values receive considerable attention from internal audit, external audit and the various financial regulators around the world. The institutions confirmed that this was an area examined by all of the major regulators that supervise them in the countries in which they operate. Most of the internal audit groups use specially trained or experienced staff for this work which is

undertaken annually — based on risk assessments. Internal auditors primarily focus on control processes surrounding valuation, while the external auditors focus on both the control processes and verification of the fair values established by the institution.

While most institutions accepted the fair value model in relation to trading portfolios, the majority of institutions did not endorse the adoption of fair value for all financial instruments for fundamental reasons such as GAAP, regulatory guidance and/or industry practices.

The remainder of this report summarizes the results of the survey of the 13 institutions under the headings in the survey questionnaire.

GOVERNANCE

Most participants indicated that oversight responsibilities for valuation were allocated among independent groups (usually financial control and risk management) and reviewed by senior management through various senior management and/or Board of Director committee structures. The most common committees encountered were: new product approval, various risk and capital groups and increasingly a financial statement disclosure committee as well as the executive committee and audit committee. Generally, the independent groups promoted the availability and the transparency of information throughout the organization that resulted in both direct and indirect feedback mechanisms. It was clear that governance structures have been implemented to ensure that processes are independent and designated groups are empowered to ensure appropriate valuations. Independence was described in terms of direct reporting lines and duties performed with clear delineation between business activities and control group activities.

The survey responses indicated an institution's formal and informal oversight responsibilities were directly influenced by the regulatory framework (either existing or legacy) the organization's culture and the 'tone-at-the-top', accepted industry practices, product type and management intent. Many institutions described a deliberate escalation process to senior management for various valuation oversight topics which was based on judgment and/or discrete monetary thresholds.

The executive committee and audit committees usually approved the policies for valuation and any significant adjustments. Any changes to policies and control procedures were generally reported to the same groups.

For the majority of the institutions the main group responsible for valuations was financial control and ultimately the CFO. In almost all cases it was financial control (and the CFO) that had the 'final say' on fair values for particular transactions — usually after consultation with risk management departments — as well as those responsible for accounting policy and valuation methodology. In addition, it was stressed that while the final say rested in financial control, those responsible for risk taking had the initial responsibility for determining fair values, and in all cases senior management responsible for those areas would be consulted. In many cases separate groups of specialist staff reporting to financial control or market risk management had been created to approve models and advise on complex or hard-to-value instruments. The need for a division of responsibilities between those taking risks (e.g., front office and treasury) and those ultimately responsible for valuations in the financial statements was a widespread feature of the institutions in the survey.

For those institutions for which fair values were a key aspect of performance, the results of the control procedures and any adjustments or judgmental areas were reported on a regular (and frequent) basis to the executive committee (or equivalent) often having been reviewed by risk management committees. Many organizations provided, directly or indirectly, to the board of directors and the audit committee access to information consistent with that produced by the independent groups for senior management. It was generally understood that the board of directors and audit committees expected a high level of involvement and appeared accessible to senior management. There is a movement toward more formalization of the reporting to boards of directors and audit committees.

CONTROL

All institutions use statistical measures such as Value-at-Risk ('VaR') as a key risk measure. In all cases, this was combined with stress testing and ad hoc scenario analysis. In addition, non-statistical measures are used such as the present value of a one basis point shift, a one percent shift in volatility and notional amounts depending on the institution and product.

Limits were generally established by risk management groups in consultation with the business heads within a risk appetite set by senior management and approved by the board of directors. The level at which limits are established

varied by institution. In certain institutions, limits were only set to the level of the risk-taking unit as a whole, such as equities or fixed income, while in other firms limits are set at a lower level, such as a specific desk or risk taker.

Monitoring of market risk limits was usually by risk management groups with some involvement by financial control and the independent valuation groups. Market risk is generally managed centrally, though risk managers are also located in near proximity to front office.

There is usually a defined escalation process via which requests for temporary excess limit approvals are made to senior management. Such requests may be triggered by an actual limit breach or may be initiated before undertaking a large transaction where it is known that the limit will be exceeded. Senior management is responsible for approving the increase, and the size of the increase determines the level to which the request is escalated. This may be delegated to risk management for small excesses.

In general there was an acknowledgement that operational risk issues need to be considered in the valuation and control processes, but few institutions had any systematic approach for this, and certain institutions felt that adjustments for operational risk are not appropriate.

Every institution in the survey had a group dedicated to model verification. In all cases this was independent of the risk taking business and formed part of market risk or financial control. The group varied in size, but was always composed of individuals with qualifications in areas such as mathematics, science or engineering. In all of the institutions, fully dedicated or virtually full-time people were allocated to model review, with tens of thousands of hours a year spent on the activity.

The model verification process was consistent across the institutions in the survey. An inventory of models used for the generation of data feeding the financial statements and the risk management systems is maintained and 'owned' by the model verification groups. In addition to a model listing, the inventory frequently included each model's review status and date of last review, limitations to use, and the scheduled re-review date.

The model verification group's role is usually solely to review models, with the initial development of models being the responsibility of the front office. The model verification group is generally contacted by the front office once a model has been developed. At this point, the model review group determines the nature and timing of the review. At the conclusion of its review, the model verification group gives a formal approval for model usage.

While most institutions require some level of review before trading commences, most permit trading on models that have not been formally approved by the model verification group. Most institutions limit the number of trades or the amount of risk on a particular model until full approval has been obtained. However, most firms have a process of prioritization involving both financial control and the model verification group to make sure that there are no unapproved models on which significant risk exposures are run.

All institutions have a process of change control to avoid the release or update of models into the live systems environment without notification to control groups including product controllers and the model verification group. In most cases, the front office notifies the model verification group about changes to the model. In all cases, this is supplemented by other price verification controls to identify changes. In certain cases, regression testing using 'frozen' models to highlight amendments or model failure is undertaken. Certain institutions have introduced the rigor of a quarterly process whereby the heads of the development teams sign off to indicate that all changes have been identified on the model listing maintained by the model verification group.

There are two main ways in which independent model verification is performed, and sometimes both methods are employed at the same institution depending on the circumstances. The first involves the independent building of a model, which is not based on the risk taking department's model, and a comparison of the results from the two models. The second involves a review of the risk taking department's model work and sometimes involves the replication of the model code to check that it is functioning as documented. In most cases, however, the models are reviewed for stress events and boundary conditions to identify whether the model behaves appropriately under all scenarios.

The review report from the model verification group generally includes an opinion on the model, as well as additional information covering significant assumptions and model limitations, which should be communicated to all interested parties. In some cases, only partial sign-off is given pending further enhancements to the model or to model controls, and a limit is set to constrain trading until

remedial action has been taken and deemed sufficient. At certain institutions this is taken further and specific recommendations for risk limits and/or valuation adjustments are made as part of the full formal sign-off.

In limited cases, there is a formal timeframe set for a further review of the model, either to check that required enhancements identified in the independent model review process have been developed appropriately, or to check that the model is still appropriate to value the products for which it was initially approved. At most institutions, this has not been formalized, and a further review is only scheduled when there is some indication that the model may no longer be the most suitable.

Considerable high-quality and skilled resources are used in model review and validation. The responsibility for model validation is usually split between financial control and market risk management (risk control). A group of quantitative experts, independent from the front office, was involved in virtually all the institutions in the survey. It was clear that most of the institutions have dedicated a considerable number of full- or virtually full-time people to model review.

Most institutions have highly formalized procedures over the initial review and subsequent changes to valuation models and methodologies. The procedures were generally similar across organizations. The reviews are performed by the quantitative experts with reporting to both market risk and financial control. The people performing these reviews are also involved in the new product approval process and/or a process of approval for large/unusual transactions.

Institutions did not have a formalized process to ensure that valuation methodologies were continuously improved, but in practice they considered that 'trader pull' combined with the skill of the staff in the model approval groups ensured this was not an issue in practice. The responsibility for improving and keeping valuation methodology up to date was shared between front office, financial control, product control and market risk management as well as the model verification group. The performance of a valuation model may be further verified, and the need for change may be identified, through publications of new technical research, new transactions, termination, unwinds and assignments, daily profit and loss attribution and analysis, the collateral comparison process and the back-testing of profits and losses against model expected results. In limited cases, reviews of the more significant models are performed by external parties.

All institutions had a procedure to approve new products involving the various control and infrastructure groups in the institution — such as financial control, risk management, compliance, tax, legal, operations and technology. In addition, internal audit were involved in the process to ensure that the institution's procedures for new products had been followed.

Virtually all of the institutions stressed the vital role played by the daily analysis of profits and losses by either the financial control and/or risk management groups. The ability to explain the results of the previous day's activity by reference to particular transactions and market price movements was identified as a key control over valuations. Other controls over fair values included reviewing:

- Specific sales of positions to establish the appropriateness of values in 'hard-to-value areas' such as large risk positions with low confidence in prices or where independent external prices were hard to obtain.
- Profits/losses on early termination.
- Collateral posted or received.

Most organizations applied the full range of valuation adjustments — credit, bid/offer, liquidity, and model uncertainty as well as early termination and a range of other adjustments. Valuation adjustments were reviewed in detail by risk management and financial control to ensure that they were in accordance with policies established and approved by the institution and the relevant GAAP.

Financial control was primarily responsible for the review of valuation adjustments and in all cases reports were provided to executive management groups and in some cases to the audit committee. Highly structured, large or unusual trades were usually reviewed and approved under a special process (similar to those for new products) involving most of the control areas and approval at a senior level that varies based upon the materiality of the transaction.

All organizations reporting under US GAAP had changed their procedures regarding the valuation of derivatives as a result of EITF 02-03. In most cases a systematic mark-to-market continues as previously, with day one profits being identified and accounted for separately. Most organizations considered that following the requirement within EITF 02-03 for 'observability' had the potential to lower the level of control over such transactions. Any differences were documented and approved by senior management

and appropriate board-level committees providing oversight. Institutions sought to minimize differences between risk oversight/management reporting/management information and financial statements prepared in accordance with GAAP. For trading books and other financial assets held at fair value, there was agreement that the fair values used in external financial statements, internal management information, capital management and risk oversight should as far as practicable be the same.

For institutions using hedge accounting, the significant documentation, valuation and control requirements are being managed centrally by financial control in order to ensure that the institution's policies and GAAP requirements were properly followed.

Virtually all institutions make some or most of the disclosures suggested by the 1993 G30 Report, "Derivatives: Practices and Principles" (the 'G30 Report'), and the Shipley Report. All felt that more disclosures would be required in the future, but most felt that the SEC's proposal for enhancing disclosure regarding critical accounting policies in the area of sensitivity of fair value estimates to be of little value and potentially misleading. Some institutions had voluntarily increased the disclosures around fair values in their 2002 financial statements.

PRICE VERIFICATION PROCEDURES

Considerable resources are devoted to the price verification process, which is seen as a key component of the control environment. The independent price verification procedures are performed on a daily basis for products with readily available price data with a more formal process undertaken on a monthly basis — usually at month end. For more complex transactions, independent price verification procedures are usually performed at month end. The month-end process involves gathering independent prices for all transactions — as far as possible — using all forms of prices and pricing services (e.g. consensus pricing services, broker quotes, etc). The procedures are performed independently of the front office. A few institutions also have mid-month or random checks but most rely on the daily profit and loss explanation procedures to monitor values of the hard-to-value transactions during the month. Reports of the level of evidence supporting the valuation of the various portfolios are usually produced and circulated to executive management.

The staff involved in independent price verification procedures are usually highly experienced and are provided formal training in quantification techniques, risk management procedures and new products. Many of the staff employed in the independent price verification procedures are experienced risk managers, qualified accountants and valuation experts. It was clear, however, that experience was a key qualification, though on-the-job training is frequently required. For the highly technical areas, quantitative experts — often in an independent group — were used.

Differences between front office and independent price verifications are usually resolved by dialog elsewhere, but in instances that differences could not be resolved, the prices from the independent price verification process would always be adopted. Any major unresolved differences are usually reported to executive management and sometimes the audit committee.

The price verification process is in most cases part of the financial control area, but with considerable input from market risk management. All institutions used independent external prices and external price data for models and have procedures to ensure that 'own quotes' are not used for verification. 'Independent' in this context is usually assessed against a hierarchy of available evidence, and where possible reliance only on quotes from brokers is avoided. The procedures are usually documented and approved by executive management and often by the audit committee. Other procedures adopted to help validate prices include the review of recent transactions and collateral values.

AUDIT PRACTICES

Internal audit departments generally adopted a risk-based approach. A rotation plan was followed and the frequency with which valuation procedures were tested was dependent on the frequency with which the related business was audited but for high-risk products including those carried at fair value, this tended to be on an annual basis. Internal audit staff generally did not perform valuation procedures only confirming that the institution's procedures for price verification were being applied in practice. In most cases internal audit was involved in looking at policy changes as part of their normal audit. Internal audit was involved when methodologies were established in relation to new products.

The internal audit staff involved in this work were all experienced and on the whole attended similar formal training to those staff in the independent price verification area. All the institutions in the survey spent in excess of 1,000 hours per annum in on this aspect of their work. In most

cases internal audit was also involved when methodologies were changed and in relation to new products.

In general internal audit participated in several committees and reported to the audit committee as well as to the CFO.

Institutions all said that external audit devoted considerable resources to reviewing price verification procedures as well as re-performing the calculations of the fair values calculated by management.

EXHIBIT 7: SURVEY OF BEST PRACTICES

INTRODUCTION

The purpose of this survey is to provide a summary of best practices for governance, control, price verification and audit practices used for insuring the objectivity, consistency and integrity of fair valuation and accounting practices. This survey is part of Phase I of the Group of Thirty Study Group on Accounting Policy, which will be used to identify and examine key issues and potential areas of consensus regarding the relevance and reliability of fair value accounting of financial transactions.

1. Please provide the names, titles, and positions of those that will be present at the interview.
2. Describe the nature of your institution (e.g., investment bank, commercial bank, retail bank).
3. How extensively do you use fair valuation techniques in the preparation of your financial statements? From a scale of one to five, with five indicating very important, rate the importance of fair valuation techniques to your institution's results of operations.
4. Do you manage the risk of your institution on a fair value basis?

GOVERNANCE

5. Identify the groups within your organization that have responsibility for the management and oversight of control and valuation policies and procedures.
6. Describe the types of formal control and valuation policies that exist within each group and the basic functions that each group performs with respect to valuation procedures.
7. Are there different control and valuation policies and procedures for financial instruments that are held in a trading portfolio versus an investment and/or accrual portfolio? If so, please describe the different approaches.
8. Describe the reporting lines and segregation of duties between the groups listed above, responsible for the management and oversight of control and valuation policies and procedures.
9. Does your organization apply the same control and valuation policies for internal capital management, risk oversight, management (MIS) and financial statement reporting? If different valuation procedures are used, please describe the reasons for the difference.
10. Describe your procedures for changing control and valuation policies. Which groups must review and approve the changes in control and valuation policies? Which groups subsequently monitor changes in control and valuation policies and procedures?
11. Does your organization have a Board committee responsible for the oversight of its control and valuation policies and/or market risk?
12. Communication with the Board of Directors and the Audit Committee
    a) Is there regular communication with the Board and the Audit Committee regarding controls and valuations of financial instruments? What is the frequency of such communication?
    b) Are changes to control and valuation policies and procedures communicated?
    c) Are significant changes in valuation estimates reviewed?

EXHIBIT 7, CONTINUED

13. To what extent is Internal Audit involved with the oversight of control and valuation policies and procedures?
14. Have your organization's policies and procedures been reviewed by regulators? If so, to what level of detail and what types of regulatory bodies?

CONTROL

15. What types of market risk measurements does your organization utilize (e.g. VaR, stress testing, other non-statistical methods)?
16. How are market, credit and concentration limits established and monitored? Are guidelines established for the types of transactions that a specific business is allowed to trade?
17. Indicate whether your risk management activities are largely centralized or decentralized by line of business. Are there different risk management practices/measurements for financial instruments that are held in a trading portfolio versus an investment and/or accrual portfolio? If so, please describe the different approaches.
18. How do operational risk and operational issues get reflected in the consideration of valuation issues? At what level are these operational issues reviewed?
19. Describe your organization's model review and validation process, including the frequency of such reviews. Describe your methods for assessing, measuring, monitoring and mitigating model risk.
20. How many people are dedicated to the model review and validation process? Please estimate the number of hours per year that are allocated to this process.
21. Describe your organization's control procedures over changing valuation methodologies and models.
22. How does your organization ensure that valuation methodologies are continuously improved and incorporate changes or developments in products and markets on a timely basis?
23. In addition to model review, what other controls are in place to validate estimates (e.g., profit and loss analysis, benchmarking to similar products, back testing, etc.)?
24. What types of valuation adjustments does your organization regularly take and how are they determined?
    a) Credit
    b) Bid-offer
    c) Liquidity
    d) Model uncertainty
    e) Servicing
    f) Other (if yes, describe)
25. Which internal groups review these adjustments and at what levels in the organization are they reported?
26. Does your organization have specific policies that require formal review of highly structured trades, unusually large trades or trades with significant profit at inception?
27. Has your organization changed any of its control procedures as a result of Emerging Issues Task Force Issue No. 02-03, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities"? In what way have procedures changed?
28. Describe your organization's control procedures to ensure issues are escalated to senior management.
29. What controls are in place to ensure that hedge accounting requirements, including documentation requirements, are met where applicable? What types of controls are in place for hedge valuation adjustments and substantiation of those amounts?
30. Does your organization maintain its disclosure standards at the level recommended by the Group of Thirty and the Working Group on Public Disclosure (Shipley Report)?
31. Does your organization plan to enhance existing disclosures to address the sensitivity of fair value estimates? If so, what type of qualitative and quantitative information would your organization plan to disclose?

EXHIBIT 7, CONTINUED

PRICE VERIFICATION PROCEDURES

32. Does your organization widely employ independent price verification procedures and are they documented? What is your organization's definition of "independent" for price verification purposes?
33. Has senior management approved the price verification procedures? Does the organization view price verification as an integral element of the overall control framework?
34. How many people are dedicated to the price verification procedures? Please estimate the number of hours per year that are allocated to the process.
35. How often are the procedures performed and by whom? Are they performed at a different frequency for different products?
36. Describe the requisite training, experience and market knowledge needed by employees performing independent price verification procedures.
37. How are differences between front office and independent price verifications resolved? Are they recorded in the financial statements? Who are such differences reported to?
38. What types of daily price and parameter verification procedures are performed and by whom?
    a) Preparation and review of all daily trading P&L
    b) Specific review of trading activity during the day, particularly large or unusual trades
    c) Reconciliation to daily front office estimates
    d) Review of daily P&L with senior financial management
    e) Other
39. What types of monthly price and parameter verification procedures are performed and by whom?
    a) Verification of cash positions to external marks
    b) Verification of model inputs to external price data
    c) Discussion of price verification results, differences, and less transparent positions with trading management
    d) Other
40. What types of ad hoc procedures are performed?
    a) Reconciliation of collateral called to position valuations
    b) Analysis of P&L on early termination of derivatives transactions
    c) Unscheduled price verification in order to reduce predictability
    d) Special reviews of specific complex or large trades
    e) Other
41. How does the organization price verify exotic products with little or no price transparency? How does management satisfy itself that the resultant valuations are fair? What alternative procedures are performed?

AUDIT PRACTICES

42. How often does Internal Audit perform reviews? Do they cover all products, including those that require alternative price verification procedures?
43. Please describe the level of knowledge and experience of your internal audit staff. What training is provided?
44. Total annual internal audit hours allocated to assessing valuation procedures:
    a) Under 100
    b) 100-500
    c) 500-1,000
    d) Over 1,000
45. Describe the level of detail to which your external auditors review valuation procedures, valuation models and price verification practices.

CONCLUSION

46. What are the three key issues your organization sees with moving to a full fair value model for financial instruments?

>>> APPENDIX 4

Significant Proposed and New Disclosure Requirements for Financial Instruments

INTRODUCTION

The following is a list of the significant new and proposed disclosure requirements for financial instruments that have been issued by the accounting standard-setters and regulators. This list is not inclusive of all current reporting initiatives.

AcSEC/FASB

1. Proposed Statement of Position: Allowance for Credit Losses
2. FIN 45: Guarantor's Accounting and Disclosure Requirements for Guarantees

SEC

1. Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies
2. FR 67: Disclosure of Off-Balance-Sheet Arrangements and Aggregate Contractual Obligations
3. FR 61: Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations
4. Anticipated Interpretive Release on MD&A

IASB

1. Improvements to IAS 32: Financial Instruments: Disclosure and Presentation
2. Financial Risk and other amendments to financial instruments disclosures

BASEL II – PILLAR 3

DISCUSSION

AcSEC/FASB

1. AcSEC Proposed Statement of Position: Allowance for Credit Losses

This proposed Statement of Position (SOP) will require that a creditor disclose certain information regarding the allowance for credit losses, including sufficient narrative information to enable users of the financial statements to understand critical aspects of the methodology for determining the allowance for credit losses, such as the breadth and depth of such methodology. The disclosure would also include a description of the credit risk evaluation processes used (for example, credit risk grading schemes, credit scoring models, industry, collateral, and geography), loans by credit risk grade, if applicable, and the total allowance for credit losses by loan type.

The disclosure requirements of the proposed SOP are more robust than current US GAAP and current SEC rules as the proposed SOP will require more qualitative and quantitative information regarding credit risk management and the composition of the credit portfolio as described above. On the other hand, the disclosures required in the proposed SOP are consistent with the disclosure recommendations of the Shipley Report.

2. FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

This Interpretation enhances the disclosures required of an entity under FASB statement No. 5, *Accounting for*

Contingencies, about its obligations under certain guarantees, both direct and indirect, that it has issued. Under that statement, only the nature and amount of guarantees were required disclosures. Under this Interpretation, an entity is required to disclose the nature and terms of its guarantees including how the guarantees arose and the events or circumstances that would require the guarantor to perform under the guarantees. The required disclosures would also include the carrying amount of recorded liabilities, if any, and the maximum potential amount of future payments under the guarantees as well as the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantees.

SEC

1. ***Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies***

   The proposed rule specifies that a registrant identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. A company's disclosure about these critical accounting estimates would include a discussion of the methodology and assumptions underlying them, the effect the accounting estimates have on the company's financial presentation, and the effect of changes in the estimates. Even though the proposed rule is not final, many financial institutions provided a disclosure of their critical accounting policies beginning with their 2002 annual reports, which included a discussion related to the fair value of financial instruments and the allowances for credit losses, in order to meet the spirit of the proposed disclosure requirements.

2. ***FR 67: Disclosure in Management's Discussion and Analysis about Off-Balance-Sheet Arrangements and Aggregate Contractual Obligations***

   FR 67 requires the disclosure of off-balance-sheet arrangements and certain known contractual obligations. Off-balance-sheet arrangements include financial guarantees, retained or contingent interest in assets transferred to an unconsolidated entity that serve to support the assets, derivative instruments that are classified as equity, and an obligation under a material variable interest in an unconsolidated entity that provides financing or other support to the registrant.

   Disclosure should include (1) the nature, purpose and financial impact of the off-balance-sheet arrangements, (2) the importance to the company of the off-balance-sheet arrangement for liquidity, capital resources, market risk or credit risk support or other benefits, (3) known events, demands, commitments, trends or uncertainties that may impact the company's ability to benefit from its off-balance-sheet arrangements and (4) other information to provide insight to the impact of potential material risks that are reasonably likely to arise from material off-balance-sheet arrangements.

3. ***FR-61: Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations***

   FR 61 requires registrants to provide MD&A disclosures relating to (1) liquidity and capital resources, particularly off-balance-sheet arrangements, (2) certain trading activities for non-exchange-traded commodity contracts accounted for at fair value, and (3) favorable relationships and transactions with related and certain other parties. The disclosure requirements for off-balance-sheet arrangements are addressed in the final rule, FR 67 described above.

   Companies engaged to a material extent in trading non-exchange-traded commodity contracts should disclose information about these trading activities, contracts, modeling methodologies and assumptions, along with explanations of different outcomes reasonably likely under different measurement methods, how the activities affected reported results and impact on financial position.

   FR 67 encourages registrants to describe all material transactions involving related parties and certain other parties (i.e., former senior management), with clear discussion of arrangements that may involve terms or other aspects that differ from those which would likely be negotiated with clearly independent parties. Such description would include the elements of the transactions that are necessary for an understanding of the transactions' business purpose and economic substance, their effects on the financial statements and the special risks or contingencies arising from these transactions.

4. ***Anticipated Interpretive Release on MD&A***
While not a formal project, the SEC staff has indicated in public speeches and in various industry group meetings that it is considering asking the Commission to issue an Interpretive Release on MD&A in the fourth quarter of 2003 as the SEC staff believes that current MD&A disclosures could be improved. The anticipated Interpretive Release is expected to encourage registrants to include an introduction that sets the stage by providing information that allows readers to understand the underlying economics of the business and to gauge the relative significance of the matters being discussed and analyzed. The introduction would identify those matters with which senior management is most concerned in running the business, enabling readers to understand the most relevant factors impacting the business and the environment in which it operates. The introduction may be similar, in some respects, to what some companies already provide in earnings releases or Chairman's Letters. The Interpretive Release is also expected to encourage registrants to focus on organization, context and analysis of discussion, predictive value of information, materiality, and liquidity. The IASB is also considering adding a similar project to its agenda.

IASB

1. ***Improvements to IAS 32 Financial Instruments: Disclosure and Presentation***
IAS 32 prescribes requirements for disclosure of the factors that affect the amount, timing and certainty of an entity's future cash flows relating to both recognized and unrecognized (such as certain loan commitments) financial instruments (including equity instruments issued by an entity) and the accounting policies applied to those instruments. IAS 32 specifically requires disclosure of information about the significant terms and conditions of financial instruments, the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them and management's policies for controlling those risks (including hedging policies).

With respect to fair value, IAS 32 requires disclosure of the extent that non-market-based assumptions are used by management to estimate the fair values of financial instruments, and the changes thereof, including the sensitivity of the estimated fair values to changes in those assumptions. The impact to earnings of changes in the fair value of financial instruments derived from valuation techniques that require non-market-based assumptions by management must also be disclosed for each period reported. These disclosures are directionally similar to those contained in the SEC's proposed rule regarding disclosure of critical accounting policies.

2. ***Financial risk and other amendments to financial instruments disclosures***
As a result of the dismantling of regulatory barriers in many countries, and increasing competition between banks and non-bank financial services firms and conglomerates in providing the same types of financial services, it became apparent that the requirements in IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* needed to be revisited.

This project will consider whether some of the requirements in IAS 30 should be revised, such as expanding the guidance in IAS 30 on the presentation of a balance sheet and income statement applicable to deposit-taking, lending and securities activities. This project will also consider whether there is a need to enhance the disclosures relating to financial activities, specifically supplementing the disclosures of risk exposure information for credit risk, liquidity risk, market risk and operational risk. The IASB does not expect this project to supersede IAS 32 until after the 2005 EU mandate. An exposure draft is expected to be issued in the fourth quarter of 2004.

BASEL II - PILLAR 3

The objective of the proposed disclosures in Basel II-Pillar 3 is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on capital, risk exposures, risk assessment processes, and the overall capital adequacy of the institution.

Banks have the discretion to use internal methodologies to assess capital requirements under Pillar I; thus requiring a common framework for disclosure to ensure the market is informed of a bank's exposure to risks and to provide a consistent and an understandable disclosure framework that enhances comparability. In fact, the proposal would

require each bank to have a more formal disclosure policy approved by its board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process.

The disclosures should include a summary discussion of the bank's approach to assessing the adequacy of its capital and include quantitative disclosures on the capital requirements for credit risk, equity risk in the internal ratings based (IRB) approach, market risk and operational risk, as well as quantitative information that enables an assessment of these risks. Additionally, for each separate risk area (e.g., credit, market, operational, banking book interest rate risk, equity) banks must describe their risk management objectives and policies, including:

- Strategies and processes;
- The structure and organization of the relevant risk management functions;
- The scope and nature of risk reporting and/or measurement systems; and
- Policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

Group of Thirty
1990 M Street, N.W., Suite 450
Washington, DC 20036
ISBN 1-56708-124-4