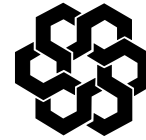

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* – Accounting for 'short sales of financial assets' (Agenda Paper 12(i))**

SUMMARY OF THE ISSUE

1. In 2005, the IFRIC received a submission that relates to a situation in which an entity enters into a short sale contract whose terms require delivery of the financial assets concerned within the time frame established by a regulation.

2. For the purposes of this agenda paper, the following terms are used:

- **A regular way purchase or sale** - a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned[1];
- **A long position** – a position involving the holding of an asset;
- **A short position** – a position assumed when traders sell shares they do not own; and
- **A sale of a long position** – a sale of an asset with the asset concerned to hand at the time when the sale is entered into.

[1] See IAS 39.9.

3. In 2005, the IFRIC discussed the issue and agreed not to take it onto the agenda. The IFRIC agreed at the August-2005 meeting to defer the discussion of the 'rejection' wording to a future meeting (see Appendix 1 to this agenda paper).

4. IAS 39.38 states: 'A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting.'

5. AG 55 and AG 56 of IAS 39 set out the trade date and settlement date accounting for regular way purchases and regular way sales of long positions.

6. The submission states that, when an entity short-sells a financial asset, it should recognise a financial liability (representing the obligation to deliver the financial asset concerned in the future) in accordance with IAS 39.14[2]. It also states that the entity should derecognise the financial liability at the time when the financial asset concerned is delivered in accordance with IAS 39.39[3]. Furthermore, the submission notes that B.32 of the Guidance on Implementing IAS 39 states that trade date or settlement date accounting cannot be applied to the recognition and derecognition of financial liabilities. The submission, therefore, states that an entity that enters into a short sale is not allowed to choose trade date or settlement date accounting.

7. The submission suggests that short sales and sales of long positions are similar trading strategies, except that the order of buy and sell transactions under short sales and sales of long positions are different. Therefore, given that entities that enter into regular way sales of long positions are allowed to choose trade date or settlement date accounting, the submission questions why entities that enter into short sales are not permitted to do the same thing. Otherwise, entities that have regular way trades very often (e.g. financial institutions) are required to monitor closely every short and long position they have.

8. This agenda paper assumes that the terms of short sales do not require or permit net settlements. AG 54 of IAS 39 states: 'A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and settlement date.'

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[2] IAS 39.14 requires a financial liability to be recognised when and only when the entity becomes a party to the contractual provisions of the instrument.

[3] IAS 39.39 states that an entity should remove a financial liability (or part of a financial liability) from its balance sheet when, and only when it is extinguished.

PURPOSE OF THIS AGENDA PAPER

9. Normally, short sales are followed by stock borrowings and stock purchases. Short sales, stock borrowings and stock purchases should be accounted for separately. The purpose of this agenda paper is not to address how stock borrowings and stock purchases should be accounted for. Instead, it focuses on how short sales should be accounted for.

10. This agenda paper summarises the requirements of trade date and settlement date accounting under IAS 39 (see paragraph 27 of this agenda paper).

11. This agenda paper addresses:
    - how a short sale contract should be accounted for under IAS 39 (see paragraph 38 of this agenda paper);
    - the key differences between short sales and sales of long positions (particularly from the economic point of view) (see paragraph 48 of this agenda paper); and
    - whether IAS 39 should be amended so that an entity that enters into a short sale is allowed to use trade date or settlement date accounting (see paragraph 53 of this agenda paper).

SUMMARY OF THE STAFF RECOMMENDATION

12. AG 12 of IAS 39 states that the fixed price commitment between trade date and settlement date under regular way purchases and sales meets the definition of a derivative. However, due to the short duration of the commitment, IAS 39 provides for special accounting for such regular way purchases and sales of long positions.

13. AG 55 and AG 56 of IAS 39 set out how trade date and settlement date accounting deal with the recognition and derecognition of <u>a financial asset</u> traded in regular way contracts.

14. Since entities that enter into short sales do not have the financial assets concerned to hand at the time when sales are entered into, the special exemptions given to regular way purchases and sales of long positions <u>are not applicable to short sales</u>.

15. Trade date and settlement date accounting, in the staff's view, does not follow the recognition and derecognition principles of IAS 39. Indeed, the staff believes that trade date and settlement date accounting are one-off special exemptions given to regular way purchases and sales of long positions.

16. The staff observes that the fixed price commitment between trade date and settlement date under a short sale contract meets the definition of a derivative in accordance with IAS 39.9. The staff also notes that the substance of a short sale contract is similar to that of a forward sale contract, which is accounted for as a derivative in accordance with IAS 39.

17. Since IAS 39 does not give any special exemptions to short sales, the staff believes that IAS 39 requires short sale contracts to be accounted for as derivatives.

18. IAS 39.14 states: 'An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. <u>(See paragraph 38 with respect to regular way purchases of financial assets)</u>.'

19. Therefore, an entity that enters into short sale contracts is required to recognise derivatives at the time when it enters into short sale contracts.

20. IAS 39 requires derivatives to be classified as financial assets at fair value through profit or loss or as financial liabilities at fair value through profit or loss (as appropriate) and to be measured at fair value at each reporting date with any changes in fair values recognised in profit or loss. For this reason, the staff recommends that the issue should not be taken onto the agenda. Proposed 'rejection' wording is set out in paragraph 54 of this agenda paper.

21. IAS 32.42 states: 'A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

    - currently has a legally enforceable right to set off the recognised amounts; and
    - intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.'

22. Therefore, the staff believes that assets and liabilities arising from each short sale, regular way purchase and regular way sale should not be offset unless the requirements in IAS 32.42 are met.

23. Though both short sales and sales of long positions require delivery of the financial assets concerned within a similarly short time frame, the staff believes that the characteristics and risks of short sales are different from those of sales of long positions in a number of respects (see paragraph 50 of this agenda paper). Consequently, the staff does not recommend any attempt to

extend to short sales the special exemptions given to regular way sales of long positions.

QUESTIONS TO THE IFRIC

24. Does the IFRIC agree that a short sale contract should be accounted for as a derivative in accordance with IAS 39?

25. Does the IFRIC agree that short sales and sales of long positions are different in nature? If so, does the IFRIC agree that the special accounting exemptions given to regular way sales of long positions should not be extended to short sales?

26. Does the IFRIC have any comment on the proposed 'rejection' wording, which is set out in paragraph 54 of this agenda paper?

STAFF ANALYSIS

Requirements of trade date and settlement date accounting under IAS 39

27. AG 12 of IAS 39 states: 'A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (i.e. trade date and settlement date accounting).'

28. AG 55 and AG 56 of IAS 39 provide guidance on how to apply trade date and settlement date accounting to the recognition and derecognition of financial assets traded under regular way purchases and sales of long positions.

29. In accordance with AG 55 of IAS 39, trade date accounting refers to (a) recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date.

30. According to AG 56 of IAS 39, settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on the day that it is delivered by the entity.

31. The staff notes that, for a regular way purchase, the key difference between trade date and settlement date accounting is the timing of the recognition of a financial asset. Regardless of which method is used, the impact on the amounts of net profit (loss) and net assets (liabilities) is the same (see Example 1 in Appendix 2).

32. Similarly, for a regular way sale of a long position, the major differences between trade date and settlement date accounting relate to the timing of the derecognition of the financial asset it had purchased previously and the recognition of any gain or loss arising from the disposal of the financial asset. Again, irrespective of which method is used, the impact on the amount of net assets (net liabilities) is the same. However, the impact on the net profit (loss) for a financial period may be different (see Example 1 in Appendix 2).

33. AG 53 of IAS 39 requires that the method used should be applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in IAS 39.9.

34. D.2.1 and D.2.2 of the Guidance on Implementing IAS 39 illustrate how trade date and settlement date accounting should be applied when an entity purchases a financial asset and subsequently sells the financial asset. Example 1 in Appendix 2 (reproduced from D.2.1 and D.2.2) demonstrates how trade date and settlement date accounting should be applied to regular way purchases and sales of long positions.

35. The staff notes that trade date and settlement date accounting are special exemptions from the general requirements in IAS 39. Under settlement date accounting: on the one hand, an entity that makes a regular way purchase of a financial asset is required to recognise any fair value gains or losses between trade date and settlement date if the financial asset is to be measured at fair value <u>(as the entity's right to changes in the fair value of the financial asset has been established on trade date)</u>. On the other hand, the entity is not allowed to recognise the financial asset until the settlement date (see AG 56 of IAS 39, D.2.1 of the Guidance on Implementing IAS 39 and Example 1 in Appendix 2).

36. Similarly, under settlement date accounting: on the one hand, an entity that makes a regular way sale of a long position in a financial asset is not allowed to recognise any fair value gains or losses between trade date and settlement date <u>(as the entity's right to changes in the fair value of the financial asset ceases on the trade date)</u>. On the other hand, the entity still recognises the financial asset on the entity's balance sheet until the settlement date (see AG

56 of IAS 39, D.2.2 of the Guidance on Implementing IAS 39 and Example 1 in Appendix 2).

37. In the staff's view, trade date and settlement date accounting merely reflect commonly adopted practice of regular way purchases and regular way sales of long positions.

Accounting for short sales in accordance with IAS 39

<u>*How short sale contracts should be accounted for in accordance with IAS 39?*</u>

38. As mentioned above, the special accounting (i.e. trade date and settlement date accounting) are designed for regular way purchases and regular way sales of long positions. Since entities that enter into short sales <u>do not have the financial assets concerned to hand at the time when sales are entered into</u>, the special exemptions given to regular way purchases and sales of long positions <u>are not applicable to short sales</u>.

39. In addition, the staff notes that a fixed price commitment between trade date and settlement date under a short sale contract meets the definition of a derivative in accordance with IAS 39. Indeed, the staff notes that the substance of a short sale contract is similar to that of a forward sale contract that requires the seller to sell a financial asset at a predetermined price at a future date. Both short sale contracts and forward sale contracts are derivatives (regardless of whether the terms of the contracts require gross or net settlements).

40. According to IAS 39.9, a derivative is a financial instrument that meets the following three characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided that in the case of a non-financial variable that the variable is not specific to a party to the contract;
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

41. IAS 39 requires a derivative to be classified as a financial asset at fair value through profit or loss or a financial liability at fair value through profit or loss, as appropriate. IAS 39 requires financial assets at fair value through profit or loss or financial liabilities at fair value through profit or loss to be recognised

at fair value on initial recognition and at subsequent reporting dates (with any changes in fair values recognised in profit or loss).

42. Since IAS 39 does not provide any special exemptions for short sales, the staff believes that IAS 39 requires short sales to be accounted for as derivatives. In other words, short sales are required to be fair-valued on initial recognition and at each subsequent balance sheet date, with changes in fair values recognised in profit or loss.

43. Furthermore, the staff believes that financial assets and financial liabilities arising from each short sale, regular way purchase and regular way sale should not be offset unless the requirements regarding offsetting a financial asset and a financial liability in IAS 32.42 are met.

44. IAS 32.42 states: 'A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

    (a) currently has a legally enforceable right to set off the recognised amounts; and

    (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.'

B.32 of the Guidance on Implementing IAS 39

45. B.32 of the Guidance on Implementing IAS 39 addresses whether trade date and settlement date accounting can be applied to the recognition and derecognition of financial liabilities. B.32 says that they cannot - noting that IAS 39 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities, and that the general recognition and derecognition requirements in IAS 39.14 and IAS 39.39 should apply.

46. The submission suggests that B.32 can be read as requiring the recognition, at the time when short sales are entered into, of (i) a financial liability (representing the obligation to deliver the financial asset concerned in the future) and (ii) a receivable to receive the sales proceeds in the future. In addition, the submission suggests that, based on the general derecognition requirements in IAS 39.39, the financial liability recognised at the time when short sales are entered into should be derecognised when the financial assets concerned are delivered.

47. In the staff's view, B.32 aims to emphasise that trade date and settlement date accounting cannot be applied to the recognition and derecognition of financial liabilities. B.32 states that IAS 39 does not contain any specific requirements about trade date or settlement date accounting in the case of financial instruments that are classified as financial liabilities. However, short sales themselves are derivatives for which IAS 39 provides specific requirements. According to IAS 39.14, short sales should be recognised as derivatives at the time when short sale contracts are entered into. In addition, as mentioned above, IAS 39 requires derivatives to be accounted for at fair value at each balance sheet date, with changes in fair values recognised in profit or loss.

Key differences between short sales and sales of long positions

48. The submission states that short sales and sales of long positions are common trading strategies. In addition, the submission claims that the key difference between short sales and sales of long positions is the order of buy and sell transactions.

49. The staff acknowledges that there are some similarities between short sales and regular way sales of long positions. For example, the terms of both sales require delivery of a financial asset within a short time frame.

50. However, they are different in a number of aspects. For example:

Motivation: If an investor expects a decline in the fair value of a financial asset in the future, he will enter into a short sale contract. Alternatively, if an investor expects an increase in the fair value of a financial asset in the future, he will purchase the financial asset now and sell it in the future when the fair value of the financial asset increases.

Exposures: Under short sale arrangements, since investors do not have the financial assets concerned to hand, the investors' obligation to deliver the financial assets in the future may cause investors unlimited losses (though the time frame for delivery of the financial assets is short). On the other hand, if investors buy financial assets first and sell the financial assets subsequently, they will not be exposed to unlimited losses. Instead, with the financial assets concerned to hand, they have potential for unlimited gain (see Diagrams 1 and 2 below).

51. The submission argues that, if the accounting for short sales and sales of long positions are different, entities are required to monitor closely every short and

long position they have. This would place an onerous burden on entities, in particular financial institutions that enter into thousands of regular way trades every day.

52. In the staff's view, the exposures of short sales and sales of long positions are so different that entities inevitably need to monitor every short and long position closely (in particular short positions). A failure to keep an eye on a short position may bring unlimited losses to an entity.

53. In conclusion, since the characteristics and risks of short sales are different to those of sales of long positions, the staff does not believe that the special accounting provided for regular way sales of long positions should be extended to short sales.

54. [Paragraph omitted from observer note].

APPENDIX 1: SUMMARY OF THE PREVIOUS IFRIC DISCUSSION

1. In the April-2005 IFRIC Update, the following tentative agenda decision was published:

   ‘The IFRIC considered an issue arising from the effect of applying IAS 39 that, in the case of ‘short sales’ that give rise to financial liabilities, an entity is not permitted a choice of applying trade date or settlement date accounting, but must apply the recognition and derecognition requirements in paragraphs 14–42 of IAS 39.

   It had been suggested that because of these requirements, differences in the sequence of buy and sell transactions in the same financial asset can result in different accounting treatments. When an entity first enters into a contract to buy an asset (a ‘long position’) and then enters into a contract to sell the same asset, the entity applies trade date or settlement date accounting consistently to both trades in accordance with its chosen accounting policy. When an entity first enters into a contract to sell an asset (a ‘short position’) and then enters into a contract to buy the same asset, the entity cannot recognise the sale before it is settled (but must recognise a liability for a short position in the meantime), while recognising on trade date the purchase of an asset (if that is its chosen policy). Consequently an entity could be required to monitor its long or short position in every security that it trades in order to determine which accounting it is permitted to follow.

   The IFRIC noted that possible solutions would all require a change to IAS 39, which would require that the Board and not the IFRIC **[Something missing]**. The IFRIC also noted that the issue involves a difference between IFRSs and US GAAP. Accordingly, the IFRIC decided not to add the topic to its agenda, but to recommend the Board consider the issue as a part of its project on convergence with US GAAP.

2. At its meeting in August 2005, the IFRIC considered submitting the issue to the IASB, with proposed wording to be considered at a future IFRIC meeting.

APPENDIX 2: Example 1

1. The facts of Example 1 are as follows:
   - Fair value of the financial asset on date of purchase (i.e. 29/12/20X1) = CU 1,000. The purchase price = CU 1,000.
   - Fair value of the financial asset on the reporting date (i.e. 31/12/20X1) = CU 1,002.
   - Fair value of the financial asset at the time when the financial asset is received (i.e.1 Jan 20X2) = CU 1,003.
   - The sale price of the financial asset on 1 January 20X2 = CU 1,003.
   - Fair value of the financial asset at the time when the financial asset is delivered (i.e. 4 Jan 20X2) = CU 1,005.

DR (CR)	**Settlement date accounting**		**Trade date accounting**	
	FVTPL	AFS	FVTPL	AFS
Date of purchase (i.e. 29 December 20X1)				
Financial asset	-	-	1,000	1,000
Financial liability	-	-	(1,000)	(1,000)
Net asset	**-**	**-**	**-**	**-**
Reporting date (i.e. 31 December 20X1)				
Financial asset	2	2	1,002	1,002
Financial liability	-	-	(1,000)	(1,000)
Net assets	**2**	**2**	**2**	**2**
Retained earnings	(2)	-	(2)	-
Equity (fair value adj.)	-	(2)	-	(2)
Date of settlement (i.e. 1 January 20X2)				
Financial asset	1,003	1,003	1,003	1,003
Retained earnings	(3)	-	(3)	-
Equity (fair value adj.)	-	(3)	-	(3)
Date of sale (i.e. 1 January 20X2)				
Financial asset	1,003	1,003	-	-
Receivable	-	-	1,003	1,003
Retained earnings	(3)	-	(3)	**(3)**
Equity (fair value adj.)	-	**(3)**	-	-
Date of settlement (i.e. 4 January 20X2)				
Retained earnings	(5)	(5)	(5)	(5)