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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 19 July 2006, London

Project: Accounting Standards for Small and Medium-sized Entities

Subject: Revised Draft of Section 12 Financial Assets and Financial Liabilities of a Comprehensive Exposure Draft – International Financial Reporting Standard for SMEs: Issues for Board Discussion (Agenda Paper 11)

1. In June, the Board discussed a proposal to simplify the provisions of IAS 39 *Financial Instruments: Recognition and Measurement* for small and medium-sized entities (SMEs) in three areas:
 - classification of financial instruments – the June draft ED proposed only two categories of financial assets and liabilities for SMEs;
 - derecognition – a simple and clear principle, though more restrictive than the derecognition provisions of IAS 39; and
 - limited relief from hedge accounting focussed on the types of hedging that an SME is likely to do.
2. The Board expressed general agreement with the thrust of the proposals and identified several matters for which revision or amplification is needed. The Board agreed to make a decision on whether to adopt this approach at a future meeting. Staff requests that the Board accept this approach at the July 2006 meeting.
3. Agenda Paper 11 contains a substantially rewritten Section 12 *Financial Assets and Financial Liabilities* of a draft IFRS for SMEs. The rewrite is based on decisions at the June Board meeting. The glossary definitions new to the IFRS for SMEs are on the last page.

Note for Observers: The draft text of Section 12 is not included in these Observer Notes. It is the policy of the IASB not to release preliminary drafts of Exposure Drafts or Standards because such drafts are staff drafts subject to Board review and approval.

Option to use IAS 39 (paragraph 12.1)

4. As revised, paragraph 12.1 gives an SME a choice of following Section 12 or IAS 39 in accounting for all of its financial instruments. The Board discussed allowing this choice in June but tentatively decided against it. Staff is proposing reconsideration of the choice for the following reasons:

- (a) While Section 12 is a more simplified approach to accounting for financial instruments than IAS 39, some of the simplifications involve eliminating options that are available to companies with public accountability under IAS 39, for instance:
 - (i) available for sale classification and the available for sale option;
 - (ii) held-to-maturity classification;
 - (iii) A continuing involvement approach to derecognition (ie partial derecognition); and
 - (iv) option to get hedge accounting for hedges other than the four specific types identified in paragraph 12.27.

The Board's general view has been that options available to those using IFRSs should be available to SMEs.

- (b) Because the default category for financial instruments is fair value through profit and loss under the IFRS for SMEs, and cost or amortised cost is permitted only when specified conditions are met, some items measured at cost or amortised cost under IAS 39 because of their nature will be measured at fair value through profit and loss under the IFRS for SMEs. Some SMEs may find this added fair valuation burdensome.
- (c) Many of the so-called "strategic investments" discussed by the Board in June, for which IAS 39 allows available for sale treatment would be at fair value through profit or loss under the IFRS for SMEs.
- (d) The derecognition provisions of the IFRS for SMEs will not result in derecognition for securitisations and factoring that SMEs may enter into, whereas IAS 39 would result in derecognition.

5. For these reasons, staff recommends retaining paragraph 12.1.

Board decision requested: Does the Board agree that the option to use IAS 39 in paragraph 12.1 should be retained?

Scope (paragraphs 12.2 to 12.4)

6. Paragraph 12.4 has been rewritten to conform to the non-financial contract exclusions in IAS 39, based on the Board's discussion in June.

Board decision requested: Does the Board agree with the exclusion in paragraph 12.4 as redrafted?

Measurement of financial instruments (paragraphs 12.5 to 12.12)

7. To simplify the IFRS for SMEs further, Section 12 no longer refers to categories of financial assets or financial liabilities. Instead it provides that fair value through profit and loss is the default measurement principle for all financial assets and liabilities but there are three exceptions, two of which are elective (basically debt instruments with no “exotic” risks and forwards and options on such instruments) and one of which is required (equity instruments whose fair value cannot be measured reliably).
8. As noted in June, an important benefit of this approach is that it avoids having to define a derivative or an embedded derivative. No fair value changes are recognised in equity. Intent-driven classification (eg held to maturity) is eliminated. A concession from IAS 39 is that amortised cost could conceivably be elected for a traded instrument, but this is not likely to be common for an SME.

Board decision requested: Does the Board concur with the recognition and measurement approach in paragraphs 12.5 to 12.12 as redrafted?

Fair valuation (paragraphs 12.13 to 12.15)

9. In June the Board asked that guidance on determining fair values that is in IAS 39 be included in the IFRS for SMEs. Paragraphs 12.13 to 12.15 and the new appendix to Section 12 are intended to implement that decision.

Board decision requested: Does the Board agree that the fair valuation guidance in paragraphs 12.13 to 12.15 and the Appendix to Section 12 provide sufficient guidance for an SME?

Impairment (paragraphs 12.16 to 12.21)

10. These paragraphs have been rewritten to reflect comments of Board members in June and editorial suggestions sent to the staff.

Board decision requested: Does the Board agree that paragraphs 12.16 to 12.21 provides sufficient guidance for an SME to recognise and measure impairment of financial assets measured at cost/amortised cost?

Derecognition (paragraphs 12.24 and 12.25)

11. These paragraphs are essentially unchanged from the June 2006 draft. They impose a high hurdle for derecognition – only when substantially all risks and rewards have been transferred. The big benefit is that an SME will not have to refer to the complex derecognition provisions of IAS 39. A drawback would be that the SME standard would not derecognise securitisations whereas IAS 39 would; however SMEs are not likely to engage in securitisation transactions anyway, and (if the recommendation on retaining paragraph 12.1 is agreed by the Board) they always have the option of following full IFRSs if they wish.

Issue: Does the Board agree that paragraphs 12.24-12.25 are appropriate principles for SMEs to follow for derecognising financial assets and financial liabilities?

Hedge accounting (paragraphs 12.26 to 12.35)

12. This part of Section 12 has been substantially rewritten, based on tentative Board decisions in June. An important staff goal in rewriting the hedge accounting provisions in the IFRS for SMEs is to allow Section 12 to be

“stand-alone” guidance on hedge accounting for an SME. The June 2006 draft had essentially required SMEs to follow the hedge accounting provisions of IAS 39, though it had some simplifications for cash flow hedge of foreign currency risk and for fair value hedges of interest rate risk. Under the rewrite, the hedging requirements are self-contained in Section 12.

13. To allow Section 12 to stand alone, it now addresses four kinds of hedges an SME is likely to enter into, namely hedges of:
 - (a) interest rate risk or foreign currency risk of a debt instrument measured at amortised cost;
 - (b) the foreign currency exposure in a commitment or a highly probable forecast transaction;
 - (c) the commodity price risk exposure in a commitment or highly probable forecast transaction; or
 - (d) the foreign exchange risk exposure in a net investment in a foreign operation.
14. The June 2006 draft had focussed only on (a) and (b) as typical hedging practices for SMEs. However, at the June 2006 Board meeting, Board members identified items (c) and (d) as additional types of hedges that SMEs sometimes enter into in managing their risks. Section 12 now covers them.
15. The hedge accounting relief granted to an SME in the limited cases under Section 12 is that if the conditions in paragraph 12.28 are met, the hedge is assumed to be effective, and calculation of ineffectiveness is not necessary. Note that “over/under hedging” would preclude use of hedge accounting. Critical terms must “match” – for instance:
 - (a) Paragraph 12.28(d)(ii) [“equal”];
 - (b) Paragraph 12.28(d)(iii) [“not later than” plus “no prepayment, early termination, or extension”]; and
 - (c) Paragraph 12.28(d)(iv) [“same”].

<p>Issue: Does the Board concur with the hedge accounting provisions in paragraphs 12.26 to 12.35 for SMEs?</p>

Disclosure (paragraphs 12.36 to 12.50)

16. These paragraphs are entirely new. The fair value disclosures of IFRS 7 are not included because the default category is fair value through profit and loss. The risk disclosures of IFRS 7 are not included on a cost-benefit basis for SMEs.

<p>Issue: Does the Board concur that the disclosure provisions in paragraphs 12.36 to 12.50 are appropriate for SMEs?</p>
