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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board meeting:	**20 June 2006, London**
Project:	**Financial Instruments**
Subject:	**Staff Questionnaire on Presentation of Changes in Fair Value (Agenda Paper 2B)**

INTRODUCTION

1. As part of the project to address the presentation of changes in fair values of financial instruments, at the joint meeting in October 2005 the IASB and FASB (the boards) directed the staff to seek the views of users of financial statements. In particular, the boards directed the staff to seek users' views on the relevance of (and how they might use) different types of information on:
   - Past changes in fair value of financial instruments;
   - Exposures to future changes in fair values of financial instruments.
2. As a first step, the staff issued a request for information in the form of a questionnaire. The questionnaire sought the views of users responsible for making investment and credit decisions (or those advising others on investment and credit decisions) and asked what types of information in respect of financial instruments measured at fair value would be relevant to their analysis.
3. The purpose of this paper is to provide the staff's analysis of the responses received and seek the Board's views on the next steps in this project.
4. [Paragraph omitted from observer notes]

RESPONSES RECEIVED

5. The staff received responses to the questionnaire from 47 individuals covering 34 organisations, including many of the major sell-side and buy-side institutions. Six of the organisations who participated are based in the US with the rest based outside the US. Some responses were received as a direct result of the request for information posted on the IASB and FASB websites, but most questionnaires were completed following meetings between the staff and the individual respondents.

6. The responses received are, in most cases, from those who perform financial statement analysis rather than from the organisations' technical accounting experts. Consequently, in many cases, the respondents did not necessarily have detailed technical accounting knowledge. The views expressed were the personal views of the respondents and did not purport to represent the views of the organisation as a whole.

7. The staff notes that there was considerable enthusiasm from the respondents to help the staff and the boards understand the practical issues that face users when undertaking their financial analysis.

8. [Paragraph omitted from observer notes]

9. The respondents to the financial instruments questionnaire can be split into 3 main categories: buy-side equity analysts, sell side equity analysts and rating agencies. The staff also spoke to a number of fund managers (both credit and equity). However, there was no significant correlation between the role of the individual and the responses given (although see following paragraph).

10. Respondents to the questionnaire followed a wide range of different companies/industry sectors including banks, automotive, transport, retail and technology. As would be expected, the information needs of the users of bank financial statements (referred to as "bank users") are different from those of users of the financial statements of other corporates (referred to as "corporate users"). [Text omitted from observer notes] However, no significant differences in the information needs of corporate users emerged.

11. The staff believe that it is important that the responses received from those analysing non-US GAAP companies are put into context. For many such respondents, this is the first year they have used financial statements prepared under IFRS. Consequently, these users are relatively unfamiliar with the format of the information provided. In addition, most of the financial statements seen so far by users are prepared using the disclosure requirements of IAS 32 *Financial Statements: Disclosure and Presentation*

rather than the more comprehensive requirements of IFRS 7 *Financial Instruments: Disclosures*.

12. Many of the respondents also provided views on issues about which the questionnaire did not directly seek comments. However, the staff believes it is important to bring a number of these comments to the attention of Board members in so far as they have a bearing on this project - these are included in the "Other comments" section of this paper.

13. [Paragraph omitted from observer notes]

STAFF ANALYSIS

14. In the opinion of the staff, the main points to emerge from the responses to the questionnaire are as follows:

- Users require some disaggregated information for financial instruments that are measured at fair value. In particular, users continue to want information on bad debts (both in terms of bad debt charges and bad debt allowances) and interest. However, most users do not believe that further disaggregation of fair value changes and balances would provide information that would be of significant value given the current valuation methods that are used;
- There is little or no demand for interest income/expense to be reported on a "fair value" basis. Most users express a preference for interest information to be presented on an accruals basis;
- There is support for the provision of more information on the exposure of an entity to future changes in the fair value of financial instruments (such as enhanced sensitivity analysis or stress tests).

15. Each of these points is discussed further below.

Users require some disaggregated information for financial instruments that are measured at fair value.

16. It is clear from the responses received that users of financial statements require some disaggregated information in respect of financial instruments carried at fair value.

17. Most respondents stated that interest income/expense should continue to be separately reported in the income statement even when financial instruments are carried at fair value. There were mixed views as to whether information on interest income/expense

should also be provided for financial instruments managed as part of a trading portfolio.

18. In addition, most users stated that they would continue to want information on impairment/bad debt allowances and the effect that changes in these allowances have on the income statement. Comments of this type were most often received from bank users as they believed that such information provides an important insight into the way a bank is managed and helps them understand the attitude of management towards risk; corporate users were less concerned about this issue as, in general, financial receivables are much less material to non-financial institutions. However, most corporate users also stated that they would find information on bad debt allowances and charges useful.

19. Very few users expressed any interest in obtaining further disaggregation of fair value changes and balances. Respondents do not believe that further disaggregation would provide information that would be of any significant value given the current valuation methods that are used.

There is little or no demand for interest income/expense to be reported on a "fair value" basis

20. Despite the fact that it is inconsistent with a fair value model, most respondents believe that the interest figure presented should be based upon contractual cash flows or some form of effective interest type calculation. There was very little support for interest to be calculated based upon the current market cost of debt. This response is in line with comments received from respondents to the JWG Draft standard on financial instruments published in December 2000.

21. In isolated circumstances there was some support for market based interest data (for example, for property investment companies or in situations where refinancing was imminent and critical to the future of an entity). However, even in these situations there appeared to be no real desire amongst users that an entity be forced to produce such data given all of the subjective assumptions that might be required.

Users support the provision of more information on the exposure of an entity to future changes in the fair value of financial instruments.

22. A significant number of respondents believed that the best way to gain an understanding of an entity's exposure to future changes in fair value would be enhanced sensitivity analysis/stress tests on the entity's exposure. However, there was

no consensus over how these tests should be performed or what risks they should cover.

23. Many respondents stated that it is not current market practice to perform detailed analysis on the exposure of entities to changes in the fair value of financial instruments. Most users who made this comment also stated that this is not necessarily a satisfactory situation but that they currently have insufficient information to perform such an analysis. However, the staff notes that rating agencies, who normally have access to more detailed (and private) management information, do regularly perform sensitivity analysis on fair value exposures arising from financial instruments for financial institutions.

24. Even if sensitivity analysis were enhanced, a significant number of users expressed the concern that the information provided in stress tests/sensitivity analysis may not be sufficiently detailed to provide information that is useful in their quantitative analysis.

OTHER COMMENTS

25. Some respondents to the questionnaire provided more general opinions about financial reporting. While many of these comments were not directly relevant to the questions asked the staff believes it is important to bring two of these comments to the attention of the boards.

Users are critical of current practice regarding the presentation of fair value changes in the income statement and believe that clear guidance on financial statement presentation is required

26. A significant number of users were critical of financial statement presentation generally and the presentation of fair value changes in the income statement specifically. With regard to the presentation of fair value changes, many users stated that they would like more consistency of presentation between entities and clearer disclosures of what has been included in each line item.

27. In particular, bank users stated that it is often unclear where fair value changes relating to different lines of business have been reported. In addition, different banks will often treat similar items differently leading to a lack of comparability between reporting entities.

28. As discussed in paragraph 11 above, it is unclear whether these concerns are the result of users that follow non-US GAAP entities being unfamiliar with the format of financial statements prepared under IFRS. It is possible that industry practice will develop over time, leading to greater consistency of presentation.

29. Many users expressed the view that clear presentation of fair value changes in the income statement is required if the use of fair values is to be extended. It is interesting to note that respondents to the JWG document on financial instruments published in December 2000 made similar comments about the need for improvements in the reporting of fair value changes.

A significant number of users do not currently use (or know how to use) fair value information in their analysis

30. There is far greater acceptance of the use of fair values in the balance sheet than in the income statement. For example, balance sheet fair value information is sometimes used to derive enterprise values.

31. However, a significant number of the users we spoke to stated that they attempt to strip out the effect of financial instrument fair value changes from income to arrive at cost based numbers. These cost based numbers are then used to derive earnings based valuations. There appeared to be little developed practice as to how to use fair value accounting information in financial analysis.

32. Again, it is interesting to note that similar comments were made by respondents to the JWG draft standard.

NEXT STEPS

33. The staff believes that the next steps in the project are to hold further discussions with selected users to:

    - Ensure that the staff analysis as set out in this paper is appropriate; and
    - Attempt to develop requirements for sensitivity analysis/stress tests that will provide useful information to users. The staff believe that rating agencies who already carry out analysis of this type might be able to provide valuable input into this area;

34. Given the obvious overlap between this project and the Financial statements presentation project, the staff also suggests that any further work be more closely integrated with that being conducted by the Financial statements presentation team.

35. In terms of possible eventual output of this project, the staff believes that it:

- Could be incorporated into the due process document on financial instruments (see agenda paper 2A), and/or
- Be incorporated in the documents produced by the Financial statements presentation team

APPENDICES 1 -3

[Appendices omitted from observer notes]