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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: 21-22 September 2006, London

Project: Accounting Standards for Small and Medium-sized Entities

Subject: Revised Draft of Section 12 Financial Instruments of a Draft Exposure Draft of an IFRS for SMEs (Agenda Paper 15A)

Background

1. Board Agenda Paper 15A presents the latest draft of Section 12 *Financial Instruments* of the draft IFRS for SMEs starting on page 6. The draft reflects comments of the Board on the version of Section 12 discussed at the July 2006 meeting, as well as some drafting comments submitted by Board members. Additionally, staff asked two outside reviewers to do a “cold review” of the Section in detail, and their comments are reflected as well.
2. The glossary definitions related to financial instruments are presented at the end of the revised draft of Section 12.
3. In developing Section 12, the Board recognised that IAS 39 is complex and daunting for an SME, and agreed to simplify the requirements for SMEs, not just extract the “black letter” principles from IAS 39. Key examples of simplifications are:
 - (a) Two categories of financial assets rather than four. This means no need to deal with all of the “intent-driven” held to maturity rules or related “tainting”, no need for an available for sale option, and many other simplifications.
 - (b) For simplification, the default measurement principle is fair value through profit or loss. However, three types of financial instruments will continue to be at cost or amortised cost when certain conditions are met. These include (i)

receivables, payables, and loans, (ii) most commitments to make or receive loans, and (iii) equity instruments whose fair value cannot be reliably measured and options on such instruments. Categories (i) and (ii) may optionally be at fair value through profit or loss.

- (c) The terms derivative and embedded derivative are not used, and there is no need to separate out embedded derivatives from a host contract. Financial assets and liabilities are defined with examples [eg paragraph 12.2(g)] that clearly include those derivatives. But with fair value through profit or loss as the default, there's no need for all of the details about derivatives and embedded derivatives that is in IAS 39.
- (d) Section 12 includes a clear and simple principle for derecognition – if the transferor has any significant continuing involvement, do not derecognise. As a result, derecognition would be allowed in fewer circumstances than under IAS 39. Staff does not believe this will be a problem for most SMEs. For one thing, banks and other financial institutions will be prohibited from using the IFRS for SMEs, so the fact that there's no derecognition for most securitisations is not likely to affect most SMEs unfavourably. Another plus is that the complex “pass-through testing” and “control retention testing” of IAS 39 are avoided. Probably, some receivables factoring transactions will not result in derecognition. An SME that prefers the complex derecognition of IAS 39 to the simple principle in Section 12 can elect to use IAS 39.
- (e) For hedge accounting, Section 12 addresses the four kinds of risk hedges that SMEs typically do – listed in paragraph 12.31. Hedge accounting is not allowed for any other kinds. This is stricter than IAS 39, though, again, an SME can opt to use IAS 39 in full instead of Section 12. In addition to the restricted set of hedge accounting, Section 12 imposes strict conditions on the designation of a hedging relationship [paragraphs 12.30 to 12.33]. The payback for the SME is that if the SME meets those conditions for any of the four typical types of SME hedging activity, subsequent hedge effectiveness is assumed without need for measurement or recognition of ineffectiveness at each reporting date. [An alternative approach is discussed in the next part of this Agenda Paper under “Issues for Board consideration”.]
- (f) With respect to hedge accounting:
 - (i) Hedge accounting cannot be achieved with cash instrument hedging.
 - (ii) Hedge accounting cannot be achieved with an option-based hedging strategy.
 - (iii) Hedge accounting for portfolios is not permitted.

Staff does not believe that these simplifications will affect SMEs adversely because these are not typical SME hedging strategies.

Issues for Board consideration

1. Hedge accounting – how to simplify

4. The single issue that staff would like to raise about Section 12 for Board discussion is: How should hedge accounting be simplified for SMEs?
5. At the July meeting, the Board discussed two approaches to hedge accounting simplification. Both would restrict hedge accounting to the four types of hedges that SMEs typically enter into (see paragraph 12.31). One of the approaches would impose strict conditions on the designation of a hedging relationship with subsequent hedge effectiveness assumed without need for measuring ineffectiveness (similar to FAS 133's "shortcut method"). The alternative would require periodic measurement and recognition of ineffectiveness for all hedging activities, but would not require as a qualifying condition that the hedging relationship be effective within a range of 80% to 125%. IAS 39 has such an 80%-125% condition, requiring somewhat complex and retrospective calculations.
6. Those who favour the shortcut method generally cite (a) its rigour in restricting hedge accounting to situations in which a loss is highly unlikely to occur and (b) its simplicity for SMEs. Those who favour the alternative approach believe that accounting should reflect actual results, not likelihoods. If, for whatever reason, unexpected hedge ineffectiveness occurs, there is a decline in the fair value of a financial instrument that should be recognised in profit or loss. Because ineffectiveness must be measured and recognised, some who hold this view would expand the circumstances in which hedge accounting could be used.
7. At the July meeting, the Board voted 11-2 in favour of the shortcut method approach. At the same time, the Board asked to see the alternative approach written in ED format. The shortcut approach is reflected in paragraphs 12.29 to 12.40 of the draft of Section 12 that begins on page 6 of this Agenda Paper. The alternative approach (with measurement of effectiveness required for all hedges) is reflected in alternative paragraphs 12H.29 to 12H.39 for Section 12 that would replace paragraphs 12.29 to 12.40. Those alternative paragraphs are presented in this Agenda Paper immediately following Section 12 (ie immediately after the glossary).
8. A third viewpoint about simplification of hedge accounting for SMEs is for Section 12 not to provide for any special hedge accounting principles. Those who hold this view believe that paragraphs 12.29 to 12.40 and the disclosures in 12.50 to 12.52 add unnecessary complexity to Section 12. If 12.29 to 12.40 and 12.50 to 12.52 were removed, an SME would follow the remaining provisions of Section 12, and perhaps other Sections of the IFRS for SMEs, in accounting for the hedging instrument and the hedged item. All hedge ineffectiveness would automatically be recognised in profit or loss. Where changes in fair values of the hedging instrument and the hedged item fully offset due to a "natural hedge", there is no net effect on profit or loss. An SME could always elect to follow IAS 39 instead of Section 12 if it wished to follow special hedge accounting principles.
9. Staff favours the "shortcut method" as set out in paragraphs 12.29 to 12.40, for the reasons noted in paragraph 6 above.

Issue for the Board: Does the Board concur with retaining the shortcut method of hedge accounting for SMEs as set out in paragraphs 12.29 to 12.40?
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2. Other matters?

10. Are there other issues Board members wish to raise regarding Section 12?

Notes for Observers

11. The revised draft of Section 12 in Agenda Paper 15A is part of an exposure draft (ED) that is not yet a public document. Accordingly, it is not available to observers. However, in August 2006 the IASB posted on its website a draft of the ED prepared by staff. Section 12 of that draft is close to, but not identical to, the draft in Agenda Paper 15A. That draft can still be downloaded from the IASB's website.