30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 5A**

Financial Instruments: Due Process Document (DPD)

Moving towards a fair value model

BACKGROUND

1. As noted in agenda paper 5, the staff envisages the DPD comprising two parts.

2. The first part of the DPD will set out the principal components of an accounting model that is based on the preliminary view of the Boards that all items in the scope of the DPD should be remeasured at fair value, with changes in fair value being recognized in the period in which they occur (the 'fair value model').

3. The second part of the DPD will discuss how the Boards might move towards the fair value model following issuance of the DPD.

PURPOSE OF THIS PAPER

4. This paper considers the second part of the DPD – how the Boards might move towards the fair value model following issuance of the DPD. This paper does not address any technical issues relating to the fair value model.

5. This paper discusses possible approaches that might be taken to achieve the long-term objectives of the Boards in relation to the accounting for financial instruments.

OVERVIEW OF THIS PAPER

6. Following consideration of comments received on the DPD, the Boards could decide to wait and do nothing for a period of time. The Boards might then reconsider at some future date what, if any, action could be taken to move towards their long-term objectives.

7. Such a decision might allow more time for the Boards to work together with stakeholders of financial statements to better understand (and to the extent possible, address) their concerns regarding the fair value model.

8. However, such a decision would neither improve nor simplify current requirements despite demand from many constituents. Furthermore, there would be a possibility that existing requirements would actually become *more* complicated because continuing amendments to existing standards (and development of interpretations) would inevitably be required. Such a repair and maintenance process requires considerable Boards and staff resources. Typically, such amendments also do little to simplify existing requirements. In addition, no momentum towards the fair value model would be achieved.

9. Therefore, this paper discusses two possible approaches that would address the concerns of many constituents and that are consistent with the long-term objectives of the Boards. The two approaches considered are:

- Approach 1 – developing an exposure draft of the fair value model (the 'ED' approach); or

- Approach 2 – taking one or more interim steps before requiring the fair value model (the 'Interim steps' approach).

10. It is intended that the DPD will discuss some examples of the next step under the 'Interim steps' approach. This paper also suggests possible parameters that might be used to develop such examples.

APPROACH 1 – THE 'ED' APPROACH

11. Under Approach 1, an ED would be developed based on the fair value model.

12. The ED would take into account comments from respondents to the DPD regarding implementation of the fair value model. The ED could also address some of the concerns of respondents to the DPD through giving exceptions to the principles of the fair value model in certain circumstances, if justified.

13. Of course, the ED would also have to address the opposition to the fair value model. This would require extensive discussion in the Basis for Conclusions.

Possible reasons for pursuing the 'ED' approach

Demand for improved and simplified financial reporting for financial instruments

14. There is significant demand for improved and simplified accounting for financial instruments. Reasons include[1]:

    - Existing accounting standards that use a mixed measurement attribute model are highly complex and include many internal inconsistencies;

[1] At joint IASB/FASB meetings held in April and October 2005, the Boards acknowledged that the existing accounting standards for financial instruments are complex and that use of different measurement attributes for different instruments is one source of that complexity.

- Comparability between financial statements of entities prepared under existing standards is often not achieved due to the significant role that management intent plays in the classification and measurement of financial instruments; and

- Existing standards provide many alternative treatments for certain financial instruments – once again impairing the comparability and decision usefulness to users of financial statements.

15. The 'ED' approach would dramatically reduce the complexity of existing requirements – assuming that there are few exceptions to the underlying principles.

16. Furthermore, the Boards have already reached the preliminary view that the fair value measurement is the most relevant measure for financial instruments. Therefore, the 'ED' approach would be the quickest way to improve and simplify the accounting for financial instruments.

Efficiency for the Boards and constituents

17. The 'ED' approach would be the most efficient way for the Boards and their constituents to achieve the Boards' long-term objectives. It would also allow constituents to begin preparing for a fair value model.

18. The 'Interim steps' approach will be discussed later in this paper. However, putting a requirement of a fair value model in place and allowing a significant implementation period (during which constituents could identify and solve implementation issues) is going to be significantly more efficient for everybody than putting one or more interim steps in place (with all of the education and implementation challenges that would inevitably result).

Convergence with US GAAP

19. Approach 1 would also be the most efficient way in achieving convergence with US GAAP (assuming that each Board decides to issue an ED, and the two EDs are the same).

20. The Boards are committed to converging the accounting for financial instruments. Following several discussions of possible short-term convergence projects, the Boards have previously agreed that the most efficient way to converge standards is to develop an improved and simplified standard in the longer term.

Possible reasons for not pursuing the 'ED' Approach

Reliability of fair value measurement

21. A reason that will be advanced by some for not pursuing the fair value model relates to the reliability of fair value measurement. Some believe that more time should be given to develop improved valuation methodology before implementing the fair value model.

22. Not all financial instruments have readily obtainable fair values - for example, financial instruments that are not traded in an active market and financial instruments that are traded in government controlled markets.

23. To determine the fair values of financial instruments which are not traded in active markets such as shares of private entities, reporting entities inevitably have to make assumptions. Some argue that the need for such assumptions would result in measurements that are not sufficiently reliable for financial reporting purposes.

24. However, the Boards have already taken, or are taking, numerous steps to address concerns over how to measure fair values[2]. In addition, the IASB has already reached a preliminary view that all financial instruments can be measured with sufficient reliability for financial reporting purposes.

[2] For example, the FASB issued Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157). In November 2006, the IASB published a discussion paper on fair value measurements based on principal issues contained in SFAS 157.

To further develop the fair value model for financial instruments and allow related projects to make further progress

25. Another reason that may be advanced for not pursuing the 'ED' Approach is to allow further time to identify and solve issues specifically related to the fair value model and to allow related projects to make further progress.

26. The DPD will not offer solutions for all issues related to the fair value model. The DPD focuses only on the recognition and measurement of financial instruments. However, other related issues will have to be addressed in due course.

27. For example, enhanced presentation and disclosure requirements will have to be developed to supplement the fair value model. Issues that may need to be addressed include:

    - the level of (dis)aggregation of financial instruments in the balance sheet and the level of (dis)aggregation of changes in the fair value of financial instruments in profit or loss; and

    - the information to be disclosed in the financial statements to reflect 'economic' hedging activities.

28. There are also a number of other projects that will have an impact on the accounting for financial instruments. For example, the Financial Statement Presentation project may alter the architecture of the Income Statement and this could change where certain gains or losses are reported.

29. In addition, the joint Conceptual Frameworks project has been studying what measurement bases are appropriate for financial reporting. However, that discussion is still at a preliminary stage.

Possible steps that could be taken in conjunction with the ED Approach

30. Alongside the development of an ED, additional steps could be taken to address some of the concerns constituents may have. Such steps might include:

- providing significant lead time before the effective date of the standard
- performing extensive field testing with both preparers and users of financial statements. However, such testing would arguably make most sense to be performed after issuance of the ED. The purpose of such field testing would be to identify major practical difficulties constituents have in applying the fair value model. This process would also help identify any necessary exceptions to the fair value model.

31. It is worth noting that, regardless of how much effort the Boards take to address the concerns of constituents, some will never agree with the fair value model. For example, some constituents will always believe that management intent should have primacy to the Boards' conceptual frameworks.

APPROACH 2 – THE 'INTERIM STEPS' APPROACH

32. The 'Interim steps' approach would involve the Boards taking one or more interim steps before implementing the fair value model.

Possible reasons for pursuing the 'Interim steps' approach

33. The 'Interim steps' approach would take some steps to move towards the fair value model. As such, accounting for financial instruments would (or could) be improved and simplified gradually.

34. Such an approach would also communicate to constituents that the Boards intend to move towards the fair value model and would result in some momentum towards the fair value model.

35. Another advantage of the 'Interim steps' approach is that convergence between IFRSs and US GAAP might be achieved sooner rather than later. However, the staff notes that the Boards have previously agreed not to make short-term amendments simply to eliminate the differences between IFRSs and US GAAP. Furthermore, the

adoption of the ‘Interim steps’ approach that results in convergence would require both Boards to agree the interim steps to be taken.

36. The ‘Interim steps’ approach would allow more time for related projects to make further progress. Such projects include those that are specific to financial instruments (for example, presentation and disclosures issues) and those that might impact the accounting for financial instruments such as the Financial Statement Presentation project.

Possible reasons for not pursuing the ‘Interim steps’ approach

37. Given the time and resources involved to develop and implement each interim step, the Boards might never achieve their long-term objective.

38. Numerous interim steps might be required before the fair value model is achieved. Significant Boards, staff and constituent resources will be required to develop and implement each interim step. Multiple steps may require multiple systems changes. In addition, each interim amendment requires the development of transitional provisions to help constituents implement the amendment smoothly. Such transitional provisions might impair the comparability and decision usefulness of information in the financial statements.

EXAMPLES OF THE NEXT POSSIBLE INTERIM STEP

39. As mentioned above, there may be a number of interim steps before requiring the fair value model. However, it is intended that the DPD will only discuss some examples of *the next step* under the ‘Interim steps’ approach – rather than attempt to set out all possible steps (and permutations of all possible steps) before requiring the fair value model.

Parameters for developing the next possible step

40. Parameters should be set to develop such examples. Such parameters will also enable respondents to comment on the examples contained in the DPD and to suggest other possible next steps consistent with the set parameters.

41. Such parameters might include:

- more financial instruments being remeasured at fair value (‘relevance’); and
- reducing complexity of existing standards (‘understandability’), including reducing alternatives and eliminating the role of management intent (‘comparability’)

Possible additional parameters

42. An additional parameter might be that any step should also be a meaningful change to existing requirements. However, an alternative approach might be to break down any possible step into a series of smaller steps. While such an alternative approach could be less efficient for both the Boards and constituents, it still maintains the momentum towards the long-term objectives of the Boards.

43. Another parameter could be that any possible interim step should increase convergence between US GAAP and IFRS.

44. As noted previously, the Boards are committed to converging the accounting for financial instruments. Following several discussions of possible short-term convergence projects, the Boards agreed that the most efficient approach is to converge on a simplified and improved standard in the longer term.

45. This does not preclude the IASB or FASB from undertaking separately a shorter-term project that is consistent with the joint long-term objectives of fair value measurement and simplifying or eliminating the need for special hedge accounting requirements.

46. This suggests that convergence between IFRSs and US GAAP is not necessarily a parameter for developing examples of a possible next interim step.

Relationship between the two suggested parameters

47. The two suggested parameters in paragraph 41 are of course interrelated.

48. Remeasuring more financial instruments at fair value would reduce overall complexity.

49. However, reducing complexity would not necessarily result in more financial instruments being remeasured at fair value.

50. It is possible that an interim step might simplify existing requirements but *not result in more* financial instruments being remeasured at fair value than is required today. That is, no progress is made towards the Boards' long-term measurement objective.

51. In addition, an interim step that results in *fewer* financial instruments being remeasured at fair value than currently required is inconsistent with the Boards' long-term objective of requiring all financial instruments to be remeasured at fair value.

QUESTIONS TO MEMBERS

52. **Do members have any comments or observations regarding the two approaches discussed in this paper? What are other possible approaches that should be included in the DPD?**

53. **Are the parameters suggested in this paper appropriate in order to develop and assess examples of the next interim step under the 'Interim steps' approach? If not, why not? What other parameters would you add, and why?**