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International Accounting Standards Board

INFORMATION FOR OBSERVERS

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

Financial Instruments: Due Process Document (DPD)

An approach to developing 'interim step' examples for the DPD

BACKGROUND TO PAPERS

1. This set of papers focuses on an 'interim steps' approach following consideration of comments received after publication of the DPD (see agenda paper 5A for background).

2. The Boards' long-term objectives in respect of the accounting for financial instruments is to require all financial instruments to be measured at fair value with realised and unrealised gains and losses being recognised in the period in which they occur. The preliminary view of the IASB is that all gains and losses should be recognised in profit or loss (the fair value model).

3. In addition, existing requirements are highly complex. Complexity arises because of long and detailed accounting requirements with alternative accounting treatments. Such requirements require (i) preparers and auditors to devote significant resources

to understand and apply the requirements and (ii) users to devote significant resources to understand the financial information and to use it for financial analysis.

4. Paper 5A discussed two parameters to develop examples of the next possible interim step for inclusion in the DPD. These were (1) to result in more financial instruments being remeasured at fair value, with changes in fair value being recognised in profit or loss immediately; *and* (2) to reduce complexity of the existing requirements.

PURPOSE OF THIS PAPER

5. This paper discusses an approach to developing examples of a next interim step using these two parameters. The suggested approach takes a principle-based fair value measurement approach with the aim of reducing complexity, but considers possible exceptions to that principle. This paper provides an outline of two examples of a next interim step developed using the suggested approach.

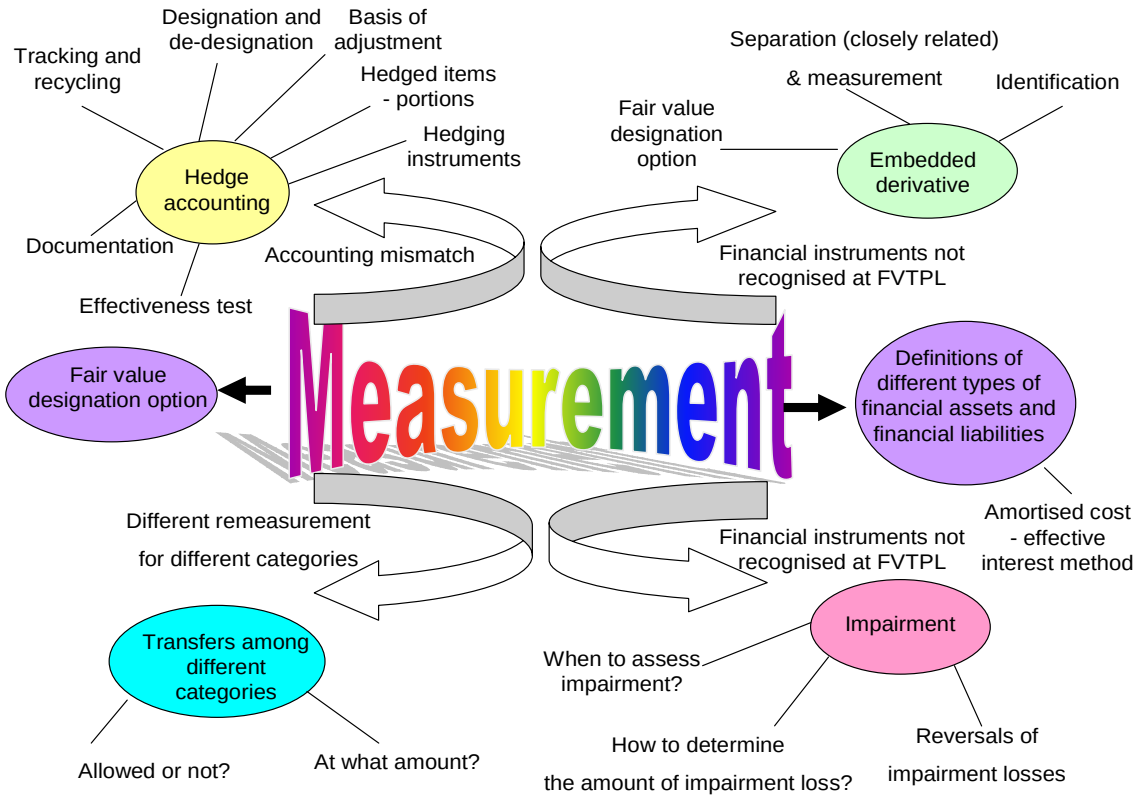
6. Paper 5C discusses the complexity arising from the exceptions to the fair value measurement principle suggested in this paper, and other possible exceptions suggested in that paper.

7. This paper asks for comments on the suggested approach to developing examples of the next interim step for inclusion in the DPD.

8. Where relevant, this paper makes reference to IFRS requirements (notably IAS 39 *Financial Instruments: Recognition and Measurement*). Similar references could also be made to US GAAP.

OVERVIEW OF THE SUGGESTED APPROACH

9. The Boards have been told *on many occasions* that existing requirements are extremely complicated. This is (to a large extent) depicted in the following diagram that summarises the requirements of IAS 39.



10. As illustrated in this diagram, the mixed cost-fair value measurement requirements of IAS 39 are the principal source of complexity.

11. To address this complexity, in developing examples of the next interim step for inclusion in the DPD, the staff suggests starting with one measurement principle – that is, the fair value measurement principle. Any deviations from the fair value measurement principle in the interim steps examples will be exceptions.

12. Such an approach is consistent with the Boards' long-term objective.

13. Some argue that the next interim step could be started elsewhere. For example, the next interim step could simplify a particular component of the existing standards, say, hedge accounting. However, such an approach is *not* an effective approach because measurement drives most of the complexity of the other components of the standard on financial instruments. In addition, such as approach does *not* meet parameter 1 set out in paragraph 4 of this paper (more financial instruments to be remeasured at fair value).

14. Alternatively, some may suggest that the starting point could be existing measurement requirements in IAS 39 (or US GAAP equivalent). However:

- Such an approach will not provide the means to significantly reduce complexity;

- Such an approach is *not* consistent with the fair value measurement principle. Existing requirements describe each different class of financial assets and financial liabilities and use these to drive measurement – this creates significant complexity, as noted above; and

- Such an approach is *not* consistent with the way that the DPD defines a financial instrument, a financial asset and a financial liability. The proposed definition of a financial instrument in the DPD is characteristic-based. The DPD simply describes a financial asset as a financial instrument that is an asset and a financial liability as a financial instrument that is a liability (see agenda paper 8A).

SO HOW DOES THE FAIR VALUE MEASUREMENT PRINCIPLE REDUCE COMPLEXITY OF EXISTING REQUIREMENTS?

15. Application of the fair value measurement principle dramatically reduces complexity of existing requirements; it reduces the need for voluminous and complex rules for establishing boundaries for selecting and using different measurement attributes.

16. The table below demonstrates how the fair value measurement principle significantly reduces the complexity of existing requirements.

Key components	Required if the fair value model is applied?
Measurement	Fair value measurement is the default. No need to describe each class of financial assets and financial liabilities. No requirement for effective yield guidance.
Impairment and uncollectibility of financial assets	Not required.
Transfers between different categories of financial instruments	Not required.
Hedge accounting	No more accounting anomalies between items within the scope of the fair value model[1], though demand for hedge accounting for the following hedges may still arise: (i) exposures to changes in the fair value of assets or liabilities outside the scope of the fair value model; and (ii) exposures to changes in the expected cash flows of a forecast transaction to buy or sell an item.
Embedded derivatives	Not required for derivatives embedded in hybrid contracts within the scope of the DPD. However, provisions for the identification and separation of derivatives embedded in hybrid contracts may still be required for the following hybrid contracts: (i) hybrid contracts with hosts outside the scope of the fair value model; and (ii) hybrid contracts that contain financial liability component and embedded equity component.

[1] This table considers a model in which all financial instruments are measured at fair value. Such a model would eliminate the demand for fair value hedges of 'portions' of financial instruments, which is a source of significant complexity in current requirements. This issue is discussed in greater detail in Paper 10A.

17. Some may argue that the application of the fair value measurement principle might result in greater complexity. For example, the complexity associated with the determination of fair value of a financial instrument. The staff notes that under IFRS 7 *Financial Instruments: Disclosures* an entity is already required to disclose the fair value of all financial instruments (with minor exceptions – see paragraph 29 of IFRS 7). Therefore, the application of the fair value measurement principle should *not* introduce further complexity in this respect.

18. However, a fair value requirement would inevitably increase scrutiny of fair value measurements; increased scrutiny may arise because such numbers are used in the financial statements (rather then 'simply' being disclosed), or because an entity may wish to manage the earnings effect of fair value measurements.

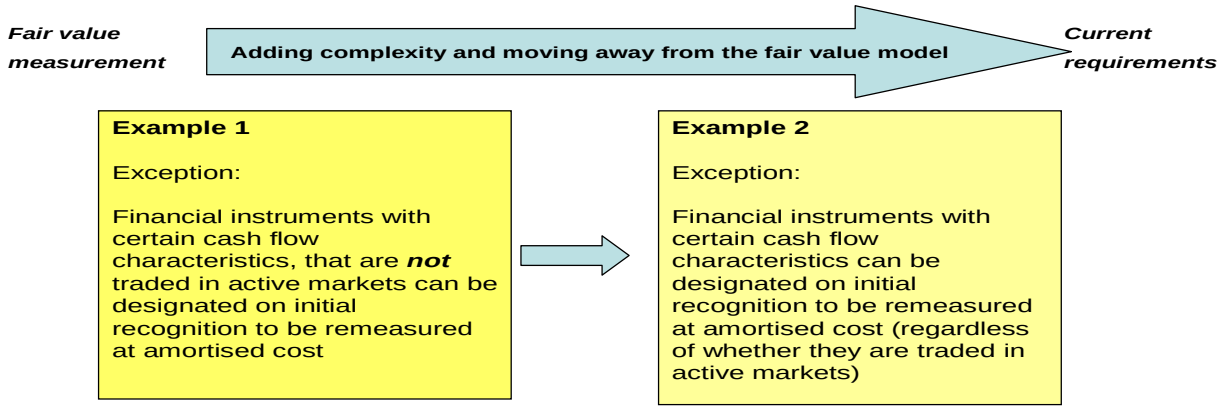
POSSIBLE EXAMPLES OF A NEXT INTERIM STEP

19. In developing examples of a next interim step, the suggested approach starts with fair value measurement principle. As previously discussed, the existing mixed cost-fair value measurement requirements are the source of much complexity.

20. Obviously, any interim step will require exceptions to this principle.

21. The question then is how many exceptions are required – given that each exception to the principle will create complexity.

22. Two possible initial exceptions to the fair value measurement principle are suggested below (others are suggested in paper 5C):



23. Examples 1 and 2 are different with regard to the extent of the exception to the fair value measurement principle. Specifically, with regard to whether those financial instruments that are allowed to be designated to be remeasured at cost should include those traded in an active market[2].

24. This paper does *not* discuss the cash flow characteristics on which each of the examples is based. However, the staff would envisage them to be similar to those set out in the IASB *Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities (the 'SME ED')*

25. In terms of measurement, Example 2 is similar to the approach set out in the SME ED.

26. The above diagram provides two possible examples. Other possible examples could include more or less exceptions to the fair value measurement principle.

[2] The use of the term 'active market' may create demand for further guidance on what is meant by 'active market'. There may be other better ways to describe the same thing; however this paper does not explore that issue.

27. For example, another possible exception to the fair value measurement principle might be equity instruments that are not traded in active markets.

28. **Question to members:**

(a) Do members have any comments or observations on the suggested approach to developing examples of a next interim step?

OTHER ISSUES

29. Complexity is inevitably created by making exceptions to the fair value measurement principle. Paper 5C discusses some of the consequences of the exceptions in the two examples.

30. The questions that directly arise from the measurement exception in the two examples include:

- When should an entity be permitted to designate an eligible financial instrument to be measured at cost?
- Should an entity be permitted to change the measurement of a financial instrument following initial recognition or designation at cost?

31. The following sections do not seek 'answers' to these questions, but rather summarises some considerations that might be relevant.

When should designation of a financial instrument at amortised cost be permitted?

32. Designation should not be permitted to be made retrospectively, for obvious reasons including the risk of 'cherry-picking' gains or losses.

33. The interim step examples could permit an entity to designate an instrument at cost only on initial recognition. This would be the simplest approach as it would not require any additional guidance regarding the cost base on designation (and all the consequential issues that arise from that). This is also consistent with the fair value option and the prohibition on transfers into or out of the fair value through profit or loss category in IAS 39.

34. An alternative might be to permit an entity to designate an eligible instrument at amortised cost at any point in time. However, this adds complexity and would

require the additional guidance set out above. In addition, this would be a bigger exception to the underlying principle of fair value measurement.

35. An issue related to this question is the accounting treatment if the terms of the instrument are changed (and the instrument is no longer eligible to be measured at cost) or the instrument starts being traded in an active market (see Example 2).

Should an entity be permitted to change the measurement of a financial instrument previously measured at cost to fair value?

36. Designation at cost could be irrevocable. This would eliminate the need for any reclassification requirements.

37. However, it may be more consistent with the fair value measurement principle to permit an entity to fair value a financial instrument that had previously been designated at amortised cost. This would, however, raise issues including:

- How the difference between the amortised cost and fair value should be accounted for? Should the difference be recognised in profit or loss?
- How the difference should be presented?

38. **Question to members:**

(a) Do members have any comments or observations with regard to the issues raised in paragraphs 29-37 of this paper?