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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 March 2007, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Next steps after issuance of the DPD (Agenda Paper 7)**

BACKGROUND

Fair value accounting model

1. 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 recognized in profit or loss immediately (the 'fair value model').

2. Compared with existing requirements, the fair value model will not only improve the financial reporting for financial instruments and other items in the scope of the DPD, but also significantly reduce complexity.

3. However, the DPD will not propose solutions to all issues related to the fair value model. For example, given the tight timetable, the DPD is unlikely to comprehensively address presentation and disclosure issues (such as aggregation or disaggregation of changes in fair values).

How to achieve the long-term objective of a fair value model for financial instruments

4. 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

5. 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.

6. This paper seeks the Boards' comments regarding the possible approaches the Boards might take to achieving the fair value model.

7. This paper does *not* ask for any preliminary views from the Boards. Obviously, until the Boards receive and analyse comments from respondents to the DPD, the Boards will not be in a position to decide how to progress.

OVERVIEW OF THIS PAPER

8. This paper discusses three possible approaches to moving towards the fair value model following consideration of comments from respondents to the DPD. The three approaches are:

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

   - Approach 2 – doing nothing. The Boards could decide to do nothing, but rather consider at some undefined future point what action, if any, could be taken to move towards the fair value model (the 'Wait and see' approach); or

   - Approach 3 – taking one or more interim steps before requiring the fair value model. Such an approach could result in eliminating differences between IFRS and US GAAP, and/or removing exceptions and alternatives in existing standards (the 'Interim steps' approach).

9. It is intended that the DPD will discuss some examples of the next step under the ‘Interim steps’ approach. This paper seeks the Boards’ comments on the parameters that might be used to develop such examples.

10. To help the Board set such parameters, this paper sets out one possible example of the next step and assesses that example against the suggested parameters.

11. A subsequent paper will discuss in more detail other possible examples of the next step.

APPROACH 1 – THE ‘ED’ APPROACH

12. Under Approach 1, the Boards would develop an ED based on the fair value model.

13. 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.

14. 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

15. 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;

    - 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.

16. Approach 1 would dramatically reduce the complexity of existing requirements – assuming that there are few exceptions to the underlying principles.

17. 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

18. The 'ED' approach would be the most efficient way for the Boards and their constituents to achieve the Boards' long-term objectives.

[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.

19. 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

20. 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).

21. 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

22. 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.

23. 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.

24. 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.

25. 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.

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

26. 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.

27. As mentioned above, it is not intended that the DPD will 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.

28. 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.

29. 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.

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[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.

30. 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

31. Alongside the development of an ED, the Boards could take additional steps 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 the Boards identify any necessary exceptions to the fair value model.

32. 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 'WAIT AND SEE' APPROACH

33. Under Approach 2, the Boards would not take any active steps to move towards the fair value model following consideration of comments from respondents to the DPD. Instead the Boards at some future date might reconsider what, if any, action should be taken to move towards their long-term objectives.

34. Some constituents may prefer the 'Wait and see' approach (although some Board members may believe that this approach is actually not an approach to moving towards the fair value model).

Possible reasons for pursuing the 'Wait and see' Approach

35. The 'Wait and see' approach has some advantages. One advantage is that it would 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.

36. In addition, the Boards and/or their constituents may prefer the 'Wait and see' approach to a series of amendments to existing requirements (as discussed under Approach 3 – 'Interim steps'), especially if the amendments do not significantly improve and simplify the accounting for financial instruments.

Possible reasons for not pursuing the 'Wait and see' approach

37. The 'Wait and see' approach would neither improve nor simplify current requirements, despite demand from some constituents.

38. If the 'Wait and see' approach was adopted, there would be a possibility that existing requirements would actually become *more* complicated. 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 do little to simplify existing requirements.

39. Furthermore, if the 'Wait and see' approach was adopted, there would be a risk that the Boards might lose momentum towards the fair value model. This certainly happened following the Joint Working Group proposals in *Financial Instruments and Similar Items* (despite the enormous time and effort that was dedicated to the development of that document).

40. Finally, as mentioned above, the Boards agreed to achieve convergence on standards on financial instruments through developing an improved and simplified standard in the longer term. The 'Wait and see' approach would make no progress on convergence.

APPROACH 3 – THE 'INTERIM STEPS' APPROACH

41. The 'Interim steps' approach would involve the Boards taking one or more interim steps before implementing the fair value model. Such an approach could include eliminating differences between IFRSs and US GAAP, and/or removing exceptions and alternatives in existing standards.

Possible reasons for pursuing the 'Interim steps' approach

42. Unlike the 'Wait and see' approach, 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.

43. Such an approach better communicates with constituents that the Boards intend to move towards the fair value model than the 'Wait and see' approach. The 'Interim steps' approach would maintain the Boards' momentum towards the fair value model.

44. Another advantage of the 'Interim steps' approach is that differences between IFRSs and US GAAP could be reduced. However, the staff notes that the Boards have previously agreed not to make short-term amendments 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.

45. 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

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

47. 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

48. 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

49. The Boards should set parameters 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.

50. Such parameters might include:

- more financial instruments being remeasured at fair value ('relevance');
- reducing complexity of existing standards ('understandability');
- reducing alternatives and eliminating the role of management intent ('comparability'); and
- moving towards convergence with US GAAP.

51. 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 may result in stronger momentum towards the long-term objectives of the Boards.

52. There could be a large number of possible steps that meet at least one of the above-mentioned parameters. Some examples of a next step may meet one or more, but not all, of these parameters. Therefore, it would be helpful if the Boards could decide if any parameter(s) should take precedence over the others – particularly the relationship and trade-offs between the suggested parameters of reducing complexity and more financial instruments being remeasured at fair value.

53. To help with this discussion, the following section summarises one possible example of the next step and discusses how the chosen example fits with the parameters suggested above.

54. Paragraphs 54 – 81 omitted from Observer Notes.

QUESTIONS TO THE BOARDS

82. **Do the Boards have any comments on the three approaches to moving towards the fair value model? Do the Boards wish to add any other possible approaches?**

83. **Do the Boards have any comments on the suggested parameters for developing examples of the next step under the 'Interim steps' approach? What other parameters do the Boards wish to add? Do the Boards wish to prioritize any particular parameters?**

APPENDIX 1

Appendix omitted from Observer Notes