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International Accounting Standards Board

This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **February 2008, London**

Project: **FINANCIAL INSTRUMENTS**
(*Agenda Paper 5*)

INTRODUCTION

1. The purpose of this session is to:

    a. provide members with an update about the discussion paper *Reducing Complexity in Reporting Financial Instruments* that will be published shortly

    b. discuss the proposed questions included in the draft discussion paper

    c. request input from members regarding how the purpose of the discussion paper can be effectively communicated to constituents.

2. This paper contains a brief summary of the draft discussion paper. The staff intend to do a short slide presentation to members before asking members for their views and comments.

PROJECT BACKGROUND

3. At their joint meeting in April 2006, the IASB and FASB agreed to a goal of issuing a due process document (discussion paper) on financial instruments in 2008. This document was envisaged in the Memorandum of Understanding (MOU) between the boards that was issued in February 2006.

4. The purpose of the discussion paper is to ask constituents how the boards should respond to requests to improve and simplify the reporting of financial instruments; many urge the boards to produce standards that are principles-based and less complex than today's requirements.

5. The discussion paper is intended to form the basis for future discussion by the boards of issues related to *measuring* financial instruments (including hedge accounting requirements).

OVERVIEW OF DRAFT DISCUSSION PAPER

6. The draft discussion paper consists of background information, three sections and a number of appendices.

7. The Background describes some sources of today's problems. One source is that financial instruments themselves are complex.

8. Another problem identified in the background is the difficulty for:

    a. financial statement preparers and their auditors to understand and apply today's requirements, and

    b. users of financial statements to understand and use information in the financial statements.

9. The sources of that difficulty include:

    a. the number of exceptions to the principles underlying today's requirements

b. the many different ways that financial instruments are measured, and the associated rules required

c. cash flow hedge accounting

d. other issues such as scope, unit of account and derecognition of financial instruments.

10. Section 1 emphasises that the draft discussion paper primarily addresses measurement and related problems (including hedge accounting). However, the importance of presentation and disclosure is highlighted throughout the draft discussion paper.

11. Section 1 suggests that a *long-term* solution to resolve many measurement and related problems is to use one measurement method that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

12. Section 2 discusses possible ways that existing measurement and related requirements for financial instruments might be improved and simplified more quickly than an approach of using one measurement method (an ‘intermediate’ approach).

13. Section 2 sets out the criteria for any intermediate changes, and discusses three broad approaches:

a. to amend the existing measurement requirements (to eliminate or change today’s classification categories)

b. to replace the existing measurement requirements with a principle of fair value measurement, but to allow some optional *exceptions*

c. to simplify hedge accounting (by replacing today’s fair value hedge accounting with some other mechanism, and/or to simplify today’s hedge accounting requirements while maintaining discipline regarding the reporting of earnings).

14. These approaches could be considered together or in isolation. There may be other possible approaches. Section 2 also highlights the importance of presentation and disclosure.

15. Section 3 discusses a long-term solution of using one measurement method that is appropriate for all types of financial instruments within the scope of a standard for financial instruments. This section summarises why fair value appears to be the only measurement attribute that provides appropriate information (from a recognition perspective) for all different types of financial instruments. Section 3 also acknowledges that a general fair value measurement requirement is a *long-term* objective, and discusses the concerns and problems associated with fair value and the presentation of changes in fair value. These include:

   a. the volatility and stability of earnings

   b. the recognition and presentation of unrealised gains and losses of financial instruments (including measurement reliability in non-active markets, recognising gains and losses that might never be realised and unrealised gains on financial liabilities when bad things happen)

   c. the complexity associated with fair value measurement, including complexity arising from measurement issues, presentation and disclosures (for example, through possible disaggregation of fair value changes).

16. Section 3 also summarises issues the boards have to address before fair value measurement for financial instruments could become a general requirement. These include:

   a. the presentation of the effects of fair value changes (including any disaggregation)

   b. the disclosure of information

   c. the definition of fair value and how the fair values of particular instruments should be measured

d. scope and related issues (including the appropriate definition of a financial instrument)

PROPOSED QUESTIONS TO BE INCLUDED IN THE DISCUSSION PAPER

17. As noted, the purpose of the discussion paper is to solicit views as to how the boards should address today's measurement and related problems.

18. In the staff's view, the proposed questions to respondents are the most important part of the document.

19. The appendix sets out the draft questions. The staff welcome the views of members as to whether:

    a. the proposed questions are clearly expressed. If not, what changes would you make?

    b. the proposed questions are the right questions.

    c. the document should ask other questions. If so, what additional questions should be asked and why should they be asked?

COMMUNICATION ABOUT THE DISCUSSION PAPER

20. The purpose of the draft discussion paper is to ask for views as to how the boards should respond to requests for standards for financial instruments that are principles-based and that are less complex than today's requirements.

21. The staff welcomes any comments or suggestions from members as to how the IASB could most effectively communicate with constituents the purpose of the discussion paper.

APPENDIX

Background

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the boards respond to assertions that the current requirements are too complex?

Section 1 Problems attributable to the many ways of measuring financial instruments

Question 2

To reduce today's measurement-related problems, Section 1 suggests that the long-term solution is to measure all financial instruments within the scope of a standard for financial instruments the same way.

> Do you believe that accounting for all financial instruments within the scope of a standard for financial instruments the same way could avoid some of today's complexity, and that measuring all financial instruments the same way would be an important milestone for the boards in addressing today's measurement-related complexity?

Section 2 Intermediate approaches to address measurement and related problems

Question 3

(a) Should the boards consider intermediate approaches to address measurement-related complexity? Why or why not?
(b) If so, which approach or approaches would you recommend to the boards? Why?

Question 4

Approach 1 is to amend existing measurement requirements. If you support Approach 1, what specific suggestions would you make to the boards? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph [1]?

Question 5

Approach 2 is to replace existing measurement requirements with a fair value measurement principle with some optional exceptions. If you support Approach 2:

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph [1]?
(b) How should instruments that are not measured at fair value be measured?
(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?
(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph [1]?
(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph [1]?

Question 6

Approach 3 sets out [three] possible methods of replacing fair value hedge accounting.

(a) Which method(s) (if any) should the boards consider, and why?

(b) Are there any other methods (not discussed in this section) that should be considered by the boards? If so, what are they and how are they consistent with the criteria set out in paragraph [1]? If you suggest changing measurement requirements under Approach 1, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

Question 7

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the boards regarding how the existing hedge accounting models could be simplified?
(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?
(c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.
(d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a

hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

Section 3 A long-term solution to reduce today's measurement-related problems

Question 8

Part A of Section 3 suggests that fair value is the only measurement attribute that is appropriate for all financial instruments within the scope of a standard for financial instruments.

(a) Is there a measurement attribute other than fair value that is appropriate for all financial instruments within the scope of a standard for financial instruments?

(b) If so, what is it and why do you think that measurement attribute is appropriate for all financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

Question 9

Part B of Section 3 sets out concerns with fair value measurement of financial instruments.

(a) Are there any significant concerns with fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they concerns?

(b) How should the boards address those concerns (including those identified in Section 3)?

Question 10

One issue discussed in Part B of this section is whether the information required to determine the fair value of instruments with highly variable cash flows is sufficiently objective and verifiable for financial reporting purposes (see paragraphs []). The resulting question raised is:

> whether it is better to use objective information for recognition purposes (eg cost or proceeds of an instrument) that generally bears little or no relation to current value or future cash flow prospects, or to use an amount that is intended to represent current value but may be subjective and may change significantly from period to period.

What are your views on this question?

Question 11

Another issue discussed in Part B of this section is whether information about gains and losses that are unlikely to be realised is of any use (see paragraphs []). The resulting question raised is:

> Are the benefits of using a single measurement for all financial instruments within the scope of a standard for financial instruments outweighed by including in earnings gains and losses that are unlikely to be realised?

What are your views on this question?

Question 12

Part B of this section addresses whether an entity should recognise unrealised gains or losses on financial liabilities arising from changes in credit risk. Part B also acknowledges the importance of separately reporting unrealised gains and losses on financial liabilities arising from changes in credit risks.

> Do you believe that an entity should or should not recognise unrealised gains and losses on financial liabilities arising from changes in credit risks? Why? What are the consequences of your views for the problems that arise from measuring financial instruments in different ways?

Question 13

Part C of Section 3 identifies [four] issues that the boards need to resolve before proposing fair value measurement as a general requirement for all financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the boards should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the boards address them?

(b) Do you believe that the boards could require the general fair value measurement for financial instruments before they resolve all of the issues identified in Section 3? In your view, are there any issues that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why?

Overall document

Question 14

Do you have any other comments for the boards regarding how they could improve and simplify the accounting for financial instruments?