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**International Accounting Standards Board**

*This document is provided as a convenience to observers at the Global Preparers Forum meeting, to assist them in following the discussions. 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 papers prepared for the GPF meeting. Paragraph numbers correspond to paragraph numbers used in the GPF agenda paper.*

**INFORMATION FOR OBSERVERS**

**Global Preparers Forum Meeting: July 2008, London**

**Project: The Credit Crisis**

*(Agenda Paper 5)*

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1. The current state of the financial markets has generated a significant amount of debate and led to the publication of many reports that attempt to identify how regulators, preparers, auditors, rating agencies and accounting standard setters could take steps to avoid similar difficulties in the future.

## Financial Stability Forum

2. The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. In April 2008 the FSF issued a report, *Enhancing Market and Institutional Resilience the Financial Stability Forum*, to the G7 Ministers and Central Bank governors.

3. The FSF report analyses the causes and weaknesses that have led to the current financial market turmoil and set out recommendations for increasing the resilience of markets in the future.

4. The report is the result of an intensive collaborative effort of many national bodies and international organisations, including the IASB. The report recommends actions in the following areas:

   (a) Strengthened prudential oversight of capital, liquidity and risk management
   (b) Enhancing transparency and valuation
   (c) Changes in the role and uses of credit ratings
   (d) Strengthening the authorities' responsiveness to risks
   (e) Robust arrangements for dealing with stress in the financial system

5. The report also recommends that the IASB:

   (a) improve the accounting and disclosure standards for off-balance sheet vehicles;
   (b) improve the guidance and disclosures about valuations, methodologies and the uncertainty associated with valuations;
   (c) examine the requirements and principles for disclosures about the valuation of financial instruments to identify areas in which they can be improved; and
   (d) enhance guidance on valuing financial instruments when markets are no longer active.

## Our response

6. In response to the credit crisis, and the FSF recommendations, we have increased the priority being given to the consolidation and derecognition projects—both of which we had been working on before the current credit crisis developed: We have also started two new initiatives—a review of IFRS 7 *Financial Instruments: Disclosures* and the establishment of an expert advisory panel.

**Consolidation**

7. Consolidation involves identifying the circumstances in which an entity should combine its financial statements with those of another entity- including special purpose entities and structured investment and securitisation vehicles. The goal of

the Consolidation project is to publish a single IFRS on consolidation to replace IAS 27 Consolidated *and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*. That is to say, the control criteria within a single IFRS should be developed for all entities.

8. Our work on a revised control definition will focus on the consolidation of structured entities. Other issues include assessing whether reputational risk is an appropriate basis for consolidation. We are also improving the guidance in relation to power with less than a majority of the voting rights; potential voting rights; veto rights; economic dependence and applying the control concept to fiduciaries.

9. Our work on disclosures aims to provide users of financial statements with information about:

   (a) the judgements made by management when reaching decisions to consolidate or not;

   (b) the nature and financial effect of restrictions on assets and liabilities resulting from legal entity boundaries that exist within the reporting group; and

   (c) the nature of, and risks associated with, the reporting entity's significant involvement with legal entities that it does not control.

10. The first draft of an exposure draft will be presented to the Board in July, and will be publicly available. We intend using that draft as the basis for seeking input from preparers and the major accountancy firms. We expect to hold public round-tables in September or October. From those consultations, which can be thought of as an extended fatal-flaw review, we will prepare an exposure draft for formal public comment. If the initial review indicates general support for the proposals we expect to publish the exposure draft in the fourth quarter of this year.

**Derecognition**

11. Derecognition involves identifying the circumstances in which it is appropriate for an entity to remove an asset from its balance sheet. We are accelerating our work on this project. A project on derecognition is currently being considered as part of our formal agenda proposal process.

### IFRS 7 review

12. We have begun reviewing IFRS 7 *Financial Instruments: Disclosures*, to assess its effectiveness in ensuring that entities disclose information that reflects their exposure to risk and any potential losses arising from financial instruments with the off-balance sheet entities with which they are involved. IFRS 7 includes disclosure requirements in relation to fair value measurement and these requirements are included in our review.

13. We expect to have proposals for the Board to consider at its September meeting.

### Expert advisory panel

14. We have created an expert advisory panel to discuss the valuation of financial instruments in inactive markets and the related disclosures. The discussions of the panel will provide input for our work on financial instruments and fair value measurement. The panel will assist us in:

    (a) reviewing best practices in the area of valuation techniques, and

    (b) formulating any necessary additional practice guidance on valuation methods for financial instruments and related disclosures when markets are no longer active.

15. The discussions of the panel members over the next few weeks will give the Board insight into the type and extent of additional guidance that might be necessary in this area and the form of any such guidance.

16. The discussions of the panel will provide input for our work on financial instruments and fair value measurement. The panel's views will be discussed with other interested parties before the Board makes any decision on guidance to be issued.

17. The expert advisory panel comprises experts from preparers and users of financial statements, as well as regulators and auditors. Participants have been selected based on their practical experience with the valuation of financial instruments in the current market environment.

*First meeting*

18. The expert advisory panel met for the first time on 13th June 2008 in London to identify specific valuation and disclosure issues encountered in practice in the current market environment.

19. The issues relating to measurement included:

(a) **Selection of a valuation technique**: The panel discussed how to select an appropriate valuation technique, and when that valuation technique might or should be changed.

(b) **Calibration of valuation model**: The panel discussed when and how a valuation model should be calibrated to actual transactions when applying a particular valuation technique.

(c) **Use of third-party price quotes**: The panel discussed the use of, and reliance upon, price quotes by third-parties (for example, brokers or pricing services) when transactions have occurred and when quotes were indicative and no transactions were occurring, and what to do when those indicative quotes differ from the value derived from a model.

(d) **Adjustments to valuation models**: The panel discussed the types of adjustments that should be made to the model to reflect the value of the instrument being valued, and how such adjustments might be determined. For example, the panel discussed whether and how adjustments to reflect liquidity should be made.

(e) **Meaning of 'observable' and 'significant' inputs**: The panel discussed what 'observable' and 'significant' meant in the context of inputs to a valuation model. This is important to determine the level in the fair value hierarchy (Level 1, Level 2 or Level 3) of the fair value hierarchy in FASB Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157).

(f) **Distinguishing between active and inactive markets**: The panel discussed how to distinguish between an active market and an inactive market, and the importance of being able to determine when fair value might be based on something other than an observed transaction price.

(g) **Forced transactions and distressed sales**: The panel discussed whether observed market prices could ever clearly identify forced or distressed sales and, if so, the implications of using such prices.

(h) **Measurement of changes in own credit**: The panel discussed how to measure changes in own credit.

20. The issues relating to fair value disclosures included:

(a) **Disclosures using the fair value hierarchy**: The panel noted that banks outside the US have begun using the fair value hierarchy terminology in SFAS

157, that is ‘Level 1,’ ‘Level 2’ and ‘Level 3’, when discussing disclosures and inputs to valuation techniques. The panel discussed whether any relationships between instruments in different levels of the hierarchy should be disclosed.

(b) **Disclosures of valuation techniques, inputs, sensitivities and ranges**: The panel discussed whether disclosures might be improved if the material data inputs used, and the valuation sensitivities of those inputs, were disclosed. The panel also discussed whether sensitivities would be more meaningful if they are presented in the aggregate (eg under an ‘adverse outcome’ scenario) rather than at an individual input level (eg changing one input at a time, holding all others constant).

21. In the last few weeks, a subset of panel members has met twice to discuss specific practice issues in detail. The focus of those meetings has been on measurement issues. We have a third meeting at the end of this month to consider disclosures.

22. To ensure that the panel is able to discuss freely the practical issues that have arisen in the credit crisis, these meetings will be held in private sessions. However, a summary of the discussions will be presented to the Board in a public meeting and will be published on our Website.

**Reducing Complexity in Reporting Financial Instruments**

23. The existing requirements for the reporting of financial instruments are widely regarded as being difficult to understand, interpret and apply and constituents have urged us to develop standards that are principle-based and less complex. The discussion paper on reducing complexity in reporting financial instruments is the first stage in a project which aims to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

24. The discussion paper analyses the main causes of complexity in reporting financial instruments and proposes possible intermediate approaches to address some of them. Those approaches seek to improve and simplify measurement and hedge accounting by amending or replacing the existing requirements. Furthermore the discussion paper sets out the arguments for and against a possible long-term approach that would use one measurement method for all types of financial instruments in the scope of a financial instruments standard.

25. We are seeking views on both the possible long-term and intermediate approaches and are interested to hear about possible alternatives on how it should proceed in developing new standards for reporting financial instruments that are principle-based and less complex.

26. IAS 39, which we inherited from our predecessor body, is far too complex. We are determined to simplify and improve IAS 39 by creating a principle-based standard. Those who believe in reducing complexity in accounting standards have now the opportunity to shape the way ahead.

27. The discussion paper is open for comment until 19 September 2008.