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*This document is provided as a convenience to observers at the Standards Advisory Council 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 SAC meeting. Paragraph numbers correspond to paragraph numbers used in the SAC agenda paper.*

### **INFORMATION FOR OBSERVERS**

**SAC Meeting:**            **November 2008, London**

**Project:**                **Recognition and Measurement of Financial Instruments -  
Agenda Proposal**

*(Agenda Paper 3)*

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### **INTRODUCTION**

1. This paper discusses a proposal to add to the IASB's active agenda a project on recognition and measurement of financial instruments. The project 'Financial Instruments: A Replacement of IAS 39 *Financial Instruments: Recognition and Measurement*' is on the IASB's research agenda.
2. This paper:
  - a) summarises the background of the project to replace IAS 39
  - b) discusses whether the project meets the IASB's agenda criteria

c) provides a staff recommendation

d) asks the IASB whether it wants to add the project to its active agenda.

## **BACKGROUND OF THE PROJECT TO REPLACE IAS 39**

3. IAS 39 sets out requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.
4. IAS 39 was originally issued by the Board's predecessor body, the International Accounting Standards Committee (IASC). A revised IAS 39 was issued in December 2003 as part of the 'Improvements' project. However, that project did not entail addressing the fundamental basis of IAS 39.
5. For some time the Board has acknowledged the need to improve the reporting of financial instruments and to reduce the complexity of that reporting. IAS 39 has been amended several times since 2003 for various reasons, but the Board has not reconsidered the fundamental requirements of IAS 39.

## **Work performed to date**

6. The research project referred to in paragraph 1 of this paper is included in the Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006-2008*. One of the goals for 2008 set out in that MoU was 'to have issued one or more due process documents relating to the accounting for financial instruments' (the project is also included in the updated MoU).
7. In accordance with the 2008 goal, the IASB published the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* in March 2008. The FASB also published an Invitation to Comment, which included the IASB's Discussion Paper.

8. The Discussion Paper set out several possible approaches for improving and simplifying the accounting for financial instruments. The discussion paper focussed on measurement and hedge accounting. Over 160 comment letters have been received to date, and at the joint IASB-FASB meeting in October 2008 the staff presented a summary of the comments received (the Observer Notes from that meeting are included in appendix one for reference).
9. The IASB added a project on derecognition to its active agenda in July 2008. This proposed project would address other aspects of reporting for financial instruments.

#### **Decisions taken at the joint IASB-FASB meeting in October 2008**

10. As part of our commitment to work in an internationally coordinated manner to consider accounting issues emerging from the global crisis the IASB and the FASB (the Boards) decided at the joint meeting in October 2008 to establish an advisory group comprised of senior leaders with broad international experience with financial markets.
11. The advisory group will be asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The group will be asked to identify any accounting issues that require urgent and immediate attention of the boards as well as issues for longer-term consideration.
12. In developing their approaches on issues resulting from the discussions the boards will follow appropriate due process. In the interest of transparency, the advisory group will meet in public session with webcasting facilities available to all interested parties.
13. While the advisory group is being established, the boards will also organise three roundtables—one each in Asia, Europe and North America. The purpose of these

public roundtables is to gather input on reporting issues emanating from the current global financial crisis—including responses by governments, regulators and others. This should enable the boards to act rapidly and the advisory group, once established, to advance its deliberations efficiently. The first roundtable will be held in London on 14 November.

14. In addition to considering the potential for short-term responses to the credit crisis, both boards emphasised their commitment to developing common solutions aimed at providing greater transparency and reduced complexity in the accounting of financial instruments. The boards will use their joint discussion paper *Reducing Complexity in Reporting Financial Instruments*, the responses received to the discussion paper, and the deliberations of the high-level advisory group as starting points for this longer term objective. The boards will reconsider the composition of the existing IASB Financial Instruments Working Group to ensure that working group provides appropriate and balanced advice to both boards.

15. The press release announcing these decisions is in appendix two.

### **Agenda decision by the FASB**

16. The FASB has announced its intention to consider adding a project on financial instruments to its active agenda concurrently with the IASB.

17. The staffs of both boards believe it to be important that a project is added to the active agenda of both the IASB and FASB to ensure that the boards can improve the reporting for financial instruments on a timely basis.

### **IASB'S AGENDA CRITERIA**

18. The IASB due process handbook sets out five criteria to be considered in deciding whether to add an item to the agenda.

**Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided**

19. Criterion 1 considers whether the project addresses the needs of users across different jurisdictions. The criterion considers the following factors:

- a) international relevance
- b) pervasiveness
- c) urgency
- d) consequences of not adding the project to the agenda.

20. The credit crisis and the reactions of governments, regulators, and investors demonstrate that measurement of financial instruments is an issue that has widespread international relevance.

21. Recent developments have also resulted in new challenges for financial reporting. Determining fair value in circumstances where previously active markets become inactive has evolved as an issue. Moreover, users as well as preparers themselves were often unsure of, and sometimes even surprised about, the exposure of entities to particular risks arising from some financial instruments.

22. The reporting of financial instruments (and of course the effects of the credit crisis) is relevant to all industry sectors. This is demonstrated by the diversity of responses to the recent discussion paper.

23. Many constituents have requested that the accounting for financial instruments be improved and simplified. The number and variety of issues addressed both by the

Board and the IFRIC illustrates the need for improvements in this area. The recent development of the credit crisis has resulted in a particular urgency to revisit the accounting for financial instruments. The consequences of the IASB not improving the accounting for financial instruments on a timely basis may include increased diversity in practice, reduced comparability and (most importantly) the threat of reduced transparency for users of financial statements at a time when increased transparency is vital to restoring confidence in markets.

24. The staff thinks a project on recognition and measurement of financial instruments meets Criterion 1.

**Criterion 2: Existing guidance available**

25. Criterion 2 considers whether the project will address an area on which existing guidance is insufficient.

26. There is much guidance available today – however the IASB’s Discussion Paper *Reducing Complexity in Reporting Financial Instruments* is testimony by itself that the current requirements of IAS 39 are difficult to understand and apply. There is also much anecdotal evidence from preparers and auditors that accounting for financial instruments is a particularly complex and difficult area, and from users that the financial information produced is difficult to understand and not useful to them in making investment decisions. Of course, there have also been many requests for IFRIC and the Board to clarify the requirements of IAS 39 over the past few years.

27. Examples of issues that have arisen in practice in applying IAS 39 are various unit of account questions, effective interest rate calculations, bifurcation of embedded derivatives, when impairments are triggered, reversals of impairment, the impact of credit quality on derivatives and the related knock-on effects on hedge accounting, and the valuation of instruments whose markets have become inactive.

28. The staff thinks a project on recognition and measurement of financial instruments meets Criterion 2. There are criticisms and practice problems related to the current requirements. Moreover, requirements in IFRSs and US GAAP are different, particularly at a detailed level.

### **Criterion 3: The possibility of increasing convergence**

29. Criterion 3 considers whether undertaking the project would increase the possibility of achieving convergence of accounting standards in different jurisdictions.

30. As noted in paragraph 8, a project on replacing the existing Standard on accounting for financial instruments is included in the MoU between the IASB and FASB.

31. As noted previously, the boards emphasised their commitment to developing common solutions aimed at providing greater transparency and reduced complexity in the accounting of financial instruments at the October 2008 joint meeting. The FASB will also consider adding a project on financial instruments to its active agenda concurrently with the IASB.

32. The staff believes that the boards have a significant opportunity to improve and converge the requirement for financial instruments, and therefore that the proposed project meets Criterion 3.

### **Criterion 4: The quality of the standards to be developed**

33. Criterion 4 considers the quality of the standards that are proposed to be developed. This criterion considers the following factors:

- a) availability of alternative solutions
- b) cost/benefit considerations

c) feasibility.

34. The IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments* includes a number of alternatives to improving the reporting for financial instruments, including introducing a general fair value measurement requirement. Others have made alternative suggestions.
35. The costs of implementing new requirements will depend on any change made, and this will be an issue the Board will need to consider in deciding how to proceed. It is also important to note that such costs apply to all constituents. One thing is clear - that respondents to the discussion paper do not want a series of changes.
36. The benefits of improving and simplifying the requirements for financial instruments could be significant to both users and preparers. As with costs, this is an important consideration for the Board in deciding how to proceed.
37. In the light of the discussions of alternative solutions and other discussions that have already taken place the staff is confident that developing solutions within a reasonable period of time is feasible. The staff thinks that the challenge lies in the diverging views among constituents about the preferable way of improving financial reporting and reducing complexity. The additional challenge is for the Board to balance the need for any short-term improvements to current requirements with the development of solutions aimed at providing greater transparency and reduced complexity.
38. The staff thinks that there are identified feasible alternative solutions that will improve financial reporting. Hence, the staff thinks that the proposed project meets Criterion 4.



## **Criterion 5: Resource constraints**

39. Criterion 5 considers whether there are sufficient resources to undertake the project.

The criterion considers the following factors:

- a) availability of expertise outside the IASB
- b) amount of additional research required
- c) availability of resources.

40. The IASB has access to valuable external expertise through the Financial Instruments Working Group (FIWG) and its interaction with other interested groups such as the Financial Stability Forum. In addition, the initiatives announced by the boards (roundtables, high-level advisory group etc.) will provide other valuable sources of input and advice for the boards.

41. As noted previously, the IASB and FASB are committed to addressing the issues set out in this agenda proposal together. The IASB staff therefore expects that the project team would consist of both IASB and FASB staff. In the staff's view there are sufficient staff resources with financial instrument accounting expertise, banking and relevant industry experience, and staff who are familiar with practice problems related to the current requirements to address the challenges (on a timely basis) that the proposed project will inevitably create.

42. Based on the above, the staff thinks a project on recognition and measurement of financial instruments meets Criterion 5.

## **STAFF RECOMMENDATION**

43. The staff believes that a project on recognition and measurement of financial instruments meets the agenda criteria. Therefore, the staff recommends that the project is moved from the research agenda to the IASB's active agenda.

## **INPUT FROM THE STANDARDS ADVISORY COUNCIL (SAC)**

44. The staff intends to discuss the proposed project with the SAC on 13 November 2008 and to seek the views of SAC members. The staff will provide a verbal update to the Board following that discussion.

## **QUESTION FOR THE BOARD**

45. **Does the Board agree that a project on recognition and measurement of financial instruments should be added to the active agenda? If not, why?**