

## Staff Paper

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### Response to the Global Financial Crisis

1. The International Accounting Standards Board (IASB), as part of its response to the global financial crisis, took a series of actions to address recommendations made by the G20 leaders in November 2008.

#### **Consolidation and improved accounting for off balance sheet items**

2. On 18 December, we published proposals to strengthen and improve the requirements for identifying which entities a company controls.
3. The proposals form part of our comprehensive review of off balance sheet activities and address an area cited by the G20 leaders at their 15 November meeting. The proposals also respond to the recommendations contained in a report published in April 2008 by the Financial Stability Forum (FSF).
4. The use of special structures by reporting entities, particularly banks, to manage securitisations and other more complex financial arrangements was highlighted by the FSF and the G20 as a matter of concern. Some commentators have questioned whether the current requirements have resulted in all the assets an entity controls and all its liabilities being brought onto the

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This paper has been prepared by the technical staff of the IASB for the purposes of discussion at the meeting identified in the heading this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board of the IASB.

Any decisions made by the Board at the meeting at which this paper is discussed will be reported in *IASB Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

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balance sheet. Similar concerns exist that financial statements do not convey the extent to which reporting entities are exposed to risks from those types of structures.

5. The proposals address those concerns by presenting a new, principle-based, definition of *control of an entity* that would apply to a wide range of situations and be more difficult to evade by structuring. The proposals also include enhanced disclosure requirements that would enable an investor to assess the extent to which a reporting entity has been involved in setting up special structures and the risks to which these special structures expose the entity. The proposals would apply not only to the banking sector but to any entity that uses legal entities to manage its activities.

### **Derecognition**

6. Further proposals on off balance sheet items, covering the derecognition of financial assets and liabilities, are due to be published at the end of the first quarter of 2009, consistent with the G20 target date of 31 March 2009.

### **Financial Instruments**

#### **Short term**

##### **Amendment to IAS 39 Reclassification of financial assets**

7. As a result of the crisis and amid complaints from the EC that entities using IFRS were at a disadvantage in comparison to their US counterparts, the board issued an amendment to IAS 39 to permit reclassifications of some financial assets in particular circumstances. While bringing US generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) more in line, different scope, transition and impairment requirements meant that differences in treatment would still exist. The incident revealed

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sharply the problems for investors if two different sets of accounting rules for identical situations exist.

### **Exposure Draft Improving Disclosures About Financial Instruments – October 2008**

8. The exposure draft proposed amendments to disclosure requirements that are based on a three-level fair value hierarchy (similar to that used in Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* issued by the US Financial Accounting Standards Board). The proposed amendments would require disclosures about the level of the fair value hierarchy into which fair value measurements are categorised in their entirety, the fair value measurements resulting from the use of significant unobservable inputs to valuation techniques and the movements between different levels of the fair value hierarchy.
9. The exposure draft also proposes amendments that would clarify the definition of *liquidity risk*, improve the quantitative disclosures about liquidity risk, and strengthen the relationship between qualitative and quantitative disclosures about liquidity risk.
10. The Board discussed the comments received at its meeting in January and decided to proceed with most of the proposals.

### **Educational Guidance on the Application of Fair Value Measurement of financial instruments when markets become inactive**

11. The guidance took the form of a summary document prepared by IASB staff and the final report of the expert advisory panel established to consider the issue.
12. The summary document set out the context of the expert advisory panel report and highlights important issues associated with measuring the fair value of financial instruments when markets become inactive. It took into consideration and is consistent with documents issued by the US Financial

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Accounting Standards Board (FASB) on 10 October and by the Office of the Chief Accountant of the US Securities and Exchange Commission (SEC) and FASB staff on 30 September.

13. The report of the expert advisory panel is a summary of the seven meetings of experts who were users, preparers and auditors of financial statements, as well as regulators and others. In the report, the panel identifies practices that experts use for measuring the fair value of financial instruments when markets become inactive and useful practices for fair value disclosures in such situations. The report provides useful information and educational guidance about the processes used and judgements made when measuring and disclosing fair value.
14. The IASB has also used the work of the panel to address the issues of disclosure, an area identified by the Financial Stability Forum (FSF) along with fair value measurement and off balance sheet accounting. The feedback from the panel was incorporated in the preparation of the exposure draft proposing improvements to IFRS 7 *Financial Instruments: Disclosures* published on 15 October (mentioned above) and will be used in the development of the forthcoming standard on fair value measurement.
15. Several of the issues below were the subject of a letter dated 27 October from the European Commission to the Board.

### **Impairment**

New disclosure requirements related to impairment

16. Following the FASB-IASB round tables convened last year, the IASB and the FASB are both proposed similar new disclosure requirements relating to impairments. The proposals will require companies to disclose the profit or loss that would have been recorded if all financial assets (other than those categorised at fair value through profit or loss) had been measured using

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amortised cost (ie using an incurred cost model) or all had been measured using fair value. The boards published their exposure drafts in late December 2008 and asked for comments by mid-January. The Board discussed comments received at its meeting in January and in the light of comments received decided not to proceed with the proposed amendments at this time.

Acceleration of efforts to address broader issues of impairment on a globally consistent basis

17. Both the IASB and the FASB, whose respective standards have different impairment requirements, have asked their staff to consider together how existing requirements relating to reversals of impairment losses might be changed, and to report back to the boards in the next month. The boards will also address the whole question of impairment as part of an urgent broader project in 2009, and this will also be a topic for consideration by the Financial Crisis Advisory Group (FCAG).

### **Ensuring consistent treatment of accounting for particular credit-linked investments between US GAAP and IFRSs**

18. Some stakeholders have called for the need to clarify any possible difference in the accounting treatment between IFRSs and US GAAP. The FASB is planning to issue mandatory implementation guidance, and will publish the draft guidance shortly. The guidance will ensure consistency between IFRS and US GAAP—an objective supported by G20 leaders.

### **Ensuring embedded derivatives are assessed and separated if financial assets are reclassified**

19. Following requests from some stakeholders at the recently convened FASB-IASB round tables, the IASB has published an exposure draft with a 30-day comment period that proposes clarifying that all embedded derivatives should be assessed and, if necessary, separately accounted for in financial statements. Participants in the round tables asked the IASB to act in order to prevent any diversity in practice developing as a result of the amendments made to IAS 39

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Financial Instruments in October 2008 to permit the reclassification of some financial assets in particular situations.

### **Considering fully other issues related to financial instruments, including the fair value option, raised at the recent series of round tables in London, New York, and Tokyo**

20. Round-table participants supported reconsideration of the fair value option alongside a broader reconsideration of the classification categories. At the same time, almost all the users of financial statements at the round tables said that permitting reclassification out of the fair value option now, without proper consideration of all the issues, would not improve financial reporting or enhance investors' confidence in financial markets—reclassifications out of the fair value option would permit losses to be hidden. Both boards found the views of those user participants compelling and believe that any change in the fair value option should be made only as part of a broader examination of accounting for financial instruments.

### **Medium term**

21. Participants at the roundtables saw an urgent need for a broader examination by the IASB and the FASB of the role of fair value measurement for financial instruments, including the issues of improving the impairment requirements, classification issues, the fair value option, and transfers between the categories. The boards have agreed to fast track this urgent project, which could involve significant changes to IAS 39 and the relevant US standards. Given the urgency of the matter, the boards' intention is to work to finish this project in a matter of months rather than years.
22. The recommendations of the IASB/FASB Financial Crisis Advisory Group chaired by Harvey Goldschmid, a former commissioner of the US Securities and Exchange Commission, and Hans Hoogervorst, chairman of the Netherlands Authority for the Financial Markets will be jointly considered by

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the two boards as they debate major changes to the existing financial instruments standards.

23. The FCAG is being invited to discuss, among other issues, the following:

- Areas where financial reporting helped identify issues of concern during the credit crisis.
- Areas where financial reporting standards could have provided more transparency to help either anticipate the crisis or respond to the crisis more quickly.
- Whether priorities for the IASB and the FASB should be reconsidered in light of the credit crisis.
- Potential areas that require future attention of the IASB and the FASB in order to avoid future market disruption.
- The implications of the credit crisis for the interaction between general purpose financial reporting requirements for capital markets and the regulatory reporting, particularly for financial institutions.
- The relationship between fair value and off balance sheet accounting and the current crisis, both during and leading up to the crisis.
- The findings and relevance of conclusions of various studies underway, including the US Securities and Exchange Commission's study under the Emergency Economic Stabilization Act of 2008.
- The need for due process for accounting standard-setters and its implications on resolving emergency issues on a timely and inclusive basis.
- The independence of accounting standard-setters and governmental actions to the global financial crisis.

24. The group's first meeting was held in London on 20 January 2009 and the second meeting in NYC on 13 February 2009.