Financial Accounting Standards Board

International Accounting Standards Board

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting: 24 March 2009, London

Project: **Financial Instruments–Recognition and Measurement**

Subject: **Financial Instruments–Improvements to Recognition and Measurement (Agenda paper 6)**

Purpose of This Memorandum

1. In November and December 2008, the two Boards added to their active agendas a joint project to develop a comprehensive standard for the recognition and measurement of financial instruments.

2. The purpose of this memorandum is to:
   a. Discuss possible objectives for this project
   b. Discuss criteria or characteristics that may be considered when determining a measurement attribute other than fair value for a financial instrument
   c. Outline potential challenges and technical decisions that will be required to be addressed by the Boards in this project.

Background

3. Current accounting guidance under both US GAAP and IFRS has multiple recognition and measurement models that are applicable to financial instruments. These accounting models range from fair value models to historical cost models and are based on the type and intended use of the financial instrument. As a result, it is common for similar financial instruments to be accounted for under different recognition and measurement models, both within and between different entities, resulting in decreased comparability both within and between different entities and usability of the financial statements.

4. In addition to other recognition and measurement differences, the current models have differences in subsequent recognition of gains and losses (for example, changes in value of trading instruments are recorded in profit or loss, changes of value in available-for-sale assets are recognized in other comprehensive income, loans held for sale are measured at the lower of cost or market with changes recognized in profit and loss under US GAAP, and other loans are measured at amortized cost with changes in the carrying amounts recognized in profit or loss). Subsequent measurement guidance also differs with respect to impairment. These complexities currently make understandability of financial statements difficult for users.

5. In the responses to the Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, and in the 2008 Roundtable Discussions, users have stated they want information that can help them assess the effect (that is, improve the understandability) that current economic events may have on an entity's financial statements. Most users believe that fair value is the most relevant measurement for such an assessment.

6. A fair value model which requires all changes in fair value to be reflected in earnings will result in entities reporting economic gains and losses immediately, thus improving financial statement transparency. Measuring financial instruments at fair value also provides more current information about a financial instrument and it provides better information about the current wealth of an entity than any other single

measure. Fair value is also a means to provide users information so they can assess the entity's prospects for future cash flows and liquidity risk.

7. Over time, financial instruments have increased in complexity, risks, and volume. Some of these complexities have been introduced to achieve specific accounting results to improve an entity's reported financial position or earnings. Some believe that accounting models have not been appropriately modified during this time period to reflect these complexities and risks in the financial statements. As a result, increases in risk, and the impact of an entity's risk management strategies on that risk, are neither captured by nor disclosed in the financial statements.

8. However, many constituents, primarily auditors, preparers and regulators, believe a full fair value model would reduce financial statement usability; some also believe that fair value accounting (that is, mark-to-market or mark-to-model) played an instrumental role in the recent economic downturn. In response to these concerns, United States Congress mandated that the SEC perform a study of fair value accounting. The SEC's study concluded that fair value accounting did not cause the current economic downturn. Recent discussions by the Financial Crisis Advisory Group set up by the Boards seem to confirm this view.

9. Inherent in the current economic state and the questions swirling around fair value accounting in the marketplace, the staff acknowledges that the debate regarding whether fair value is the most appropriate measurement basis for all financial assets and liabilities is not only being engaged globally but more passionately and by a wider array of constituents and other interested parties than at any other time in recent history. While it is true that there is a belief among many users that recognizing all financial instruments at fair value is not only conceptually but practically the only acceptable answer, others do not agree. The staff believes that recognizing all financial instruments at fair value *may* not be the most appropriate measurement model to achieve an improvement to the usefulness, in particular the understandability and comparability of information provided to users of financial statements. The staff also believes that the scope of this project should be a comprehensive reconsideration of when other measurement models may achieve this goal.

Project Objectives

10. The objective of financial statements is to provide decision-useful information about an entity's financial position (including changes) and performance to a wide range of users.

11. The question for the Boards to consider is how this objective can best be translated into specific and measurable objectives for this project. In other words, how can the reporting for financial instruments be rendered more useful? Answering this question is important in order to ensure there is a common understanding among Board members about the project objectives. The staff seeks a decision from the Boards on the project objectives that will provide a reference basis for the remainder of this project.

12. The staff believes this project's primary objective should be improving the (decision) usefulness of reporting for financial instruments for users. It should not be about simplifying the application of existing requirements for financial instruments accounting.

13. To determine how to improve usefulness for users the Boards must determine who the users are. FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states, "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions." In other words, the primary focus of financial reporting should be for those users who are making capital decisions regarding the entity. Accordingly, for the purpose of this project debt and equity investors would meet the definition of a user, but prudential regulators would not The reference to users in the IASB Framework also includes employees, customers, governments and their agencies, and the public. The IASB Framework acknowledges that different users may have different information needs. It states that not all those needs can be satisfied by financial statements but that a focus on the information needs of investors who provide risk capital will result in the financial statements satisfying most of the needs that are common to all users.

14. Thus, while prudential regulators also use information provided in general purpose financial statements, these statements cannot be expected to satisfy their specific regulatory information needs. An important objective of such regulators is to achieve financial stability. Good financial reporting helps enhance investor confidence in the information provided, and as such is a contributory factor to achieving financial stability. However, for such confidence to be generated, it is important that financial reporting provides, as best as possible, evenhanded, neutral, or unbiased information. In addition, it is important to note that regulatory authorities have the authority to obtain additional needed financial and other information above and beyond what has been communicated to investors, and hence have the ability to adjust the reported information for their own purposes. Therefore, the staff believes that the focus of this project should be providers of capital. The staff also believes that a project that improves the usefulness of the financial statements for users, as defined above, must better capture the risks that an entity undertakes than the current model. The staff also sees no reason to believe that an improvement in reporting risks should not also improve a prudential regulator's ability to achieve another of its goals which is to identify, so as to focus its attention on, those entities who have accepted more risks than others.

15. Therefore, the staff recommends that the Boards adopt the following project objective: **To improve the decision usefulness of financial reporting for financial instruments for users.**

<u>Questions for the Board</u> (**Note:** These questions are being asked to allow the Boards the opportunity to provide guidance to clarify the project objectives.)

Question 1: Do you agree with the staff's recommendation regarding the project objective? If not, what project objective do you suggest, and why?

Question 2: Do you agree with how the staff has defined users in the context of the project objective? If not, how would you define users, and why?

16. In considering how to achieve the objective of this project, it is useful to identify the ingredients necessary for improved financial reporting. The staff thinks

that if the Boards can achieve the following goals, the result will meet the project objective:

a. Increasing understandability
b. Increasing comparability
c. Increasing relevance
d. Increasing reliability.

17. Understandability relates to the user perspective and financial information that is useful. It could be increased by reducing complexities for users through reporting information that better represents the underlying economics, or by reducing the number of alternative accounting methods applicable to a subset of assets. However, information that increases understandability must be useful and comparable. To be useful, information must be reliable as well as relevant. Achieving comparability increases information's usefulness.

18. The staff notes this discussion on understandability from a user's perspective differs from reducing complexity in terms of reducing efforts involved in generating the required information, which is the preparer perspective.

19. Comparability is information about a particular entity that can be compared with similar information about other entities and with similar information about the same entity for some other period or some other point in time. The Boards must determine if they want comparability to be driven by the type of instrument or other factors such as management intentions and industry segments (for example, financial service, software, manufacturing, etc.)

20. Relevance is the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations. Relevance in this project may be represented by determining which values assigned to financial instruments allows users to make better decisions based on the information provided to them. Information may be deemed more or less relevant based on which measurement basis is required, what industry the entity is in, or what management intentions are.

21. Reliability is the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent. It relates to faithful representation and verifiability. An aspect in the context of reporting for financial instruments is for example the reliability of measurements including relevant disclosures about such reliability.

22. Consideration must be given to determine if relevance or reliability conflict and, if so, is one more important than the other to users of financial statements. For example, reporting assets at historical cost may be more reliable, but not very relevant to users of financial statements if those assets have significantly declined in value, likewise for derivative instruments. However, providing more relevant information may decrease the reliability of information due to estimates required in determining a value.

23. The Boards will need to make decisions about prioritizing between the different goals discussed above to the extent that conflicts arise, for example, between increasing the relevance and the reliability of information. Such decisions should be taken in the context of the overall goal of the project.

<u>Questions for the Board</u> (**Note:** These questions are being asked to allow the Boards the opportunity to provide guidance to clarify the project objectives.)

Question 3: Do you agree that the Boards should further define the project objective as having the following goals for reporting of financial instruments?

a. Increasing understandability
b. Increasing comparability
c. Increasing relevance
d. Increasing reliability

If not, how would you further define the project objectives, and why?

Question 4: If so, do you believe that certain of these goals should be pre-eminent? If so, which ones should be pre-eminent, when should they be pre-eminent, and why?

Characteristics and Criteria

24. The staff has created a decision tree, or a road map, to assist the Boards with providing the staff the overall project objectives and a general road map to achieve such objectives. The proposed road map combined with the Boards' direction will allow the staff to focus its efforts on appropriate matters in the most efficient and effective manner.

25. The starting point of the decision tree is that a fair value measurement model may be appropriate for many, but not all, financial instruments. Under a fair value measurement model financial instruments are recognized at fair value (exit price as defined in Statement 157; the IASB's fair value measurement project also uses that notion) with the changes in fair value recorded in earnings. The staff believes that in most cases, fair value is the single measurement basis that best meets the goals of the project (presuming that the Boards have agreed with the staff's recommendations). Specifically, the staff believes that in most cases, reporting financial instruments at fair value results in comparability between and within all entities and improves the

relevance of the financial information by reflecting how changes in economics have impacted the wealth of the entity. The staff believes that using a fair value measurement, coupled with changes to financial statement presentation and disclosures for financial instruments, will allow the disclosures to be reduced significantly and to be better focused on user needs, resulting in improved understandability of reporting for financial instruments. The staff believes that in many cases, these three goals could be met without decreasing the reliability of the reported information and in some cases may improve it.

26. However, the staff acknowledges that fair value may not be the best single measurement basis for all financial instruments. For example, the staff thinks it might be worthwhile to analyze whether there should be a reliability threshold for valuing financial instruments at fair value. This is one of the questions which has been hotly contested by banks, regulators, politicians, and some investors in recent months. The staff thinks that it is worthwhile considering whether, in certain circumstances, the reliability of the fair value estimate is so low that in turn it deteriorates comparability and relevance (if the range of possible values is extremely wide, for example). If the Boards agree that fair value may not always be the best single measurement basis for all financial instruments, it will need to consider when a financial instrument will not be measured at fair value and what the alternative measurement basis should be.

27. Possible alternative measurement models that have been suggested by some Board members are:

a. Amortized cost – Instruments are recognized at cost adjusted for amortization of items such as premiums, discounts and transaction costs; instruments are also tested for impairment.
b. Other remeasurement approaches using discounted cash flow – Instruments are recognized at the present value of an instrument's expected cash flows discounted at a determined rate. A measurement basis other than cost or fair value would require further development.

28. If the Boards agree that fair value may not be the measurement basis for all financial instruments that would best achieve the project goals, the staff believes that it would be useful to identify how the population of financial instruments should be

analyzed. In other words, what criteria should the staff be considering as we determine what financial instruments we should analyze and bring back to the Boards for consideration? The decision tree progresses to characteristics of financial instruments that may be considered when instruments are recognized at something other than fair value. For instruments not measured at fair value, the road map details out issues that the Boards must conclude on if they want to improve the understandability, comparability, relevance, and reliability of information provided to users of financial statements.

29. Criteria and characteristics of financial instruments may potentially determine which measurement model applies to a financial instrument. Those potential criteria range from characteristics of an instrument, to how management intends to use a financial instrument, to the type of entity holding the instruments. The following are examples of criteria or characteristics for determining how to measure financial instruments and what impact they may have on the understandability, comparability, relevance and reliability of reporting for financial instruments:

Characteristics Related to the Financial Instrument

- Variability of future cash flows (for example, fixed future cash flows vs. highly variable future cash flows)
- Variability of fair value changes (for example, fixed rate bonds vs. floating rate bonds)
- Does the entity have the ability to impact the timing of cash flows either received or paid on the instrument?

Determining a measurement model based on the characteristics of a financial instrument would result in comparability in the reporting for similar instruments within and amongst all entities. However, it may decrease the relevance of certain financial statements, such as when financial instruments are used differently by different entities. For example, a fixed rate bond has no variability in its (contractual) cash flows whereas an interest rate cap has significant variability in the (contractual) cash flows.

Characteristics Related to Management's Intended Use of the Asset or the Entity Itself

- Intent to market and trade the security
- Ability and intent to hold to maturity
- Intent to match financial assets and financial liabilities

Determining a measurement model based on management's intended use of the instrument or entity itself will decrease comparability, as similar instruments will be accounted for differently within and between entities. Based on management's intent, relevance and reliability may be both positively and negatively impacted as different entities may have different intended uses of the similar instrument or managements' intent may change. For example, if an entity trades in a 10-year fixed rate bond, the implications of effective interest for the return on the investment are different compared to an investor who holds the instrument for 10-years. The trader focuses on the changes in fair value in the short term using the long maturity to increase exposure to fair value changes, that is, the trader looks at values changes driven by changes in market interest rates and credit spreads. In contrast, the long-term investor focuses on the return that results from receipt of coupon payments and principal repayment. This focus is on the market interest that, at the time of making the investment, reflected a market return for the chosen investing period.

Other

- market liquidity (for example, traded in an active market)
- difficulty in valuing the instrument
- comparability between entities in different industries

Determining a measurement model based on market liquidity, difficulty in valuing, or industries may each have positive and negative impacts on the objectives of the project. For example, not measuring an instrument at fair value because it is in an illiquid market or difficult to value may increase the reliability of the measurement, but may also decrease the relevance of the measurement to users. Measuring an instrument based on an entity's industry would decrease the comparability of financial statements across industries. For example, the financial liabilities of a financial trading entity may be measured at fair value (assuming that would apply to the assets as well), thus avoiding a measurement mismatch. Conversely, for a manufacturing entity, its financial liabilities that fund the investments in property, plant, and equipment (assuming this is measured at cost less depreciation) could be measured at amortized cost in order to avoid a measurement mismatch.

27. The staff notes that in US GAAP and to a lesser extent, IFRS, some of the considerable complexity and therefore degradation in the understandability of reporting for financial instruments resulted from the consideration at different times and in different standards (even by different standard setting bodies) of all of the characteristics above as well as consideration of individual instruments. Therefore, the staff thinks that the Boards should limit the number of characteristics that should be considered. The staff is interested in understanding whether the Boards believe that we have identified all of the potential characteristics that we might consider as well as whether we can eliminate any of these from the outset.

<u>Questions for the Boards</u>

Question 5: Do the Boards agree that most financial instruments should be recognized at fair value in the financial statements? If not, why not?

Question 6: If you agree that **most** financial instruments should be recognized at fair value, what criteria or characteristics should be used to identify those financial instruments which the Boards will consider for an alternate measurement?

Has the staff identified all the potential criteria that you think should be considered? If not, what other criteria should be considered, and why?

Would you eliminate any of the criteria identified by the staff? If so, which ones and why?

Other Issues

30. Below is a list of other issues (not exhaustive) that the staff believes may or will need to be addressed by the Boards in this project.

Scope

31. Decisions will be required relating to what instruments should be within the scope of the project. The staff is starting from a working presumption that all financial instruments would be within the scope; however, we recognize that the scope of the project will need to be examined more closely and that certain financial instruments may end up being scoped out of the project.

Financial Instrument Working Group

32. The IASB has a Financial Instrument Working Group (FIWG) whose function is to advise the Board on how the accounting for financial instruments should be improved. At the joint October meeting, the Boards tentatively decided to consider forming a joint advisory group to replace the FIWG. The staff believes that once the objectives and scope of this project have been decided, the Boards should consider in more detail the nature and composition of an advisory group that might best help the staff and Boards in advancing this project.

Classification / Reclassification / Tainting of Financial Instruments

33. Current standards classify instruments into a number of categories based on management intent: for example, trading, available for sale, and held to maturity. The premise of the categories permits identical instruments to be accounted for in different ways both within and between different entities. Changes in value for certain instruments are included in current earnings, changes in value for other instruments are recorded in other comprehensive income until the instrument is sold and the changes are released to the current period's earnings, and yet other instruments' changes in value are not recorded. Addressing these areas will be dependent upon what measurement attributes the Boards decide to require or permit for financial instruments.

Hedging / Fair Value Hedging / Bifurcation of Financial Instruments

34. Two areas that are impacted by more financial instruments potentially being recognized at fair value are fair value hedging and bifurcation of financial instruments. At a minimum, those areas would need to be addressed. The Boards may also want to address other areas of hedge accounting, such as cash flow hedges.

35. Accounting for hedges requires extensive documentation at the inception of the hedge as well as an ongoing assessment of the effectiveness of the hedging relationship. The requirements of the detailed process lend itself to a high risk of inadequate documentation and testing which may lead to restatements. Additionally, since hedge accounting is optional, enterprises with similar risks and instruments may have different accounting outcomes.

36. Bifurcation of financial instruments is the process of identifying an embedded derivative can be laborious and require expertise. Separately valuing the embedded derivatives each reporting period can be complex if the instrument is not traded in a liquid market.

Fair Value Option

37. Currently US GAAP allow entities to elect and apply on an instrument-by-instrument basis a fair value option (FVO) for most financial assets and liabilities, creating the potential for financial instruments with similar economic characteristics to be reported using different measurement bases. IFRSs permit application of the FVO if particular eligibility criteria are met. The FVO has received criticism that an instrument-by-instrument application introduces treatment alternatives that reduce the comparability of reported results within and between different entities. Depending on the measurement attributes the Boards decide to require or permit for financial instruments, the Boards may need to decide whether fair value option should be continued to be permitted.

Presentation

38. Different types of instruments are reported separately on the balance sheet from similar assets that are subsequently measured using another measurement attribute. Presentation of gains and losses on financial instruments is based on the type of gain or loss (realized, unrealized, impairment) and the management's intent for the instruments. With the possibility of more financial instruments being measured at fair value or another remeasurement approach, the Boards will need to consider how changes in value should be presented in the financial statements.

Disclosure

39. The FASB Board currently has an active project to improve disclosures about fair value of financial instruments. The IASB Board has recently made some changes to IFRS 7, *Financial Instruments: Disclosures*. If it is decided that some financial instruments would not be measured at fair value, the Boards may consider requiring additional disclosures to allow users to better understand the different measurement attributes applied by an entity in valuing its financial instruments. If the number and basis for categories changes, it is likely that significant amendments and reductions in required disclosures would need to be made as well.