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DISCUSSION PAPER

Reducing Complexity in Reporting Financial Instruments

Comments to be submitted by 19 September 2008

International Accounting Standards Board®

Discussion Paper

Reducing Complexity in Reporting Financial Instruments

This discussion paper *Reducing Complexity in Reporting Financial Instruments* is published by the International Accounting Standards Board (IASB) for comment only. Comments on the contents of the discussion paper should be submitted in writing so as to be received by **19 September 2008**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction

IN1 Many preparers of financial statements, their auditors and users of financial statements find the requirements for reporting financial instruments complex. The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have been urged by many to develop new standards of financial reporting for financial instruments that are principle-based and less complex than today's requirements.

IN2 This discussion paper is being published by the IASB. However, it will also be considered for publication by the FASB for comment by its constituents. The paper is designed to gather information to assist the boards in deciding how to proceed in developing new standards that are principle-based and less complex than today's requirements.

Summary of the discussion paper

IN3 This paper discusses the main causes of complexity in reporting financial instruments. It also discusses possible intermediate and long-term approaches to improving financial reporting and reducing complexity.

Measurement and complexity

IN4 The *many ways* of measuring financial instruments and the associated rules are one of the main causes of today's complexity. Section 1 discusses the complexity and problems created by the many ways in which financial instruments are measured.

IN5 A *long-term* solution to address such measurement-related problems is to measure in the same way all types of financial instruments within the scope of a standard for financial instruments. Fair value seems to be the only measure that is appropriate for all types of financial instruments. However, there are issues and concerns that have to be addressed before the boards can require general fair value measurement. It might take a long time to resolve all these issues and concerns. Consequently, this paper considers some intermediate approaches that might be taken to reduce today's complexity more quickly than by introducing a general fair value measurement requirement.

What are the possible *intermediate* approaches to reducing complexity?

IN6 Section 2 sets out possible intermediate approaches that might improve and simplify measurement and hedge accounting requirements for financial instruments more quickly than the introduction of a general fair value measurement requirement. The approaches discussed in the paper are:

(a) to amend measurement requirements (eg by reducing the number of categories of financial instruments);

(b) to replace the existing requirements with a fair value measurement principle and some optional exceptions to fair value measurement; and/or

(c) to simplify hedge accounting.

IN7 These three approaches could each be considered in isolation or some combinations of them could be considered.

A *long-term* solution for reducing measurement-related complexity

IN8 As mentioned earlier, a *long-term* solution is to measure in the same way all types of financial instruments within the scope of a standard for financial instruments. Many of the rules associated with measuring financial instruments in different ways could be eliminated. A single measurement attribute for all types of financial instruments would also facilitate comparisons between entities and between accounting periods for the same entity.

IN9 Section 3 explains why fair value seems to be the only measurement attribute that provides relevant information for all types of financial instruments. Fair value is an example of a current value. The definition of fair value is crucial and the IASB has an ongoing project to establish general principles in determining fair value. However, the purpose of this paper is not to discuss or solicit views on the definition of fair value.

IN10 There are some concerns and issues associated with the fair value measurement of financial instruments, and these are set out in Section 3. The main concerns are (a) volatility of earnings* arising from changes in

* The term earnings is used in this discussion paper to refer to profit or loss (IFRSs) or net income (US GAAP) and to distinguish it from other comprehensive income or equity adjustments.

fair value and (b) presentation of unrealised gains and losses in earnings. In addition, greater use of fair value might result in more complexity (eg the difficulty in disaggregating changes in fair value into components). The IASB acknowledges that it will need to undertake work on presentation and disclosure issues before it can introduce a general fair value measurement requirement for financial instruments.

Next steps

IN11 The IASB will review the responses to this paper before deciding how to proceed. In doing so, it will pay particular attention to the need for users of financial statements to receive relevant and reliable information, at a reasonable cost, as a basis for economic decisions.

IN12 In considering the comments, the IASB will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.

IN13 The constitution of the IASC Foundation requires the IASB to consider holding public hearings to discuss proposed standards and to consider undertaking field tests (both in developed countries and in emerging markets) to ensure that proposed standards are practical and workable in all environments. There is no requirement to hold public hearings or undertake field tests for every project. When the IASB reviews the responses to this discussion paper, it will consider whether a public hearing would provide input beyond that provided by its Financial Instruments Working Group. The IASB does not plan to conduct field tests during the period for comments on this discussion paper. The IASB will consider in due course whether field tests would be appropriate later in the project.

Invitation to comment

IN14 The IASB invites comments on all matters in this paper. Sections 1–3 include questions for respondents. Appendix E lists all the questions. Comments are most helpful if they:

(a) comment on the questions as stated.

(b) indicate the specific paragraph or paragraphs to which the comments relate.

(c) contain a clear rationale.

(d) describe any alternative the IASB should consider.

IN15 Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

IN16 The IASB will consider all comments received in writing by 19 September 2008.

Background

Purpose of this discussion paper

BD1 The IASB and the FASB have been urged by many constituents to develop new standards of financial reporting for financial instruments that are principle-based and less complex than today's requirements. Anecdotal evidence suggests that many users of financial statements and other constituents find the requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and the requirements under US GAAP difficult to understand, apply and interpret.

BD2 The many ways of measuring financial instruments is one of the main reasons for today's complexity. This discussion paper is being published as a basis for future discussion of issues related to measuring financial instruments and hedge accounting. The ultimate objective of both boards is the convergence and improvement of the requirements for measuring financial instruments and hedge accounting requirements.

BD3 Subsequent steps in this project are expected ultimately to lead to new standards, but neither the timing nor the content of those standards has been determined. This discussion paper is designed to gather information to assist the IASB in deciding how to proceed.

History of the project

BD4 The boards have been addressing the reporting for financial instruments for many years.

BD5 The FASB undertook a broad project on financial instruments in 1986. The four main issues the FASB intended to resolve were:

(a) how financial instruments should be measured, including how to report gains and losses.

(b) when financial assets should be considered sold and when financial liabilities should be considered settled (including when assets and liabilities of special purpose entities should be included in consolidated financial statements of other entities).

(c) how to account for instruments designed to transfer risks (derivative instruments).

(d) how to distinguish between liability instruments and equity instruments (classification).

BD6 Since undertaking the project in 1986, the FASB has issued several standards and other pronouncements on measurement of financial instruments. Some of the more notable standards are:

- SFAS 114 *Accounting by Creditors for Impairment of a Loan*
- SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities*
- SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*
- SFAS 155 *Accounting for Certain Hybrid Financial Instruments*
- SFAS 157 *Fair Value Measurements*[*]
- SFAS 159 *The Fair Value Option for Financial Assets and Financial Liabilities*.

Most of those standards have been amended, some more than once.

BD7 Likewise, the IASB's predecessor body, the International Accounting Standards Committee (IASC), began its work on the reporting of financial instruments in 1988. IASC issued IAS 32 *Financial Instruments: Disclosure and Presentation* in 1995 and IAS 39 in 1999. The IASB has amended IAS 32 and IAS 39 several times to clarify and add guidance as well as to eliminate internal inconsistencies. The IASB also issued IFRS 7 *Financial Instruments: Disclosures* in 2005 to replace the disclosure requirements for financial instruments previously set out in IAS 32 and other standards. However, the IASB has not previously undertaken a fundamental reconsideration of the issues relating to reporting financial instruments.

BD8 This discussion paper focuses on how financial instruments should be measured and, to a lesser extent, addresses how to account for derivative instruments. In 1986 most derivative instruments were not recognised or, if recognised, were reported at nominal amounts. IAS 39 and FASB standards today require most of them to be recognised and measured at fair value. Few suggest that derivative instruments should be measured using a cost-based method. This paper does not reconsider that fundamental issue but does address some hedge accounting issues.

[*] SFAS 157 addresses fair value measurement in general and technically is not a part of the financial instruments project. However, it is included in this list because it must be applied by any entity applying US GAAP and measuring a financial instrument at fair value.

BD9 Much of the information in this discussion paper has been included in other forms in papers previously published by the boards and other standard-setting bodies. The most comprehensive of those previous papers are:

- FASB Discussion Memorandum *Recognition and Measurement of Financial Instruments* (November 1991)
- IASC/Canadian Institute of Chartered Accountants Discussion Paper *Accounting for Financial Assets and Financial Liabilities* (March 1997)
- FASB Preliminary Views *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (December 1999)
- Joint Working Group of Standards Setters Draft Standard *Financial Instruments and Similar Items* (December 2000).

BD10 This discussion paper includes information and perspectives that those papers do not describe. It also draws on the more recent experiences with financial reporting issues.

BD11 The two boards also published their Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP—2006 to 2008* in February 2006, affirming their commitment to convergence. One of the goals for 2008 announced in the MoU is 'to have issued one or more due process documents relating to the financial reporting for financial instruments.' This paper fulfils that commitment.

Problems with financial reporting of financial instruments

BD12 Complexity is one of the most important issues in financial reporting, and financial instruments are among the most complex things on which to report clearly.

BD13 A draft decision memorandum published in January 2008 by the Advisory Committee on Improvements to Financial Reporting (chartered by the US Securities and Exchange Commission) defines complexity as the state of being difficult to understand and apply, and refers primarily to the difficulty for:

(a) users to understand the economic substance of a transaction or event and the overall financial position and results of the company,

(b) preparers to properly apply generally accepted accounting principles and communicate the economic substance of a

transaction or event and the overall financial position and results of a company, and

(c) other constituents to audit, analyse and regulate a company's financial reporting.

BD14 One cause of complexity is that financial instruments themselves are complex. The term *financial instruments* encompasses a wide variety of instruments. Some are very complex and hard to understand even with full information about terms and conditions. Credit risk may make even instruments with simple terms difficult to analyse.

BD15 Another cause of complexity is that the standards for financial instruments contain many alternatives, bright lines and exceptions that often obscure the underlying principles.

BD16 More specifically, today's problems arise from:

(a) the many ways financial instruments are measured;

(b) hedge accounting;

(c) the scope of standards for financial instruments and the definition of financial instrument;

(d) derecognition of financial instruments;

(e) presentation and disclosures; and

(f) other issues (eg unit of account).

BD17 The many ways of measuring financial instruments is an important reason why today's requirements are complex. They result in many accounting rules, for example, on how different financial instruments should be measured and when and how financial assets measured using a cost-based method should be impaired.

BD18 This paper is part of the long-term efforts to address measurement and hedge accounting problems with financial instruments. This paper does not address problems associated with items set out in paragraph BD16(c)–(f).

BD19 This paper acknowledges the importance of presentation and disclosure. Disclosure is critical because no single number, regardless of the measurement attribute used, provides all the information users need to understand financial instruments (eg the purpose for which an entity acquired an instrument). Clear presentation is also critical in helping users understand the effects of changes in measurements. However, this paper is not about presentation and disclosure.

Other financial instrument issues not addressed in this discussion paper

BD20 This paper does not address two broad classes of issues of financial reporting for financial instruments:

(a) derecognition of financial instruments

(b) classification of financial instruments as liabilities or equity.

BD21 The boards have a joint research project to identify a better way of accounting for the derecognition of financial instruments. That project is in its early stages of staff research. A paper is planned for publication in the first half of 2008.

BD22 The classification of financial instruments as assets, liabilities or equity is being addressed in another project. The FASB published a Preliminary Views document *Financial Instruments with Characteristics of Equity* on 30 November 2007. The IASB published that document as part of a discussion paper in February 2008 and will begin deliberations when comments are received and analysed.

BD23 These issues are not a prerequisite to the boards' long-term objectives on measurement and hedge accounting.

Organisation of this discussion paper

BD24 This paper contains three sections.

BD25 Section 1 discusses problems caused by the many ways in which financial instruments are measured.

BD26 Section 1 states that a long-term solution to such problems is to measure in the same way all types of financial instruments within the scope of a standard for financial instruments. Fair value seems to be the only measure that is appropriate for all types of financial instruments. However, various issues and concerns have to be addressed before a general requirement for fair value measurement can be introduced. It might take the IASB some time to address these issues and concerns.

BD27 Consequently, Section 2 discusses some intermediate approaches that could be taken to reduce today's complexity more quickly than by implementing a general requirement for fair value.

BD28 Section 3 discusses the long-term solution in detail. It explains why using one measurement method for all types of financial instruments is important to improve the reporting for financial instruments and why fair value seems to the only measure appropriate for all types of financial instruments.

Next steps

BD29 The IASB will review the responses to this paper before deciding how to proceed. The IASB will pay particular attention to the need for users of financial statements to receive relevant and reliable information, at a reasonable cost, as a basis for economic decisions.

BD30 The IASB expects that the work on the financial reporting for financial instruments will proceed in parallel with other projects but will not necessarily wait for the outcome of those projects. In addition, the work on the financial reporting for financial instruments may provide useful input to other projects.

Financial Instruments Working Group

BD31 In 2004 the IASB set up a financial instruments working group (FIWG) that includes users, preparers and auditors of financial statements of both financial institutions and other entities. In addition, other interested parties participate, such as regulators of financial institutions.

BD32 The FIWG met six times between September 2004 and January 2008. Several IASB members attended each meeting.

BD33 The IASB greatly appreciates the time and energy participants have devoted to this process and the quality of their contributions. Their comments and insights on the development of a new standard on financial instruments have been very helpful.

Section 1
Problems related to measurement

Introduction

1.1 This section discusses the complexity and problems created by the many ways in which financial instruments are measured, and how unrealised gains and losses are reported.

How financial instruments are measured today and some of the consequences

1.2 Table 1 shows *some* of the many ways in which financial instruments are measured. Some of the measurements described below are IFRS requirements only, some are US GAAP requirements only and some are requirements in both IFRSs and US GAAP. In addition, some of the measurements described below are applicable to instruments that are outside the scope of IAS 39 or US standards for financial instruments. Table 1 is not intended to be a complete list of all measurements for financial instruments. Instead, Table 1 illustrates the number and variety of measurement methods required or allowed today for financial instruments.

Table 1

Financial instruments presented as assets
• Equity method
• Consolidation – recognition of individual assets and liabilities of the issuer of the equity instruments
• Proportionate consolidation
• Fair value with gains and losses in earnings
• Fair value with gains and losses in other comprehensive income until realised
• Fair value with gains and losses in other comprehensive income until realised except required impairment losses that are reported in earnings immediately
• Fair value with part of the gains and losses in earnings and part of the gains and losses in other comprehensive income (cash flow hedge accounting)
• Cost less required impairment losses that are reported in earnings
continued...

...continued

- Cost with discount accretion, premium amortisation, accrued interest and required impairment losses in earnings
- Cost with discount accretion, premium amortisation and accrued interest plus or minus some changes in fair value if some of the changes in fair value of the instruments are hedged under fair value hedge accounting
- Cost plus accreted discount or amortised premium with a separate line item for accrued interest
- Lower of cost or market value
- Carrying value less allowances for uncollectible amounts
- For loans and receivables subject to troubled debt restructuring, as specified in SFAS 15 *Accounting by Debtors and Creditors for Troubled Debt Restructuring*
- Carryover basis of the transferred assets allocated on the basis of relative fair values of the portions sold and retained
- Not recognised unless an amount is receivable

Financial instruments presented as liabilities

- Fair value with gains and losses in earnings
- Fair value with part of the gains and losses in earnings and part of the gains and losses in other comprehensive income (cash flow hedge accounting)
- Net issue proceeds plus accreted discount or amortised premium with accrued interest
- Net issue proceeds with discount accretion, premium amortisation and accrued interest plus or minus some changes in fair value, if some of the changes in fair value of the instruments are hedged under fair value hedge accounting
- If treated as a substantial modification of the terms of an existing financial liability, gains or losses on extinguishment of original liability reported in earnings with recognition of a new financial liability at its fair value
- Initial measurement at fair value and subsequent measurement at the higher of (a) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, when appropriate, amortisation reported in accordance with IAS 18 *Revenue*
- Face value with accrued interest (if any)
- Recognised at acquisition date fair value and amortised over the estimated life (if acquired in a business combination)

1.3 Some of the measurements described in Table 1 are an attempt to portray a current estimate of value, others to portray original cost with various adjustments, some are mixtures of the two and others can be described only as the result of the calculations that produced the number. The measurement applied may also change over an instrument's life. An example is the measurement of a financial instrument that is initially measured using a cost-based method and later designated as a hedged item in a fair value hedging relationship.

1.4 Some of the measurements described in Table 1 include the effect of impairment losses. The requirements for recognising impairments of many financial assets measured using cost-based methods are based on incurred losses. In general, that means that an event has occurred that has caused the entity to suffer a loss. There are problems with that requirement, such as determining the accounting period in which a loss occurred and hence the period in which a loss should be recognised. Impairment losses are also recognised in many ways under IFRSs and US GAAP requirements, including:

(a) fair value with changes in earnings

(b) fair value with changes in other comprehensive income except for those impairments that are required to be reported in earnings

(c) lower of cost or market with changes in earnings

(d) undiscounted allowance for incurred losses with changes in earnings

(e) discounted allowance for incurred losses with changes in earnings (estimated cash flows discounted at the rate implicit in the loan at inception)

(f) cost with some impairments recognised in earnings and other impairments not recognised.

1.5 The different ways to measure financial instruments and report unrealised gains and losses may result in:

(a) two identical instruments being measured differently by the same entity, because

  (i) management's intentions for realising the value of an instrument may determine the way it is measured.

  (ii) management has the option of measuring many financial instruments at fair value.

  (iii) the way in which an instrument was acquired may affect its measurement (for example, interests received by the transferor in securitisation transactions).

(iv) the percentage of total ownership interests that an investor holds in an investee affects how the investment is accounted for.

(b) two identical instruments being measured differently by entities in different industries. Under US GAAP, specialised measurement practices apply to broker-dealers, investment companies, pension plans, mortgage bankers, insurance companies and others.

Difficulties encountered by preparers of financial statements, their auditors, standard-setters, regulators and other users of financial statements

1.6 The many ways of measuring financial instruments and the associated rules create problems for preparers of financial statements and their auditors, users of financial statements, standard-setters and regulators. These problems include the following:

(a) The criteria for determining which instrument must or can be measured in a given way are in some cases complex and difficult to apply. The criteria change or are applied differently as new types of instruments are created. Preparers of financial statements and their auditors have difficulty in keeping up with the changes and determining the appropriate method.

(b) There are no clear requirements for some instruments.

(c) In some cases, management must choose how to account for an instrument. Not making a choice at the appropriate time or even not properly documenting a choice may result in a treatment that management would have preferred to avoid. Even worse, an inappropriate choice or improper documentation may require management to restate prior period financial statements.

(d) Different gains or losses result from different measurement methods, and two or more measures may be combined in the same line in the statement of comprehensive income.

(e) It is not always easy to determine which measurement has been applied to which instrument or to understand the implications of the differences. That creates difficulties in comparing entities, different periods for the same entity, and even different line items in the financial statements of a single entity in a single reporting period.

(f) The maintenance and interpretation of those numerous and complex requirements are difficult and time-consuming for preparers of financial statements and their auditors, as well as for standard-setters.

Approaches to addressing measurement and related problems

1.7 Many preparers of financial statements, their auditors and users of financial statements have urged the boards to develop standards that are principle-based and less complex than today's requirements.

1.8 Many IASB members believe that the patchwork of measurement methods for financial instruments and the associated rules are a disservice to users of financial statements and are not sustainable, and that the long-term solution is to measure all financial instruments using a single measurement attribute.

1.9 Measuring all financial instruments the same way would make the reported information easier to understand and facilitate comparisons between entities and between periods. It also would eliminate many of the rules associated with measuring financial instruments in different ways, such as the need for criteria to distinguish between different types of financial instruments.

1.10 Table 2 illustrates how using fair value for all types of financial instruments within the scope of a standard for financial instruments (with changes in fair value recognised in earnings) could reduce today's measurement-related complexity.

Table 2

Components of standards for reporting financial instruments	**How complexity could be reduced**
Criteria to distinguish between types of financial instruments ('classification')	*Would not be required.*
Identification and quantification of impairment	*Would not be required.*
Transfers between measurement categories of financial instruments	*Would not be required.*
Hedge accounting	*Fair value hedge accounting—no measurement mismatches between financial instruments. There may be other recognition and measurement mismatches (eg those relating to non-financial instruments); in such circumstances, there will be demand for fair value hedge accounting.* *Cash flow hedge accounting—there will be demand for hedge accounting for exposures to changes in expected future cash flows.*
Identification and separation of embedded derivatives	*Not applicable for financial instruments. May still be required for other items (eg non-financial instruments with embedded derivatives).*

1.11 Sections 2 and 3 discuss approaches the IASB could take to resolve today's measurement and related problems.

1.12 Section 2 discusses some intermediate approaches the IASB might take to reduce today's complexity. Some of these intermediate approaches might address some of today's problems more quickly than is otherwise possible.

1.13 Section 3 discusses the long-term solution, ie to measure in the same way all types of financial instruments within the scope of a standard for financial instruments.

Question for respondents

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 IASB respond to assertions that the current requirements are too complex?

Section 2
Intermediate approaches to measurement and related problems

2.1 Section 1 suggests that the long-term solution to reduce today's measurement-related complexity is to use a single measurement method for all types of financial instruments within the scope of a standard for financial instruments. Section 3 suggests that fair value seems to be the only measure appropriate for all types of financial instruments. However, there are some concerns and issues with the fair value measurement of some types of financial instruments, and these may take a long time to resolve.

2.2 Consequently, this section discusses ways in which existing measurement requirements for financial instruments might be improved and simplified more quickly than by introducing a general fair value measurement requirement. The IASB has decided that any proposed intermediate change must meet the following criteria:

(a) Ideally, a change should provide more relevant information and more easily understandable information for users of financial statements. If it does not, it must not reduce the relevant information available or make it more difficult to understand.

(b) It must be consistent with the long-term measurement objective. Ideally, a change should increase the number of financial instruments measured at fair value. It must not result in measuring instruments other than at fair value if they are required to be measured at fair value today.

(c) It must not increase complexity. Ideally, a change should result in simplification for preparers, auditors and users. It must not increase complexity for any of those groups.

(d) The improvement and simplification that it offers must be significant enough to justify the cost of the change. Changes impose costs on all parties involved—preparers, auditors and users. Therefore, a change that is likely to be changed again in the relatively near future must not be made unless it is a significant improvement and simplification.

2.3 The boards have discussed numerous possibilities for improvement, simplification and convergence. Most have been rejected because they are not sufficiently significant to justify the cost and effort involved. For example, IFRSs and US GAAP requirements for amortising discounts, premiums, and up-front fees or costs on loan assets are different, as are the requirements for assessing impairment of loans. However, the differences are relatively small, and changing them for the sake of convergence would not improve or simplify financial reporting enough to be worth the cost of the change.

2.4 Some more significant possible improvements and simplifications have been proposed. This section analyses those approaches using the four criteria listed in paragraph 2.2. The approaches discussed in this paper are:

(a) amending the existing measurement requirements.

(b) replacing the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(c) simplifying hedge accounting requirements.

2.5 These approaches could each be considered in isolation, and some combinations of them could be considered.

Approach 1: Amend the existing measurement requirements

2.6 IAS 39 includes four measurement categories—financial instruments at fair value through profit or loss, held-to-maturity investments, available-for-sale financial assets, and loans and receivables.

2.7 FASB standards do not include a single comprehensive standard for financial instruments.* SFAS 115 includes three categories—trading, available-for-sale, and held-to-maturity. Loans receivable and payable, accounts receivable and payable, and other instruments that are not securities are subject to different standards or, in some cases, to accepted practices that developed in the absence of a standard. Requirements for derivative instruments (those not eligible for exceptions) and hedge accounting are included in SFAS 133.

* The FASB's codification project will eliminate separate standards but different types of financial instruments will be addressed in different parts of the codification. For example, requirements for accounting for loans will not be integrated into the three categories that apply to securities.

2.8 Table 1 in Section 1 lists many of the measurement methods that currently apply to financial instruments. There are so many possibilities that both preparers and users have trouble understanding which method applies to which instrument and in which circumstances. It might be possible to improve and simplify financial reporting by amending the existing measurement requirements.

2.9 There are many ways in which the existing measurement requirements can be amended. For example, they can be amended by:

(a) reducing the number of measurement categories of financial instruments; and/or

(b) simplifying or eliminating some of the requirements or restrictions of the existing measurement categories.

2.10 One possible approach (which the boards have, in the past, considered and rejected) is to eliminate the held-to-maturity categories in IAS 39 and SFAS 115. That would be a move towards fair value; many instruments in that category would probably be categorised as available for sale. That change would eliminate the need for 'tainting' rules against transfers in and out of the held-to-maturity category, and eliminating those rules would remove the risk that preparers would have to recategorise whole groups of instruments because of one mistaken decision. However, such an approach would still require rules regarding whether, and if so how, to reclassify gains and losses on available-for-sale investments to earnings.

2.11 Another possible approach is to eliminate the available-for-sale category and simply require measurement at fair value through profit or loss (IASB) or trading (FASB) for any instrument that is at present classified as available for sale. That would eliminate the need to reclassify, to earnings, gains and losses from other comprehensive income if an instrument is sold or an impairment charge is required to be recognised. However, some may object to this approach because of the resulting volatility in earnings.

2.12 Alternatively, some suggest requiring all instruments that are traded in active markets (however defined) to be measured at fair value. In addition, to meet the criterion set out in paragraph 2.2(b), any instruments that are measured at fair value today (eg most derivatives) would continue to be measured at fair value. Other instruments would be categorised and measured on the basis of the existing measurement requirements.

2.13 One example of how requirements or restrictions of existing measurement categories might be simplified or eliminated is to remove the 'tainting' rules for the held-to-maturity category. Such rules are added for anti-abuse purposes and could be replaced with appropriate disclosure requirements.

2.14 The above suggestions could each be considered in isolation or in combination. These suggestions would also require presentation and disclosure issues to be addressed. However, experience has shown that amending the existing measurement requirements can take considerable time and resources, and the benefits are not always significant.

Approach 2: Replace the existing measurement requirements with a fair value measurement principle with some optional exceptions

2.15 Another possible intermediate approach would be to adopt a fair value measurement principle with some optional exceptions. An instrument within the scope of a standard for financial instruments would be allowed to be measured using a cost-based method if it meets exception criteria. Other instruments would be measured at fair value.

2.16 Approach 2 is different from the long-term solution discussed in Section 3. Under approach 2, some financial instruments within the scope of a standard for financial instruments would be allowed to be measured using a cost-based method. However, under the long-term solution, all financial instruments within the scope of a standard for financial instruments would be required to be measured at fair value.

2.17 Approach 2 could significantly reduce the volume and complexity of the accounting literature. For example, a definition of a derivative instrument may be unnecessary (depending on the treatment of non-financial contracts in the scope of a standard on financial instruments).

2.18 Under approach 2, there would be some restrictions on the types of instruments to which the cost-based measurement could be applied. For example, equity instruments with readily available market prices and derivative instruments would continue to be measured at fair value. To permit cost-based measurement for those instruments would violate the criterion in paragraph 2.2(b).

2.19 Eligibility for cost-based measurement might depend on the variability of an instrument's cash flows. Instruments with highly variable future cash flows (eg derivative instruments and equity investments) might be required to be measured at fair value whereas instruments with fixed or slightly variable cash flows (eg market interest-bearing debt instruments) might be eligible for cost-based measurement. However, if fixed income instruments have highly variable cash flows (because the credit risk of the instruments is high), such impaired instruments might require fair value measurement. There might be other possible criteria for exceptions.

2.20 The IASB has discussed this principle-based approach in general terms but has not discussed details such as whether all unrealised gains and losses would be recognised in earnings. Clearly, recognising some gains and losses outside earnings and recognising others in earnings increases complexity for all parties. It is more difficult for users to understand and creates additional record-keeping requirements for preparers (to determine when to reclassify gains and losses into earnings).

2.21 Advantages of approach 2 include the following:

(a) Fair value measurement is consistent with the boards' long-term objective and a general fair value measurement principle with exceptions is a step towards that objective.

(b) To qualify for any exceptions, entities must meet specified criteria. The complexity created by the exceptions to the fair value measurement principle is clear to all and could be avoided by an entity deciding not to apply an exception.

(c) The measurement principle would apply to newly created instruments.

(d) This is the most effective and efficient intermediate step that has been identified. Other rules under the mixed measurement attribute would not need to be continually assessed.

(e) Constituents, especially users that often find the existing measurement requirements complex and confusing, would probably find a general principle more logical (and exceptions to that principle easier to understand) than an amended version of the present rules.

2.22 A disadvantage of approach 2 is that it might require significant change in the shorter term. However, that is not a foregone conclusion. Entities might be able to use exceptions to fair value measurement that will permit them not to change very much. Therefore, the practical effect

might not be as significant as the effect on the standards. Approach 2 would also include optional exceptions to fair value measurements and therefore might not result in more easily understandable (and comparable) information than today for users of financial statements.

Approach 3: Simplify hedge accounting

2.23 This approach considers possible simplifications of fair value and cash flow hedge accounting. However, it does not discuss hedge accounting for net investments in a foreign operation.

The differences and similarities between fair value and cash flow hedge accounting

2.24 Fair value hedge accounting is designed to eliminate or reduce measurement mismatches caused by measuring hedging instruments at fair value and measuring hedged items a different way.* Fair value hedge accounting changes the way the hedged item is measured to match more closely the measurement of the hedging instrument. Gains and losses on the hedging instrument are expected to offset losses and gains attributable to changes in fair value of the hedged item. If the hedge is perfectly effective, gains and losses on the hedging instrument and hedged item offset in earnings. The term ineffectiveness refers to the degree to which the two do not offset each other.

2.25 If all financial instruments were measured at fair value, many of the measurement mismatches that create a need for fair value hedge accounting would not exist. However, there would still be mismatches related to unrecognised hedged items and hedged items that are not financial instruments. One possibility is to allow a fair value option to be used for such items (see the discussion later in this section).

2.26 Unlike fair value hedge accounting, cash flow hedge accounting affects the timing of recognition, in earnings, of gains and losses on hedging instruments. Cash flow hedge accounting does not affect the measurement of financial instruments. To the extent that the hedge is highly effective, gains and losses on the hedging instrument are recognised temporarily in other comprehensive income. (The ineffective

* Firm commitments, which are eligible for hedge accounting, are unrecognised even though their fair values change in response to market factors. Fair value hedge accounting for an unrecognised firm commitment results in recognising the previously unrecognised hedged item.

portion of gains and losses on the hedging instrument is recognised immediately in earnings.) Those deferred gains and losses are reclassified into earnings in later periods to offset the effect on earnings of the changes in the designated future cash flows.

2.27 Cash flow hedge accounting is an exception (with no basis in accounting concepts) that permits management to recognise gains and losses on hedging instruments in earnings in a period other than the one in which they occur. Unlike fair value hedge accounting, the 'mismatch' that gives rise to the desire for cash flow hedge accounting is not an accounting anomaly. The economic effect of changes in fair value of the hedging instrument used as a hedge occurs before the hedged cash flows occur or are contracted for or committed to.* This is illustrated as follows:

(a) If the hedged cash flows are anticipated to result from a forecast transaction, there are no assets, liabilities, gains, losses, or cash flows to account for at the time the gains and losses on the hedging instrument occur. There is no conceivable change in financial reporting standards that would result in recognising gains or losses on future cash flows arising from a forecast transaction.

(b) The hedged cash flows could also be payments or receipts on variable rate financial instruments. Variable rate instruments are designed to protect the holder from changes in the fair value of the instrument (the cash flows of the instrument vary in a way that causes the instrument's fair value to remain constant or nearly constant). Again, there is no accounting anomaly that can be eliminated by changing a financial reporting standard.

2.28 In either case, the hedging entity is deliberately exposing itself to gains and losses on a hedging instrument in order to offset changes in cash flows that have not yet occurred. Therefore, those cash flows cannot affect earnings until they occur (or they may not affect earnings at all if the cash flows relate to an acquisition of an asset).

2.29 For these reasons, the desire for cash flow hedge accounting will not be affected by changing the general measurement requirement for financial instruments.

* IAS 39 also permits some firm commitments to be hedged using cash flow hedge accounting. SFAS 133 does not.

Two general approaches to changing hedge accounting

2.30 This discussion paper considers two general approaches to changing hedge accounting requirements:

(a) to eliminate (and possibly replace) existing hedge accounting requirements.

(b) to maintain and simplify the existing hedge accounting requirements.

2.31 The FASB has taken on to its agenda a project to improve and simplify hedge accounting. Some of the proposals considered in that project are discussed below. A summary of the FASB project on hedge accounting is in Appendix D.

Eliminate (and possibly replace) existing hedge accounting requirements

2.32 One possibility is to eliminate all hedge accounting.

2.33 Some users of financial statements argue that today's hedge accounting does not always reflect the economic consequences of hedging activities. In their view, disclosing the effects of hedging activities in financial statements provides more useful information. Eliminating today's hedge accounting requirements would address some of the problems with today's financial reporting of financial instruments. However, many financial statement preparers object to this suggestion, arguing that the resulting volatility in earnings does not reflect the economic consequences of hedging activities.

2.34 Alternatively, it might be possible to replace *fair value* hedge accounting with a less complex method by which measurement anomalies can be remedied. However, there is no obvious alternative for cash flow hedge accounting.

2.35 There are at least three ways to replace the existing *fair value* hedge accounting:

(a) substitute a fair value option for instruments that would otherwise be hedged items.

(b) permit recognition outside earnings of gains and losses on financial instruments designated as hedging instruments (similar to cash flow hedge accounting).

(c) permit recognition outside earnings of gains and losses on financial instruments.

2.36 Presentation and disclosure are issues that are integral to the following discussion. Some of the ways to replace existing fair value hedge accounting could be affected by decisions made by the boards in the financial statement presentation project. However, in this paper, the alternatives are considered in the context of current presentation requirements.

A fair value option

2.37 One way of reducing complexity might be to permit fair value hedge accounting for only those assets and liabilities that are not permitted to be measured at fair value using a fair value option. Hence, fair value hedge accounting might still be permitted for particular financial instruments and many non-financial assets and liabilities.

2.38 An entity can use a fair value option, if available, to address accounting mismatches. A fair value option need not be complex, and the results are easier to understand.

2.39 However, preparers may not view a fair value option as comparable to fair value hedge accounting. This is because the fair value option is less flexible than fair value hedge accounting. For example:

(a) Fair value hedge accounting can be started and stopped at will provided that the qualification requirements for hedge accounting are met. However, the fair value option designation is available only at initial recognition and is irrevocable.

(b) Fair value hedge accounting can be applied to specific risks or parts of a hedged item. However, the fair value option must be applied to the entire asset or liability.

(c) Hedged items under fair value hedge accounting can be financial instruments or non-financial items. However, in general, the fair value option can be applied to financial instruments only.

2.40 To address these issues, the following changes could be made to the fair value option:

(a) allowing the fair value option to be applied to more non-financial assets and liabilities.*

(b) allowing the fair value option to be applied to specific risks or parts of the designated item.

(c) allowing the fair value option to be applied at any date after initial recognition.

2.41 However, adding flexibility similar to fair value hedge accounting as described in the previous paragraph could add complexity and defeat the purpose of making a change.

2.42 For example, allowing the fair value option to be applied to specific risks or parts of an item may result in problems similar to those associated with partial hedges, as discussed later in this section.

2.43 In addition, allowing the fair value option to be applied at any date after initial recognition would raise another issue—whether dedesignation of an item should also be permitted. If dedesignation is permitted, the fair value option would give the same flexibility to start and stop as fair value hedge accounting does today (but without the restrictions surrounding hedge accounting). Giving such flexibility (but without any restrictions) would not improve comparability or result in more relevant and understandable information for financial statement users.

Recognition outside earnings of gains and losses on hedging instruments (similar to cash flow hedge accounting)

2.44 Unlike fair value hedge accounting, cash flow hedge accounting does not result in adjusting the carrying amount of a hedged asset or liability. Instead, gains and losses on the hedging instrument are initially recognised in other comprehensive income and subsequently reclassified into earnings when the hedged cash flows affect earnings.

2.45 A similar technique might be used for fair value hedge accounting. Gains and losses on the hedging instrument that arise from an effective hedge would be recognised in other comprehensive income and measurement of the hedged item would not be affected.

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* Phase 2 of the FASB's fair value option project is expected to extend the option to particular non-financial assets and liabilities.

2.46 That approach would have the following benefits:

(a) The carrying amount of the hedged item would not be affected.

(b) The measurement attribute of the hedged item would be the same whether it was hedged or not.

(c) There would be fewer ongoing effects on earnings. For example, there would be no ongoing effects on earnings because the effective interest rate of a financial asset would not need to be recalculated following the dedesignation of a fair value hedging relationship.

2.47 However, gains and losses on the hedging instrument that are initially recognised in other comprehensive income would need to be reclassified to earnings to offset the effect on earnings of the hedged item. For example, the cumulative gains or losses on an interest rate swap designated as hedging a fixed rate bond would be reclassified to earnings when the bond was sold or settled, and not throughout the life of the bond. However, the net swap settlements would be recognised in earnings as they accrue.

2.48 As noted, using a cash flow hedging technique for fair value exposures has some benefits. However, many of the restrictions that exist today would be needed. That might not result in a significant reduction in complexity.

Recognition outside earnings of gains and losses on hedged items

2.49 This suggestion has the following features:

(a) All (or at least many) financial instruments would be measured at fair value.

(b) Gains and losses on derivatives, instruments held for trading and instruments designated in their entirety at initial recognition to be measured at fair value are recognised in earnings.

(c) For financial instruments other than those described in (b), entities would be *permitted* to recognise all unrealised gains and losses or unrealised gains and losses attributable to specified risks in either earnings or other comprehensive income, subject to one exception. The exception is that unrealised gains and losses on interest-bearing financial liabilities attributable to changes in the entity's own credit risk must be recognised in other comprehensive income. An entity could also choose to report a specified

percentage of the gains or losses on these financial instruments in earnings and the remainder in other comprehensive income.

2.50 The choice described in paragraph 2.49(c) would be made instrument by instrument at inception (when the instrument is acquired, incurred, issued or originated) and would be revocable. If an entity initially chooses to recognise gains and losses on a financial instrument in other comprehensive income and later changes that choice, the cumulative net gain or loss on the instrument would be reclassified to earnings in some systematic way over the remaining life of the instrument. Alternatively, if an entity initially chooses to recognise gains and losses on a financial instrument in earnings and later changes that choice, the fair value of the instrument on the date of the new choice would determine the effective interest rate.

2.51 For those instruments described in paragraph 2.49(c) interest on interest-bearing instruments would be separately presented using an effective interest rate. Movements in the fair value due to changes in foreign exchange rates of all monetary items described in paragraph 2.49(c) would also be recognised in earnings in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 39.

2.52 Moreover, if a derivative is used to hedge the changes in fair value of a particular financial instrument, the entity could choose to recognise in earnings future gains and losses on that hedged instrument. The gains and losses on the hedged instrument and the hedging instrument would be offset in earnings in a way that is similar to fair value hedge accounting. Unlike fair value hedge accounting, this approach would not require an effectiveness test at inception or later.

2.53 This approach would result in more financial instruments being measured at fair value. In addition, hedged items would generally be measured at fair value instead of being adjusted for some fair value changes but not others.

2.54 However, this approach has the following disadvantages:

(a) It includes few restrictions about the choice of where to recognise gains and losses. If restrictions comparable to existing hedge accounting requirements were added, there would be little or no reduction in complexity.

(b) Recognising part of the gains and losses on a financial instrument in other comprehensive income and part in earnings (and being able to change that choice) would create complexity for users trying to understand the financial statements.

Maintain and simplify existing hedge accounting requirements

2.55 Another possible approach to changing hedge accounting requirements is to maintain and simplify the existing hedge accounting requirements. Many of the possible simplifications apply to both fair value and cash flow hedge accounting and both types of hedge accounting are discussed below.

2.56 The following paragraphs discuss ways to simplify the following aspects of hedge accounting:

(a) designation and documentation

(b) dedesignation and redesignation

(c) partial hedges

(d) effectiveness assessment and recognition of ineffectiveness

(e) portfolio hedge accounting

(f) reclassification to earnings of deferred gains and losses (for cash flow hedge accounting only)

(g) other issues (IAS 39 only).

Designation and documentation

2.57 An entity applying either type of hedge accounting is required to designate and document an eligible hedging relationship before hedge accounting begins. The documentation for hedge accounting relationships must include the following:

(a) the specific derivative instrument to be used as the hedging instrument

(b) the specific hedged item

(c) the nature of the risk being hedged

(d) support for management's assertion that the hedging instrument will be effective in offsetting changes in fair value of the hedged item

(e) how hedge effectiveness will be assessed.

2.58 Entities are required to designate and document hedging relationships at inception because hedge accounting is optional. If management could wait until the end of an accounting period to designate its hedging relationships, it could manipulate earnings. For example, management

could increase earnings by designating hedged items on which gains (obvious with hindsight) would offset losses on derivatives not previously designated as hedging instruments.

2.59 Existing requirements also require entities to document how they will assess effectiveness of a hedging relationship over the life of the hedging relationship. Different methods may yield different conclusions about the extent of effectiveness. Documentation of the method of assessing effectiveness at inception is intended to prevent an entity from changing methods each period to find one that demonstrates the required level of effectiveness for the period being tested.

2.60 The consequences of not strictly adhering to the documentation requirements can be severe. Restatement of previously issued financial statements to reverse hedge accounting may be required if documentation is discovered to be inaccurate or incomplete. For example, some of the restatements under SFAS 133 have occurred because the 'shortcut' method was determined to have been inappropriately applied. Some of those hedges might have been sufficiently effective to be acceptable if a different method of assessing effectiveness had been documented. However, because hedges must be documented at inception, retrospectively changing the method of effectiveness assessment was not considered acceptable.

2.61 The boards would like to find a way to prevent retrospective earnings management that would not have the possible significant negative consequences of the current requirements. One possibility might be to allow management to set a general policy for effectiveness testing that would include a fallback position if the initially documented method turns out to be in error. Both boards are considering this issue.

Dedesignation and redesignation

2.62 Hedge accounting can be started and stopped at will. A hedging relationship must be discontinued at any time if it fails the effectiveness qualification requirements, and management may choose to discontinue it any time. In either case, the same hedging instrument may be redesignated later as a hedge of the same hedged item, or a different hedged item. It may even be used as a fair value hedge and later as a cash flow hedge. However, in all cases, it must meet the eligibility requirements.

2.63 The ability to dedesignate and redesignate gives management flexibility to avoid recognising gains and losses on hedging instruments. However, dedesignation and redesignation make the financial statements less transparent (they make it more difficult for users to understand how management is applying its risk management strategies and to judge the success or lack of success).

2.64 If arbitrary rules were established to reduce the frequency of dedesignation and redesignation, users could more easily understand the financial statements, but management's flexibility would also be reduced. One possible alternative to reduce complexity is to require irrevocable designation. However, under this alternative, entities will no longer have flexibility as to when hedge accounting can be stopped or restarted and, as discussed, that is one of the main advantages of fair value hedge accounting over a fair value option.

Partial hedges

2.65 Under both IFRSs and US GAAP an entity may designate as a hedged item something less than the entire exposure to change in fair value or variability in future cash flow. There are restrictions, and those restrictions differ between IFRSs and US GAAP. For the purpose of this paper, such designated items are referred to as *partial* hedges.

2.66 Examples of such partial hedges for cash flow exposures include:

(a) a hedge of interest rate risk, credit risk, or foreign currency risk related to a forecast transaction to acquire or dispose of a financial asset or liability.

(b) a hedge of all risks in a specified percentage of a forecast transaction to acquire or dispose of an asset or to incur or settle a liability.

(c) a hedge of a specified percentage of all future variable interest payments or receipts of a particular type.

2.67 Partial hedges increase complexity associated with hedge accounting. Some users have said they find it difficult to understand, interpret and use information in financial statements when partial hedging is used.

2.68 Partial hedges are also subject to the same designation, documentation, effectiveness and other eligibility requirements as full hedges. The specific risks or part of the exposure being hedged must be identified and documented and so must the method of assessing effectiveness.

2.69 Ineffectiveness in a partial hedge must also be recognised immediately in earnings, and that causes some unique problems for partial hedges that create complexity for preparers of financial statements and their auditors. For example, there is no non-arbitrary way of separating the effects of changes in interest rates from the effects of changes in credit risk, although IAS 39 and SFAS 133 set out the required approach to be followed with differing levels of specificity.

2.70 Hedges of individual risks in cash flow hedges can be even more problematic than for fair value hedges because there is no existing asset or liability to measure. One suggested method for assessing effectiveness is to create a hypothetical derivative that would be a perfect hedge of the risk being hedged and compare the gains or losses on that hypothetical derivative with the gains or losses on the hedging instrument. The difference is ineffectiveness that must be recognised immediately in earnings. However, there have been disagreements in practice about what type of derivative would be perfectly effective.

2.71 One way to eliminate issues related to partial cash flow hedges would be to prohibit hedge accounting for partial hedges. That would reduce the complexity of hedge accounting for all parties. It would eliminate the number of rules that preparers and auditors have to deal with. It would also reduce the amounts of gains and losses that are temporarily recognised outside earnings, which would make financial statements easier for users to understand. More gains and losses would affect earnings in the period in which they occur.

2.72 However, many preparers are likely to oppose eliminating partial hedges. They argue that eliminating partial hedges would probably reduce the frequency with which hedge accounting is applied. Even if an instrument can be found that will be effective enough to qualify as a full hedge and is not too expensive to enter into, recognised ineffectiveness is likely to increase. That will result in more volatility in earnings.

2.73 In their view, the complexity created by partial hedges is 'good complexity'. (The results are desirable enough to justify tolerating the difficulties.) In addition, in relation to cash flow hedge accounting, some believe that the results of management's hedging strategies should be recognised only at the time the forecast transaction happens instead of recognising gains and losses in the periods in which they occur.

2.74 In summary, partial hedging raises the following questions, the answers to which can create complexity for preparers of financial statements and their auditors:

(a) Which partial hedges should be eligible?

(b) Should the eligible partial hedges differ according to whether the hedged item is a financial instrument (currently they do)?

(c) What rules should be provided regarding the separate measurement of changes in fair value or cash flows arising from the risks and portions being hedged?

2.75 The need for separate measurement arises to ensure that a designated hedging relationship will and does result in a sufficient degree of offset between the hedging instrument and the hedged item.

2.76 The following paragraphs discuss effectiveness. There is a close relationship between the need for qualification effectiveness tests and the flexibility permitted with regard to partial hedges.

Effectiveness assessment and recognition of ineffectiveness

2.77 For a hedging relationship to be eligible for hedge accounting, the hedging instrument must be expected to be highly effective in offsetting changes in the fair value or cash flows of the hedged item. Hedge accounting may be applied if an expectation of high effectiveness exists (prospective test), and the hedging relationship can be proved to be historically highly effective (retrospective test). The effectiveness of a hedge accounting relationship (except those subject to the 'shortcut' method in SFAS 133) must be assessed at each reporting date.

2.78 To the extent that actual gains and losses on a hedging instrument (whether realised or unrealised) offset the changes in the fair value or cash flows of the hedged item, the hedge is effective. To the extent that actual gains and losses do not offset, the hedge is ineffective.

2.79 High effectiveness is not quantified in SFAS 133, although the FASB is aware that particular percentage ranges have become accepted in practice. Similarly, if the gains and losses on the hedging instrument are between 80 per cent and 125 per cent of the losses and gains on the hedged item (or the changes in cash flows in a cash flow hedge), the hedge is generally considered highly effective in accordance with IAS 39.

2.80 The requirement for effectiveness testing is a principle rather than a rule. In effect it says: each entity should choose the method that is best (or easiest) in its own circumstances and apply it consistently.

2.81 That principle has generated uncertainty as well as disagreement among some preparers, their auditors and, at times, their regulators about which methods are acceptable.

2.82 Uncertainty and potential for disagreement over effectiveness are more significant for cash flow hedges than for fair value hedges. In a fair value hedge, gains and losses on both the hedging instrument and the hedged item are recognised in earnings in the period in which they occur. However, there is no hedged asset or liability to measure in a cash flow hedge, and variability in future cash flows may not be directly measurable. The method of creating a hypothetical derivative discussed in the context of partial hedges may appear to be straightforward if the entity can identify the risks being hedged. However, constituents have told the boards it is difficult and subjective. That is a serious concern because it affects the ineffectiveness to be recognised as well as whether the hedging relationship continues to qualify for hedge accounting.

2.83 For the above reasons, some suggest eliminating some or all of the effectiveness qualification requirements.

2.84 Some suggest eliminating all effectiveness qualification tests, and simply requiring actual ineffectiveness to be recognised in earnings immediately.* The consequences would be that more relationships would qualify for hedge accounting, and that less relevant and understandable information would be available for users of financial statements.

2.85 Consequently, some suggest eliminating all effectiveness qualification tests when and only when an item in its entirety is designated as a hedged item. The item could be designated as a hedged item at any time but could not be dedesignated.† This approach could reduce complexity and result in more understandable information for users of financial statements (but might not give as much flexibility to preparers of financial statements as the approach set out in paragraph 2.84).

2.86 Another possibility is to eliminate the retrospective effectiveness test (but require a prospective *qualitative* effectiveness test) when an item in its entirety is designated as a hedged item. An entity would be allowed to dedesignate a hedging relationship at any time. Such an approach gives some flexibility for preparers of financial statements, and retains some restrictions regarding the availability of hedge accounting (and possibly

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* For fair value hedges, this approach is similar to a fair value option for all (or part) of an item that can be designated and dedesignated at any time.

† For fair value hedges, this approach is similar to a fair value option that allows designation at any time but does not allow dedesignation.

does not reduce the relevant information available to users of financial statements or make it more difficult to understand).

2.87 Some suggest extending this approach to partial hedges. However, because of the problems with identification of an exposure in a partial hedge and measurement of changes in cash flows or fair value of the hedged exposure, something more than a qualitative assessment of prospective effectiveness might be required to ensure that a hedge is highly effective in achieving offset between changes in fair value or cash flows of the hedged exposure and the hedging instrument.

Portfolio hedge accounting

2.88 There are restrictions on how assets, liabilities or future cash flows can be grouped for designation purposes. To qualify as a hedged portfolio, they have to be 'similar' (or have a common similarity). There is greater flexibility to group items in IAS 39 than in SFAS 133.

2.89 Those restrictions prevent some entities from applying hedge accounting. Many preparers of financial statements have argued that the 'similar' criterion is too restrictive, which adds unnecessary complexity and causes economically equivalent transactions to be reported differently. Entities that manage their economic exposures on a portfolio basis (for example, financial institutions) also argue for greater flexibility to apply hedge accounting to portfolios of items so that hedge accounting requirements reflect the way that they manage economic risk.

2.90 This is an issue the boards might consider. However, experience has shown (under IAS 39) that permitting hedge accounting for a portfolio of items results in significant complexity in terms of the rules required to maintain discipline as to when hedge accounting is permitted, the effects on reported earnings and the application of those rules by preparers of financial statements and their auditors.

Reclassification to earnings of deferred gains and losses (for cash flow hedge accounting only)

2.91 Because forecast transactions are uncertain, cash flow hedge accounting for those transactions creates issues different from those created by fair value hedge accounting. A major issue with cash flow hedge accounting is the uncertainty of forecast transactions subject to hedging. The effective portion of the gains and losses on the hedging instrument, which are initially recognised outside earnings, are reclassified to earnings in the period(s) when the hedged cash flows affect earnings.

2.92 By its nature, there is no certainty that a forecast transaction will happen. Both IASB and FASB standards require a forecast transaction to be very likely to occur (highly probable) before hedge accounting is available. That requirement is intended to avoid manipulation of earnings by reclassifying gains and losses when management would like to increase or decrease earnings.

2.93 One issue is that it may be difficult to determine whether forecast transactions are highly likely to occur. Another issue is that gains and losses on a hedging instrument are never certain to offset variability in future cash flows because they are uncertain and subject to unforeseen changes. Lastly, if a hedged forecast transaction does not occur, gains and losses on the hedging instrument have been excluded from earnings for no reason.

2.94 A simpler alternative might be to state at inception when a hedged transaction is expected to affect earnings and to reclassify gains and losses to earnings at that time (whether or not the forecast transaction occurs and affects earnings as planned). That would be less complex, and might reduce the need to track individual gains and losses. However, mistakes in forecasting effects on earnings would cause volatility in earnings.

2.95 Changing the reclassification requirements might be combined with changes to effectiveness tests. If an entity cannot influence the recognition of gains and losses, simpler eligibility requirements might be appropriate.

Other issues (IAS 39 only)

2.96 IAS 39 permits a choice of fair value or cash flow hedge accounting for a hedge of the foreign currency risk of a firm commitment.

2.97 For cash flow hedges of non-financial items IAS 39 also permits:

(a) deferred gains and losses to be reclassified into earnings when the non-financial item affects earnings; or

(b) deferred gains and losses to be added to, or subtracted from, as appropriate, the carrying amount of the acquired asset ('basis adjustment').

2.98 Those choices reduce comparability between entities. Basis adjustments result in adjusting the initial carrying amount of the asset or liability away from its fair value. Eliminating these choices would reduce complexity and improve comparability.

Summary of this section

2.99 This section sets out three possible intermediate approaches that might improve and simplify measurement requirements for financial instruments and hedge accounting requirements more quickly than by implementing a general fair value measurement requirement. The three possible intermediate approaches set out in the paper are:

(a) to amend the existing measurement requirements (eg by reducing the number of categories of financial assets and financial liabilities)

(b) to replace the existing requirements with a fair value measurement principle with some optional exceptions; and/or

(c) to simplify hedge accounting.

These approaches could each be considered in isolation, and some combinations of them could be considered.

2.100 Regarding the third approach, this section sets out two general approaches to changing existing hedge accounting requirements. One approach is to eliminate all hedge accounting (and possibly replace fair value hedge accounting with a less complex alternative). The second approach is to maintain but simplify the existing fair value and cash flow hedge accounting requirements, particularly those relating to partial hedges and effectiveness testing.

Questions for respondents

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(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 2.2?

(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 2.2?

(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 2.2?

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

  (i) Which method(s) should the IASB consider, and why?

  (ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure that your comments are consistent with your suggested approach to changing measurement requirements.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the 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 IASB 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?

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

Section 3
A long-term solution—a single measurement method for all types of financial instruments

3.1 As discussed in Section 1, one of the main causes of today's complexity in the financial reporting for financial instruments is the many ways of measuring them and the associated rules needed. The boards believe that the long-term solution is to measure in the same way all types of financial instruments within the scope of a standard for financial instruments.

3.2 Using a single measurement method for all types of financial instruments would not address all of today's problems. However, it would be an important step towards resolving some of them.

3.3 This section is divided into three parts.

3.4 Part A explains why fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments. For that explanation, this discussion paper categorises financial instruments into two types—instruments with highly variable future cash flows (eg many derivatives) and instruments with fixed or slightly variable future cash flows (eg many fixed or variable rate bonds).

3.5 Part B discusses some concerns about the fair value measurement of financial instruments.

3.6 Part C sets out the issues that need to be addressed before the fair value measurement of financial instruments can become a general requirement (in particular, presentation and disclosure issues).

Part A Why fair value is the only measure appropriate for all types of financial instruments

Background

3.7 Before examining what the appropriate measure for all types of financial instruments is, it is important to consider what is meant by fair value.

3.8 Fair value is an example of a current value. The fair value of many financial instruments is a current exit value. However, today's standards may require a current settlement value or entry value in some situations.

3.9 Part C of this section acknowledges that the definition of fair value is crucial. The IASB has an ongoing project to establish general principles in determining fair value. However, the purpose of this paper is not to discuss or solicit views on the definition of fair value. This paper uses the term 'fair value' to represent a current value that, in many situations, is an exit value.

3.10 Many IASB members believe that although arguments can be made for measuring some types of financial instruments differently, fair value is the only measurement attribute suitable for all types of financial instruments within the scope of a standard for financial instruments. In addition, many documents previously published by the boards state that fair value is the only appropriate measure for all types of financial instruments.

3.11 Measuring all types of financial instruments using a cost-based method is not a feasible alternative. For example, the cost (or accreted cost) of derivative instruments does not provide users of financial statements with information about future cash flow prospects of the instruments. Fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments. To explain that view, the following discussion categorises financial instruments into two types according to the variability of future cash flows.

Instruments with highly variable future cash flows

3.12 The first category of financial instruments contains instruments that have highly variable future cash flows, for example, derivative financial instruments.

3.13 Most derivatives are required to be measured at fair value by IAS 39 and SFAS 133. The characteristics that led the boards to conclude that fair value is the *only* relevant measure for derivatives are that:

(a) the cash flows at inception are very small or otherwise not highly correlated with the ultimate cash flows; thus, cost without adjustment has no value in the assessment of future cash flow prospects.

(b) an accreted cost measurement is not possible because it requires a fixed amount and date to accrete to. Many derivatives do not have fixed payment amounts or dates. Others have fixed amounts or dates if a payment happens, but whether any such payment will happen is highly uncertain.

3.14 The following general principle can be inferred from those characteristics: If initial cash flows for a particular instrument (eg costs to acquire the instrument) are not highly correlated with ultimate cash flows, cost-based measures have little or no value for assessing future cash flow prospects.

3.15 To some extent that principle also applies to hybrid financial instruments, even if they are debts in form. Some might argue that some of the ultimate cash flows of a hybrid instrument might be predictable from the initial cash flows and interest rates. However, those cash flows might be inseparable from other interdependent cash flows that are highly variable and not highly correlated with the initial cash flows.

3.16 Some other types of instruments to which that principle applies include ordinary shares (common stocks), many partnership interests, many insurance contracts and warranties. Ultimate cash flows from many instruments of those types are highly variable because they depend on future events or conditions and are not correlated with the initial cash flows.

3.17 Therefore, cost and accreted cost (or proceeds), which are the most prevalent alternatives to fair value measurement, are not useful in assessing future cash flow prospects for instruments with variable cash flows. Consequently, according to the conceptual frameworks of the IASB and the FASB, such measures have little or no relevance.

3.18 Information about the initial cost (proceeds) may be of some use in assessing management's past success (or lack of success) in achieving a return on investments. However, cost does not allow an investor to assess management's decisions to continue to hold a financial asset. From a conceptual standpoint, the limited relevance may justify disclosing cost-based information, but it does not justify using those amounts for recognition purposes in the financial statements.

Instruments with fixed or slightly variable future cash flows

3.19 The second category of financial instruments contains instruments with fixed or slightly variable future cash flows. The phrase *instruments with slightly variable cash flows* refers to instruments that have fixed principal payments and interest payments that are designed to be reset periodically on the basis of interest rate indices to avoid significant lasting changes in fair value due to changes in market interest rates. That category does not

include interest rate derivatives. Some examples are interest-bearing instruments, instruments issued at a discount that represents interest (zero coupon instruments), and short-term instruments that do not bear interest (trade payables and receivables).

3.20 Future cash flows from those types of instruments are correlated with the initial cash flows (cost or proceeds) in such a way that future cash flows can be predicted with a high level of confidence if two conditions exist:

(a) the instrument is held to maturity; and

(b) it is highly probable that the cash flows will occur because the credit risk is low.

3.21 For instruments with fixed or slightly variable cash flows, accreted cost (proceeds) is a feasible alternative to fair value measurement, and provides some relevant information.

3.22 The following paragraphs compare fair value and cost-based measures for such instruments. The comparison considers financial assets and financial liabilities separately.

Financial assets

3.23 Reasons for continuing to use *cost-based measures* for financial assets with fixed or slightly variable cash flows are:

(a) Cost-based measures are straightforward to compute (except for high credit risk instruments) and familiar.

(b) Many consider cost-based measures more consistent with management's plans in businesses that do not generally involve trading the assets.

(c) Cost-based measures largely reflect the actual cash amounts to be received.

(d) No specific requirements exist for how to separate interest income and credit losses from other changes in fair value of financial assets measured at fair value.

3.24 Reasons to use *fair value* for financial assets with fixed or slightly variable cash flows are:

(a) Having a single measurement method for all types of financial assets would significantly simplify the existing standards by avoiding 'boundary' issues (eg how fixed is fixed, and what variability is needed to require fair value). A single measurement

method would also eliminate any confusion about the measurement method for each different type of financial assets.

(b) The requirements for when to report and how to quantify impairment losses for impaired financial assets have been heavily criticised for many reasons. Impairment issues have proved to be difficult and contentious. It seems that the ultimate solution to these issues is fair value measurement. (This issue is discussed in greater detail below.)

(c) Financial assets that are acquired at a discount or significantly written down because of high credit risk create issues about discount amortisation and interest accrual.

3.25 Compared with cost-based measures, the fair value of a financial asset better reflects the price of the asset that would be received at the measurement date. Such information is generally useful. There are often events and circumstances beyond management's control that create a need to sell. Therefore, even if management has no plans to sell an asset, it is useful for users of financial statements to know the potential effects of such events and transactions (although they are not considered highly probable by management).

3.26 In addition, fair value is a better measure for use in assessing the effect on cash flow prospects of credit risk for financial assets because:

(a) it provides information about anticipated future losses, not just losses that have been incurred.

(b) it provides information about improvements in credit risk since origination or acquisition.

3.27 Moreover, impairment losses on financial assets measured using a cost-based method raise various issues including:

(a) how to determine when a loss has been incurred is not always clear, even in concept.

(b) incurred losses lag probable losses, which creates an information deficiency.

(c) some recognised impairments do not reflect expectations of delays in cash flows if the total amount is likely to be recovered eventually.

(d) changes in credit risk might not be often reflected because of the thresholds required to be met before recognising any impairment loss.

(e) when to reverse a previously recognised impairment loss is not always clear, even in concept.

3.28 Financial assets measured at cost less required impairments might contain information about the counterparty that is available only to the holder of the asset (especially if the holder originated the loan or other instrument) and is not available to market participants. However, the information about each asset is not reported individually and, in any case, users of financial statements are not normally concerned about an individual asset unless it is individually significant relative to the holder's total portfolio of interest-bearing assets. That may argue for disclosure of management's estimate of future cash flows on individually significant assets, but it does not outweigh the benefits of fair value for the rest of the portfolio.

3.29 In the long run, impairment issues have to be addressed if cost-based measures continue to be required or permitted. Alternatively, if fair value measurement is required, requirements on how to report interest income and credit losses have to be added. Discussions with users of financial statements have shown that even if all debt-type financial assets were measured at fair value, they are still interested in breaking down into major components the total change in the fair value of such assets. At a minimum, users of financial statements are interested to know changes due to cash flows, changes due to interest accrual, changes due to credit losses, and other changes.

3.30 Regardless of whether cost-based measures or fair value is used, there is need for disclosures—users of financial statements need information about amounts and timing of contractual payment requirements to assess future cash flow prospects.

Financial liabilities

3.31 Reasons to continue using *cost-based* measures for financial liabilities with fixed or slightly variable cash flows are:

(a) Cost-based measures are straightforward to compute and familiar.

(b) Many consider cost-based measures consistent with likely outcomes because most businesses seldom transfer liabilities or purchase them in a market at a gain or loss. In fact, it may not be possible to do either.

(c) Reporting in earnings unrealised gains and losses arising from changes in credit risk of a financial liability is counter-intuitive: it does not fit with conventional ideas about gains and losses. Part B of this section addresses this issue.

(d) Reporting gains and losses on financial liabilities when the entity's obligation has not changed is also counter-intuitive. Under current standards, gains and losses on debt-type financial liabilities measured using a cost-based method are reported only if the cash flows change. Such events are relatively uncommon.

(e) No specific requirements exist for how to separate interest income and gains and losses due to changes in credit risk from other changes in fair value of financial liabilities measured at fair value (although IFRS 7 gives an example of how to estimate changes due to changes in the credit risk of a financial liability).

3.32 The best reasons to use *fair value* for financial liabilities with fixed or slightly variable cash flows are:

(a) Having a single measurement method for all financial liabilities would greatly simplify the existing standards by avoiding 'boundary' issues (eg how fixed is fixed, and what variability is needed to require fair value). A single measurement method for all financial liabilities would also eliminate any confusion about the measurement method for each type of financial liabilities.

(b) Entities with comparable credit ratings and obligations will report liabilities at comparable amounts even if the borrowing occurred at different times in different interest rate environments. The reverse is also true—entities with different credit ratings and obligations will report different liabilities.

(c) Fair value would result in an entity reporting the same measure for two equally secure payment obligations with identical cash flow requirements (amounts and timing). Currently, different amounts are likely to be reported if the two obligations were incurred at different times (because market interest rates or the entity's credit spread changed between the two).

(d) Fair value better reflects the cash flows that would be paid if liabilities were transferred at the remeasurement date.

3.33 Point (c) above may require an explanation. Accounting for debt-type liabilities has always been based on the amounts received accreted toward the amounts that will be required to be paid.

3.34 Point (c) can be most easily understood in terms of a single payment note. For example, if Entity A borrows CU785,000* on Day 1 of Year 1 when the market interest rate for unsecured notes of that quality is 5 per cent, its single payment at the end of Year 5 will be approximately CU1 million. On Day 1 of Year 2, Entity A will have accrued interest of approximately CU39,000 and the carrying amount of its debt including interest will be approximately CU824,000.

3.35 On Day 1 of Year 2, Entity A's credit rating is unchanged, and Entity A borrows an additional CU750,000 on an unsecured note payable at the end of Year 5. If the current market interest rate for notes of that quality has increased to 7.5 per cent Entity A's single payment will be approximately CU1 million.

3.36 In that scenario, Entity A's carrying amount for the new debt will be CU750,000 and its carrying amount for the old debt will be CU824,000. Both obligations require payments of approximately CU1 million at the end of Year 5, but the carrying amounts differ significantly. If the two notes were carried at fair value, the carrying amount would be the same (except for the effects of the approximations used to simplify the discussion).

3.37 Few would argue that reporting two identical obligations at different amounts serves the interests of users of financial statements. The opposition to fair value measurement is because of the effects on earnings instead of on the statement of financial position. If the two liabilities in the Entity A example were measured at fair value, Entity A would report a net gain of CU35,000 in Year 1 on the liability—the original borrowing of CU785,000 less the fair value on Day 1 of Year 2 of CU750,000. (Entity A might report interest expense of CU39,000 and an unrealised gain due to interest rate changes of CU74,000, but the net will still be CU35,000.) That gain would be even more objectionable if it resulted not from increases in market interest rates but from decreases in Entity A's credit rating.

3.38 In summary, supporters of fair value measurement for financial liabilities consider reporting the liability at fair value of paramount importance and do not believe the resulting gains and losses are accounting fictions.

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* In these and other examples, monetary amounts are denominated in 'currency units' (CU).

3.39 In contrast, opponents of fair value measurement consider the reporting in earnings of primary importance. They regard unrealisable gains and losses due to a decrease in an entity's own credit rating as 'noise' that would distort earnings and equity, *especially* if the credit rating decrease results from a decline in value of unrecognised assets or other factors not reported in earnings. This issue is further discussed in part B.

Part B Concerns about the fair value measurement of financial instruments

3.40 This part discusses three concerns about the fair value measurement of financial instruments that have been raised by some:

(a) the relevance of reported changes in fair value.

(b) why should unrealised gains and losses affect earnings?

(c) the difficulty and uncertainty in estimating fair values of financial instruments when no market-based information is available.

The relevance of reported changes in fair value

3.41 Preparers of financial statements often strive for smoothness (stability) in earnings, and one of the most common reasons cited for opposing fair value measurement is the resulting volatility in earnings. Some believe that the volatility of earnings arising from factors beyond management's control should not be reported. It is true that volatility in fair values can be difficult to manage because it is caused by market forces and other factors that management cannot control.

3.42 Volatility in fair values is a real economic phenomenon. However, supporters of fair value acknowledge that unrealised gains and losses attributable to market changes have implications for future cash flows that are different from those of transactions and changes in contractual future cash flows. Therefore, it is important to separate unrealised gains and losses attributable to changes in market factors from realised gains and losses and from unrealised gains and losses attributable to changes in credit risk and contractual changes in cash flows. In addition, some believe that unrealised gains and losses arising from trading instruments should be presented separately from other unrealised gains or losses.

Artificial volatility and artificial stability

3.43 Preparers of financial statements consider real volatility in earnings bad enough, but 'artificial volatility' is worse. Artificial volatility occurs when market changes cause the fair values of two financial instruments (or other assets or liabilities) to change in opposite directions and only one is measured at fair value. If only one financial instrument is measured at fair value, earnings are more volatile than they should be.

3.44 Fair value measurement for all financial instruments would eliminate artificial volatility caused by measuring financial instruments differently. It would not eliminate artificial volatility caused by using cost-based measures for other types of assets and liabilities or not recognising some assets (especially intangible assets). The boards acknowledge that condition. However, measuring them at fair value seems to be a necessary step towards improving and simplifying financial reporting for financial instruments.

3.45 Artificial *stability* in earnings is less often cited as a financial reporting concern, but it can be just as misleading as artificial volatility. Artificial stability most often results from cost-based measures, which do not change when fair value changes. Some have argued that artificial stability caused by cost-based measures is not a problem if management plans to hold a financial asset until its maturity. Supporters of that view state that changes in fair value of a held-to-maturity financial asset (other than incurred credit losses) are irrelevant because the fair value changes do not reflect the way the assets are managed.

3.46 Counter-arguments to that view include:

(a) Reporting changes in fair value permits assessment of the effect of management's decision to hold an instrument rather than sell it. In other words, it would be difficult for investors to discern, without information about changes in the instrument's fair value, whether the entity would have been better off if the instrument had been sold before maturity.

(b) Plans change. It is difficult for a manager to assert with certainty that a particular instrument will never be sold.

(c) Cash flows are never certain. There is always some probability that the contractual cash flows of an instrument will not be received.

3.47 Fair value hedge accounting for a single risk in a financial instrument or only part of a financial instrument can also cause artificial stability in earnings. The fair value of the hedged item may change for reasons other than the hedged risk or hedged part, but such changes are not recognised.

Presentation of unrealised gains and losses

3.48 The question is: If all financial instruments are required to be measured at fair value, what steps should be taken to avoid the misleading implications of recognising unrealised gains and losses?

3.49 The answer is to separate changes in fair value attributable to changes in market conditions and credit risk from changes in contractual cash flows and cash flows from transactions. In addition, some suggest separating unrealised gains and losses arising from trading instruments from other unrealised gains and losses.

3.50 Discussions with users of financial statements have also shown that they are interested to see the disaggregation of the total changes in fair value of a financial instrument into major components (such as changes attributable to interest accruals, changes attributable to credit losses and other causes). That issue is the subject of a separate research project associated with the financial statement presentation project.

Why should unrealised gains and losses affect earnings?

3.51 Many (including some supporters of fair value measurement) are concerned that including unrealised gains and losses in earnings can be misleading. This issue is considered by addressing the following four questions:

(a) Is the information sufficiently objective and reliable?

(b) What use is information about gains or losses that may never be realised?

(c) Why recognise an unrealised gain or loss on a financial liability when an entity's obligation is unchanged?

(d) Why recognise unrealised gains on financial liabilities when bad things happen to the entity (or unrealised losses when good things happen)?

Is the information sufficiently objective and reliable?

3.52 Any discussion of objectivity and reliability must start with a basic statement of fact. Fair value is not a forecast of an ultimate outcome. Although it may require estimates of future cash flows, it is a current market price based on collective assessment of current worth by market

participants. The fact that the outcome of a particular instrument may turn out to be different from its fair value at any given date does not mean that its fair value on that date was wrong. Objectivity and reliability do not necessarily imply forecast accuracy.

3.53 Objective fair value measurements are based on information that is not simply a judgement or assumption by the entity making the measurement. Reliability is somewhat similar. The degree of reliability of a measurement depends on the likelihood that different measurers will agree within a reasonable range.

3.54 Fair value is easy to determine for instruments that are frequently traded in markets in which price and volume information is available to the public. Such information is clearly objective and reliable. Few, if any, judgements are required.

3.55 However, some financial instruments are seldom traded (or traded in thin markets), and trades are privately negotiated between individual entities that do not make public price or volume information. Other instruments, especially liabilities, are not traded at all. That raises questions about the objectivity and reliability of the estimated fair value.

3.56 It may be possible to estimate fair value using information about comparable instruments that are traded more frequently or general economic conditions such as interest rates. Fair value estimated using that information can be objective and reliable. The primary subjective judgement required is the degree of comparability between the traded and non-traded instrument and how to adjust for differences.

3.57 However, there may be little or no market information about some instruments or comparable instruments (eg instruments that are seldom traded or traded in thin markets). In that case, fair value must be estimated using information available to or developed by the entity. Fair value estimates based on that information are clearly more subjective and less reliable than estimates based on direct or indirect market inputs.

3.58 Because the issues of objectivity and reliability are somewhat different for instruments with highly variable cash flows and instruments with fixed or slightly variable cash flows, the two are discussed separately.

Instruments with highly variable cash flows

3.59 Fair values of some instruments with highly variable cash flows can be estimated using external market-based information. Examples are derivative instruments traded in dealer markets and based on interest rates in developed nations or forward exchange rates of frequently traded currencies. Those instruments do not introduce high levels of subjectivity into financial statements.

3.60 The most subjective estimates involve long-term contracts with highly variable cash flows that depend on future events or conditions about which little information is publicly available. Examples are multi-year warranties on new products, and derivative or similar instruments based on one or more variables about which no information is publicly available. Another common example is an equity security of a privately held entity, especially a high risk entity such as one in the development stage.

3.61 For some instruments, there is no available objective information except original cost or proceeds. However, the cost or proceeds of an instrument with highly variable cash flows provide little or no information about its future cash flows.

3.62 The lack of reasonably objective information that bears any relation to current value or future cash flows creates difficulties for reporting some instruments with highly variable cash flows. Therefore, the question is:

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

3.63 Arguably, an imprecise estimate of a relevant amount is more useful than a precise estimate of a less relevant amount. Some of the concerns about using an imprecise amount can be alleviated by making the nature and amount of the unrealised gains and losses included in earnings apparent.

3.64 Both IFRSs and US GAAP require disclosures when something other than active market inputs are used to estimate the fair value of an item as a way to communicate to users that those estimates are subject to a number of factors. In addition, IFRS 7 also requires disclosure if the transaction price differs from the fair value of a financial instrument at initial recognition. It may also be desirable for entities to disclose other information—for example, factors that affect the estimates.

Instruments with fixed or slightly variable cash flows

3.65 Unless credit risk is high or changes significantly, the most important inputs in estimating fair values of instruments with fixed or slightly variable contractual cash flows are the amounts and dates of contracted payments and market interest rates. The contractual terms are known to the entity attempting to measure such an instrument, and market interest rates are published.

3.66 Adjusting published risk-free rates or rates for a specified credit risk level to apply to a specific instrument is somewhat subjective unless the instrument matches the specified risk. However, it may be possible to identify an instrument of comparable credit quality with a known credit rating. Even if the credit risk input is based on internal assumptions of the asset holder, the range of possible differences in judgement is not especially wide if the credit risk is not especially high and changeable.

3.67 Fair value estimates for instruments with high and changeable credit risk are more subjective (have a wider range of possible judgements). However, incurred loss estimates for financial assets that use a cost-based measure also have a wide range of possible judgements. In both cases earnings are affected by changes in estimates that may be highly subjective. Consequently, fair value is not significantly more subjective than cost-based measures in that situation.

What use is information about gains or losses that may never be realised?

3.68 Some financial instruments are difficult (if not impossible) to sell or transfer except in a business combination and are almost certain to be settled with the counterparty according to their terms. If the instrument has highly variable cash flows, fair value is probably still the most useful information for assessing future cash flows at settlement. However, if the instrument has fixed cash flows and it is highly unlikely that the instrument can be sold or transferred, cost-based measures in those circumstances might be an alternative to fair value.

3.69 At a date before settlement, the fair value of an instrument with fixed or slightly variable cash flows is likely to be different from the ultimate settlement amount. Therefore, unrealised gains or losses will arise over the life of the instrument. If the instrument is settled according to its terms, those unrealised gains and losses will be expected to reverse by the settlement date.

3.70 In that case, some doubt the usefulness of reporting unrealised gains or losses that are unlikely ever to be realised (particularly if investors focus primarily on cash flows for valuation purposes). It may also be a sensitive point if fair value is estimated using internal information and assumptions of the holder.

3.71 The question is: Are the benefits of using a single measurement for nearly all financial instruments outweighed by including in earnings unrealised gains and losses?

Why recognise an unrealised gain or loss on a financial liability when the entity's obligation is unchanged?

3.72 This concern implies that the recognised amount of a financial liability represents the face amount of the obligation. However, the recognised amount of a financial liability does not represent nor is it intended to represent the face amount of an obligation, even if a cost-based method is used. For example, if two entities whose credit standing differs issue an unsecured note promising to pay CU1 million in five years, the proceeds will be different. Although the two entities have the same obligation in five years, the liability amount each entity recognises will be different until the issue discount is fully accreted.

Why recognise unrealised gains on financial liabilities when bad things happen (or unrealised losses when good things happen)?

3.73 If changes in the credit risk of an entity's financial liabilities are taken into account, a decrease in the probability that the financial liabilities will be settled creates a gain to earnings in the financial statements of a borrower. To some, however, intuition would indicate that a decrease in an entity's ability to pay should be associated with a loss instead of a gain.

3.74 The following points explain why a decrease in the probability that a financial liability will be settled is associated with a gain in the financial statements of a borrower:

(a) The liability is a contract between two entities. Generally, when circumstances change that result in one entity incurring a loss, it might be expected that the other party will have a gain. That leads to a conclusion that, when a lender recognises a loss, the borrower should recognise a gain.

(b) A financial liability's fair value on initial recognition reflects its credit risk. It seems inconsistent to include credit risk in the initial fair value measurement of a financial liability but not in the subsequent measurement of the financial liability.

(c) The apparent gain does not occur in a vacuum. The reason why a borrower is unable to pay is that it has suffered losses or expects to have shortfalls in profits. If those losses are fully recognised in the financial statements of the borrower, the amount of the losses is likely to exceed the amount of gain arising from a decrease in fair value of the liability. However, not all of the losses or shortfalls are recognised in financial statements. For example, losses arising from decreases in value of unrecognised intangible assets are not recognised. The gain on the liability might provide a signal to users of the borrower's financial statements that unrecognised losses or shortfalls have been incurred.

(d) Equity holders of an entity are not required to make any additional investment to cover losses incurred by the entity except to the extent that the equity holders have a binding obligation to do so. However, when the credit risk of an instrument increases, the lender might suffer a loss. Therefore, the apparent gain to the borrower can be seen as an allocation of deficits from the owners of the borrower to the lender.

3.75 However, some have concerns about requiring an entity to consider the effect of changes in the credit risk of a financial liability in remeasuring the fair value of the liabilities. In their view, a liability remeasurement that reflects changes in the credit risk of a financial liability is confusing. When a financial liability's credit risk deteriorates, there is a gain (ie an increase in an owner's equity). In their view, such an effect is counter-intuitive. They argue that it is not useful to report lower liabilities when an entity is in financial difficulty and that it is difficult to explain to users of financial statements the reasons why a gain would be recognised when a liability's creditworthiness deteriorates.

3.76 In their view, for the purposes of remeasuring a liability, users of financial statements are better served by a measurement that focuses on the obligation. They suggest that financial statements should portray the present value of an obligation in such a way that two entities with the same obligation but different credit standing would report the same carrying amount.

3.77 IASB members are aware of these concerns. They also acknowledge that these concerns relate to (a) what is meant by fair value and (b) what is the appropriate measurement attribute for remeasuring financial liabilities. These issues will be considered in due course. For example, the IASB will consider the effect of non-performance risk* (including the effect of credit risk) as part of its project on fair value measurement.

Difficulty in estimating fair values of financial instruments

3.78 Many preparers of financial statements and others are concerned about the difficulty and uncertainty in estimating fair values of financial instruments when no market-based information is available.

3.79 Determining the fair value of financial instruments often requires the use of valuation and other non-accounting experts. Such expertise may not be widely available in some jurisdictions. In some situations, it also requires much judgement by preparers of financial statements and their auditors. Some believe that requiring more financial instruments to be measured at fair value will exacerbate these difficulties.

3.80 Such difficulty and uncertainty exist today in estimating impairment losses of an impaired financial asset. It is also worth noting that the fair values of most financial instruments are required to be disclosed by today's financial reporting standards.

Part C What remains to be done before fair value measurement is required?

3.81 There are four issues for the boards to address before fair value measurement for financial instruments can become a general requirement:

(a) Presentation: how should the effects of changes in fair values be presented in earnings?

(b) Disclosure: what information about financial instruments should be disclosed?

(c) Measurement: what is the definition of fair value and how should fair values be measured?

* Non-performance risk in SFAS 157 refers to the risk that an obligation will not be fulfilled and affects the value at which the liability is transferred.

(d) Scope: what is the appropriate definition of a financial instrument and which financial instruments, if any, should be outside the scope of a standard for financial instruments?

How should the effects of changes in fair values be presented in earnings?

3.82 There are several presentation issues, including the following:

(a) how to distinguish unrealised gains and losses attributable to changes in market factors from other components of earnings.

(b) whether the distinction in (a) should apply only to measurements based on unobservable inputs.

(c) whether the distinction in (a) should apply to instruments held for trading.

(d) whether interest income or expense should be presented separately from other changes in fair value. If so:

(i) should interest income or expense on all instruments be presented, including short-term receivables and payables, employee benefit obligations (if these are included in the scope of a financial instruments standard) and other instruments that do not explicitly bear interest?

(ii) should interest income or expense be computed using the effective yield method in use today, the contractual rate, a market rate considering the credit risk and the term of the instrument, a market risk-free rate, or some other method?

(iii) should interest income or expense be presented if not all cash flows are expected to be received or paid?

(e) whether changes in the probability that cash flows will occur should be separately presented for financial assets, financial liabilities, both, or neither? If so should such changes be computed on the basis of:

(i) incurred losses?

(ii) the effect on market prices (which raises issues of how to separate that effect from other interdependent effects such as interest rates)?

(iii) some other factor?

3.83 The boards are considering two financial instruments presentation issues in conjunction with the project on financial statement presentation and a related research project. The first is how to distinguish unrealised gains and losses attributable to changes in market factors from other components of earnings. That issue is the subject of a separate research project that is associated with the financial statement presentation project. The second is which instruments to present as part of business activities and which as part of financing activities. That issue is currently being considered as part of the financial statement presentation project.

3.84 The remaining issues will be addressed in a joint project on how to separate the components of changes in fair value. That project is currently an inactive staff research project.

What information about financial instruments should be disclosed?

3.85 Current disclosure requirements differ from instrument to instrument and for the same instrument depending on:

(a) the class of instrument.

(b) how the entity acquired the instrument (eg as the result of a securitisation as opposed to a market purchase).

(c) which industry standards apply to the entity (US GAAP).

(d) the purpose for which the entity acquired it (eg hedging, investment, trading, speculation).

3.86 The IASB's objectives with regard to disclosures are:

(a) to combine similar disclosures that appear in different notes to the financial statements.

(b) to eliminate disclosures that are not relevant for instruments measured at fair value.

(c) to add disclosures that become relevant for instruments measured at fair value.

(d) to fill in any gaps in the information.

(e) to consider the total package of disclosures.

3.87 The IASB issued IFRS 7 to revise its disclosure requirements for financial instruments. IFRS 7 requires an entity to disclose methods and assumptions used in estimating fair value, and whether inputs are based on observable market data. SFAS 157 requires particular disclosures relating to fair value measurement and the FASB currently has a project on disclosures related to derivative instruments.

3.88 However, neither IFRS 7 nor SFAS 157 was intended to produce a package of information that would be most relevant if nearly all financial instruments were measured at fair value. Before requiring fair value measurement for all types of financial instruments, the IASB will need to undertake such a project.

What is the definition of fair value and how should fair values be measured?

3.89 IASB and FASB standards for fair value measurement are different. SFAS 157 establishes general principles for determining fair value and addresses many but not all financial instrument measurement issues. The IASB's requirements for the fair value measurement of financial instruments are in IAS 39. The IASB published SFAS 157 as a discussion paper in November 2006 and has begun deliberating the comments received from respondents.

3.90 The boards will need to make decisions about some measurement issues related specifically to financial instruments. Those issues include:

(a) accounting by the issuer for financial instruments with options that create customer relationships priced in market transactions as assets to the writer. Examples include credit card contracts, loan commitments and demand deposits.

(b) accounting by a debtor for guarantees by third parties to the holder of the debt instrument.

(c) accounting by financial institutions for guarantees of deposit liabilities by government agencies.

(d) any other matters that respondents to this document may raise or that arise as a result of future deliberations.

3.91 One possible resolution of the first issue might be to exclude such instruments from the fair value measurement requirement, but decisions on the other issues are unavoidable. Those issues are described in more detail in Appendices A and B.

What is the appropriate definition of a financial instrument and which financial instruments, if any, should be outside the scope of a standard for financial instruments?

3.92 The definition of a financial instrument in IFRSs is different from the definition in US GAAP. The boards considered a possible revision to the two definitions of financial instruments during discussions of this paper. That possible definition is set out in Appendix A.

3.93 Potential scope exceptions that the boards have discussed include:

(a) financial instruments classified as equity.

(b) equity investments that make the entity the parent of another entity, are classified as associates or jointly controlled entities, or are variable interests that make the entity the primary beneficiary of a variable interest entity (under US GAAP), and any other instruments that would be eliminated in consolidation.

(c) financial instruments that result from employee remuneration such as share-based pay and post-retirement benefits.

(d) rights and obligations under leases.

3.94 A decision will also have to be taken on whether some classes of contracts that are economically similar to financial instruments but are not financial instruments by definition should be required to be measured at fair value. Examples include:

(a) insurance contracts that require the insurer to deliver medical services or other types of services to the policyholder (delivery of non-financial items).

(b) insurance contracts that permit or require an insurer to buy an insured asset (eg an insured car) for its fair market value if the cost of the repairs it would otherwise pay exceeds that amount (exchange of cash for a non-financial item).

(c) warranties that require the issuer to repair or replace a product (delivery of non-financial items).

Other financial instruments issues that are not a prerequisite to fair value measurement

3.95 Other questions of accounting for financial instruments that are being addressed are:

(a) Which financial instruments should be classified as equity?

(b) When should financial instruments be derecognised?

3.96 Determining which financial instruments should be classified as equity is the subject of the liabilities and equity project. The FASB published a Preliminary Views document *Financial Instruments with Characteristics of Equity* in November 2007. The IASB published that document as part of a discussion paper in February 2008 and will begin deliberations when comments are received and analysed.

3.97 The IASB and FASB have also undertaken a joint research project to identify a better way of accounting for derecognition of financial instruments. That project is in the early stages of staff research. A paper is planned for publication in the first half of 2008.

Summary of this section

3.98 Section 1 describes the many ways financial instruments are measured and the resulting complexity.

3.99 The boards believe the *long-term* solution for reducing measurement-related complexity is to use a single measurement method for all types of financial instruments within the scope of a standard for financial instruments.

3.100 This section explains why fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments. For discussion purposes, this section categorises financial instruments into two types—instruments with highly variable future cash flows (eg derivatives and equity investments) and instruments with fixed or slightly variable future cash flows (eg fixed or variable rate bonds).

3.101 For instruments with highly variable cash flows, fair value seems to be the only measurement attribute that is helpful in assessing future cash flow prospects of the instruments. For instruments with fixed or slightly variable cash flows, a cost-based measure is a feasible measurement attribute if the instruments are held to maturity and it is highly likely that the contractual cash flows will happen. However, if there is a

likelihood that the contractual cash flows will not happen, identifying and quantifying an impairment loss using a cost-based method is complex. In addition, a proceeds-based measurement for liabilities with fixed future cash flows does not provide any information about the effects of credit risk.

3.102 This section discusses some concerns and issues associated with the fair value measurement of financial instruments. The main concerns are (a) the volatility of earnings when changes in fair value that are unlikely to be realised are recognised in earnings, (b) the presentation of unrealised gains and losses in earnings and (c) the difficulty and uncertainty in measuring the fair value of a financial instrument when no market-based information is available.

3.103 This section also identifies some issues that need to be addressed before fair value measurement for financial instruments can become a general requirement. These issues include presentation and disclosure, what the appropriate definition for financial instruments should be, what is meant by fair value and how to estimate fair values of particular instruments.

Questions for respondents

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Question 9

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

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of 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 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

Question 11

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

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

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

Appendix A
Scope issues to be resolved

A1 This appendix describes scope issues that the boards expect to need to resolve before requiring the general fair value measurement of financial instruments. Appendix B describes measurement-related issues that need to be resolved before requiring the general fair value measurement of financial instruments. Although many of the issues discussed in this appendix and Appendix B are relevant for financial instruments that are measured at fair value today, they will become more important as more financial instruments are required to be measured at fair value.

A2 This appendix and Appendix B also describe the outcome of discussions of particular issues at meetings of one or both of the boards. The tentative decisions made at these meetings do not represent official views of the boards because they have not been subject to formal vote by written ballot. They might change as a result of future deliberations.

A3 The fundamental question on scope is: Should the scope of an eventual fair value measurement requirement be based on the definition of a financial instrument, or on a different definition or principle?

A4 IAS 39 uses the definition of a financial instrument (as set out in IAS 32) as the basis for its initial scope, but it includes some non-financial contracts and excludes some financial instruments. US GAAP deals separately with different types of financial instruments (for example, securities, loan assets, loan liabilities and accounts receivable and payable) and with derivative instruments, some of which are financial instruments. US GAAP also contains a long list of adjustments to the initial scope of standards. Such adjustments are difficult to understand and apply. In addition, the US GAAP and IFRS definitions of a financial instrument are different. Both also have technical flaws.

A5 Both IFRSs and US GAAP could be simplified if a principle or definition could describe items in a standard on financial instruments in a simple and understandable way.

A6 The tentative decision of the boards is to use a definition of a financial instrument to set the initial scope. The boards have tentatively decided on revised definitions of a financial instrument, a financial asset and a financial liability.

A7 Consequently, this appendix discusses:

(a) the boards' tentatively revised definitions of a financial instrument, a financial asset and a financial liability and possible adjustments to the scope (possible scope exclusions and additions).

(b) whether an alternative approach to setting the initial scope (eg a principle-based approach) could be developed to avoid a long list of subsequent adjustments.

Using a definition of a financial instrument to set the scope

Revised definitions of a financial instrument, a financial asset and a financial liability

A8 As mentioned above, existing definitions of a financial instrument have some technical flaws. The boards have tentatively decided on the following revised definitions of a financial instrument, a financial asset and a financial liability.

A *financial instrument* is:
(a) cash;
(b) an ownership interest in an entity;
(c) a contractual obligation of one party to deliver a financial instrument to another party and the corresponding contractual right of the latter party to require receipt of that financial instrument in exchange for no consideration other than release from the obligation; or
(d) a contractual obligation of one party to exchange financial instruments with another party and a contractual right of the latter party to require an exchange of financial instruments with the former party.
A *financial asset* is a financial instrument that is an asset.
A *financial liability* is a financial instrument that is a liability.

A9 Contractual rights and obligations to deliver or exchange financial instruments may be links in a chain of contracts that ends with the delivery of cash or an ownership interest of an entity.

A10 Delivery contracts may be conditional or unconditional. Unconditional delivery contracts include trade payables or receivables, loan payables or receivables, and similar instruments. Conditional financial instruments include life insurance and other policies, warranties and derivative instruments that require cash payments.

A11 Similarly, exchange contracts may be conditional or unconditional. Exchange contracts include physically settled options to buy or sell financial instruments (puts and calls), commitments to make loans, lines of credit, and contracts to exchange securities such as repurchase agreements.

A12 The following paragraphs explain the technical flaws in existing definitions of a financial instrument.

Flaws identified in IAS 32 definitions

A13 IAS 32 requires all financial instruments to be contractual. Cash is not a contract. Ownership interests in entities are not contracts, at least in some jurisdictions. Therefore, the proposed definition of a financial instrument specifies that cash and ownership interests in entities are financial instruments.

Flaws identified in SFAS 107 definitions

A14 A footnote in SFAS 107 says that contractual assets of one entity are contractual liabilities to another entity. SFAS 107 states that all equity derivatives whose equity is the underlying are liabilities to the entity. The proposed definition states that an obligation to deliver creates a right to receive for another entity and that exchange contracts create rights and obligations for both parties, and makes no reference to assets and liabilities.

Flaws identified in both IAS 32 and SFAS 107 definitions

A15 The existing definitions are organised to separate financial assets and financial liabilities; the result is confusing for the reader. The right to require delivery is in the asset part of the definition and the obligation to deliver is in the liability part of the definition. The asset part of the existing definitions refers to exchanges that are potentially favourable and the liability part refers to exchanges that are potentially unfavourable. That means that a forward contract could be an asset or a

liability because the exchange might be favourable or unfavourable to either party. In addition, the existing definitions exclude options with market exercise prices that may be assets to one or both parties if assurance that the exchange will take place is valuable.

A16 The proposed definition is organised around the type of contracts—both sides of a delivery contract are described together and both parts of an exchange contract are described together. The proposed definition says that a financial asset is an instrument that is an asset and a financial liability is an instrument that is a liability.

A17 The asset sides of the existing definitions refer to the right to receive a financial instrument and the right to exchange a financial instrument. Referring to the right to *require* delivery of a financial asset or to *require* the exchange of financial assets is a more accurate description of the rights in a contract.

A18 The references to delivery or exchange of *cash or another financial asset* seem to grant higher status to cash. Although cash is often involved, it is not a necessary feature of a financial instrument. The proposed definition relating to contractual arrangements omits references to cash.

A19 The proposed definition adds that in a delivery contract the only consideration the deliverer receives is a release from the obligation. That is intended to make it clear that an exchange contract (such as a forward) to buy or sell non-financial items is not a financial instrument. Without such clarification, the existing definitions could be read to say that the cash delivery side of a forward purchase and sale contract for a non-financial item is a financial instrument.

A20 The proposed definition refers to *contractual rights* and *contractual obligations* rather than *contracts*. The existing definitions, if read literally, apply to entire contracts even if there are multiple sets of rights and obligations, some of which would not be financial instruments if free-standing. For example, a single contract could require exchange of a physical asset *and* a financial instrument for cash. However, the entire contract is a financial instrument if the existing definitions are read literally. The definitions were intended to cover only part of the contract—the exchange of the financial instrument for cash.

Financial instruments that might be excluded from the scope

A21 Some financial instruments are accounted for differently from other financial instruments because, for various reasons, they are considered different from other financial instruments.

A22 Some examples of financial instruments that are subject to their own standards or are specifically excluded from standards for financial instruments are:

(a) ownership interests in consolidated entities

(b) ownership interests accounted for using the equity method or using proportional consolidation

(c) financial instruments classified as equity by the reporting entity

(d) lease receivables and payables

(e) licence fees, royalties and other obligations to pay (rights to require payment) for using non-financial items

(f) pensions and other post-employment benefits

(g) insurance and related contracts

(h) warranty contracts

(i) share-based payment plans.

A23 Items (a) and (b) are excluded because they involve ownership interests that convey control of an entity or significant influence over an entity.

A24 The equity method, which was originally developed primarily for unconsolidated subsidiaries, is applied to investments in entities that are not subsidiaries. The boards have discussed whether the equity method should be eliminated, but have not made any decisions.

A25 Payments on financial instruments classified as equity are distributions, not determinants, of comprehensive income. The boards are reconsidering in a separate project which instruments should be classified as equity. The outcome of that project will determine which instruments are excluded from any general fair value measurement requirement.

A26 Leasing involves payment for use of a non-financial asset. Whether amounts recognised as assets and liabilities under lease accounting are financial instruments or are executory contracts of a different nature may be determined in a separate project on leasing. One possible outcome of that project would be to identify the financial instruments that result from a lease and subject them to the same accounting as other financial instruments. The project has not yet progressed to the point at which that decision will be made.

A27 Other obligations to pay (rights to require payment) for using non-financial items such as licence fees and royalties are subject to the same issue as amounts recognised under leases. It is not clear whether they are financial instruments. They are excluded from the scope of IAS 39 and SFAS 133.

A28 Obligations and rights for post-employment benefits are financial instruments if they are paid in cash and the employee is not required to provide future services in exchange for them (ie they are vested). Separate standards apply to post-employment benefit obligations and rights because they have unique characteristics. For example, even if a post-employment benefit obligation is a financial instrument, an employee's future salary or wages and number of years of service may affect the amount to be paid. Both boards have an active project to reconsider post-employment benefits.

A29 Insurance contracts are covered by a unique set of reporting standards and are the subject of an active IASB project. Although some insurance contracts are financial instruments that may be similar to other financial instruments, not all insurance contracts are financial instruments. Some require the insurer to provide services instead of delivering a financial asset; others may require either, depending on circumstances. There are no plans to include insurance contracts in the fair value measurement requirement for financial instruments, but the insurance project could end up with a similar accounting.

A30 Warranty contracts are similar to insurance contracts in that some are financial instruments and some are not. Although there are no plans to include them in the fair value measurement requirement for financial instruments, neither board has a separate project on warranties.* Therefore, subjecting them to the financial instruments requirements is a reasonable possibility in the long term.

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* Some types of warranties are addressed by the boards' joint project on revenue recognition.

A31 The boards have not made any decisions about which financial instruments should be excluded from the scope, apart from the IASB tentatively deciding to exclude financial instruments that are being addressed in other projects on its agenda (such as leases, pensions and insurance and related contracts).

A32 Lastly, some financial instruments (such as loan commitments, lines of credit and credit card contracts) are currently not recognised except in particular situations—for example, in business combinations or when an entity has incurred a loss related to them. Some of these instruments include options that are priced in markets as assets to the writer of the options. The measurement issues related to those instruments are discussed in Appendix B.

A33 One solution to the measurement issues might be not to require these financial instruments to be recognised. However, the boards have not made any decision to that effect.

Possible additions to the scope

Servicing contracts

A34 US GAAP treats contracts to service financial assets similarly to financial instruments. In a servicing contract, the party providing the services (the servicer) collects and remits payments (less the servicing fee) to the holder of the financial assets. Although usually called servicing rights, such a contract can be more accurately described as a forward contract to provide services. As in all forward contracts, there is a right and an obligation. Servicing is the obligation; the right is to be paid for providing the service. The servicer may have an asset or a liability depending on the amount of the fee and the cost of providing the service.

A35 SFAS 156 *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140* requires some servicing contracts to be separately recognised and initially measured at fair value. The servicer has the option of remeasuring the contract at fair value or amortising the initial fair value and recognising impairment losses if necessary. (The holder of the serviced assets reports them net of the servicing fee; the servicing obligation is not recognised separately.)

A36 The basis for conclusions in SFAS 156 states that because servicing contracts have similarities to financial instruments, fair value is the most relevant measure.

A37 The servicer under a servicing contract is exposed to some of the same risks as financial assets—interest rate risk, credit risk, foreign currency risk and prepayment risk. That suggests including in the fair value measurement requirement contracts that are subject to the same risks as financial instruments. However, that scope would be too broad because nearly all contracts to deliver or exchange something of value are subject to credit (performance) risk, foreign currency risk and interest rate risk.

A38 The FASB tentatively decided that servicing contracts should not be included within the scope because specific accounting requirements already exist. The IASB tentatively decided that servicing contracts should be included within the scope because, at present, no IFRSs specifically address such contracts.

Non-financial contracts

A39 Contracts for the delivery (or exchange for cash) of non-financial items that are treated as financial instruments in IAS 39 if they meet the following criteria:

(a) the contract contains an explicit cash settlement or net settlement option and the exception for normal purchases, sales or usage does not apply.

(b) an entity has a past practice of net settlement (by various means).

(c) an entity has a past practice of taking delivery and selling the underlying within a short period.

(d) the item delivered is readily convertible to cash and the exception for normal purchases, sales or usage does not apply.

A40 The definition of a derivative instrument in SFAS 133 includes contracts for the delivery (or exchange for cash) of non-financial items if:

(a) the contract has a cash settlement (or net settlement) option.

(b) there is a market mechanism for cash settlement (for example, commodity contracts traded on a futures exchange).

(c) the contract requires delivery of a non-financial item that is readily convertible to cash and the exception for normal purchases and normal sales does not apply.

A41 The reason for including those items is that they are economically similar to financial instruments. If those non-financial contracts were subject to a different accounting requirement, two contracts that are similar in outcome would not be accounted for similarly. Users of financial information are entitled to expect similar items to be accounted for similarly.

A42 The tentative decision of the FASB is that non-financial derivative contracts within the scope of SFAS 133 should be within the scope of a financial instruments standard. The tentative decision of the IASB is that non-financial contracts that have a probable outcome similar to that of a financial instrument contract and non-financial contracts that meet the definition of a derivative and are within the scope of IAS 39 should be within the scope.

Derivatives embedded in non-financial contracts

A43 IAS 39 and SFAS 133 apply to components of some non-financial contracts. Such components are the element of a non-financial contract that meets the definition of a derivative (an 'embedded' derivative). An example is the foreign currency element of a contract to buy or sell a non-financial item in a foreign currency.

A44 Because the requirements to identify and separate derivatives embedded in non-financial contracts can be difficult to apply, some exceptions are made. The exceptions, which are intended to avoid difficult application issues, add complexity to determining which components must be separated. The closeness of the relationship between the economic characteristics of an embedded derivative and the 'host' contract determines whether separation is required.

A45 Reasons to include such components of a non-financial contract within the scope of a financial instruments standard include:

(a) If embedded derivatives were not included within the scope of a financial instruments standard, it would be possible to have different accounting treatments by embedding a derivative in a non-financial contract.

(b) Such an approach can reduce possible recognition and measurement anomalies. For example, an exposure created by foreign exchange risk (the embedded derivative) in a non-financial contract may be hedged by a financial instrument measured at fair

value. If both the embedded derivative and the hedging instrument are measured at fair value, there is no need for hedge accounting.

A46 Reasons to exclude such components of a non-financial contract from the scope of a financial instruments standard include:

(a) The non-financial contract is not a financial instrument because it does not require the exchange of cash (or another financial instrument) for a financial instrument.

(b) The rights and obligations in a single contract may be inextricably linked. Requiring the separate measurement of only part of such a contract may require difficult and subjective judgements.

A47 Possible approaches to reducing the complexity associated with the identification and measurement of embedded derivatives include:

(a) eliminating the 'closely related' (IASB) and 'clearly and closely related' (FASB) criteria and requiring separation of all embedded derivatives. That would simplify the decision about *whether* to account for a component separately, but would require more embedded derivatives to be separated and measured.

(b) requiring or permitting any non-financial contract containing an embedded derivative to be measured at fair value in its entirety. This approach would not simplify identification of embedded derivatives, but would eliminate the judgements required to separate and measure the components. (Presumably, measurement of an entire contract would be easier and require fewer assumptions than measuring a component.)

(c) establishing a simpler criterion to identify embedded derivatives. For example, embedded derivatives might be identified by determining whether the fair value of an entire contract might change as a result of changes in particular market factors. If the cash flows required by a contract to buy or sell a non-financial item vary because of changes in financial risks such as interest rates, then such a contract could be included in the scope of a financial instruments standard.

A48 The boards have not made any decision on this issue.

Non-contractual rights and obligations that are similar to financial instruments

A49 Some rights and obligations to deliver financial instruments are not financial instruments because they are not contractual. An example is taxes payable, which is a statutory obligation. Some consider statutory (and perhaps regulatory) assets and liabilities so similar to contractual assets and liabilities that they should be included in the definition of a financial instrument.

A50 At present, those assets and liabilities are subject to separate standards, and the boards have tentatively decided that they should not be included in the definition of a financial instrument.

Non-financial contractual rights and obligations that are similar to financial instruments

A51 Some types of contracts may be financial instruments, depending on their terms. Examples are insurance policies, warranties and some credit card contracts. Some insurance policies and warranties require the obligor to pay cash if the party holding the policy or warranty files a claim. Those contracts are financial instruments. Some otherwise similar contracts require the obligor to provide medical or repair services or to replace damaged goods. Those contracts are not financial instruments even though, from the perspective of the policyholder or the warranted party, the results of the two types of contracts are the same.

A52 Credit cards issued by banks require the card issuer to pay cash to a vendor when the holder uses the card. That contract is a financial instrument. Credit cards issued by a retailer require the retailer to provide goods or services when the cardholder uses the card. From the perspective of the cardholder the result is the same regardless of who issued the card, but the retailer-issued credit card is not a financial instrument.

A53 Accounting for similar contracts differently because one is a financial instrument and the other is not is unlikely to serve the interests of users and is likely to increase the record-keeping burden on preparers of financial statements. Consequently, the scope must be adjusted to include or exclude all similar contracts.

A54 These examples are relatively straightforward. However, some contracts, especially insurance contracts, have financial and non-financial aspects. For example, a standard motor (automobile) insurance policy often permits the insurer to buy a damaged car from the owner or pay for

repairs, whichever is cheaper. Liability insurance policies may impose an obligation on the insurer to provide legal services to the insured party and to pay damages if any are assessed. Those individual contracts might have to be separated unless an exception is made to a financial instruments standard to include or exclude the entire contract.

A55 The boards have not made any decision on this issue.

Derivative instruments that are currently excluded from IAS 39 and SFAS 133

A56 The following contracts are not subject to the requirements of SFAS 133 even if they are derivative instruments by definition:

(a) 'regular-way' security trades

(b) 'normal purchases and normal sales'

(c) some insurance contracts

(d) some financial guarantee contracts

(e) contracts with the following underlying that are not exchange-traded:

  (i) a climatic or geological variable or other physical variable

  (ii) the price or value of one of the parties' asset or liability that is neither a financial instrument nor a derivative

  (iii) specified volumes of sales or service revenues of one of the parties to the contract

(f) derivatives that serve as impediments to sales accounting

(g) a policyholder's investment in a life insurance contract if it is accounted for under a FASB Technical Bulletin or FASB Staff Position

(h) some investment contracts held by defined benefit pension plans

(i) loan commitments by potential borrowers and by issuers, except mortgage loans that will be held for sale

(j) registration payment arrangements within the scope of FSP EITF 00-19-2 *Accounting for Registration Payment Arrangements*

(k) contracts that are indexed to the entity's own stock and classified as equity

(l) contracts issued by the entity that are subject to SFAS 123 (revised 2004) *Share-Based Payment*

(m) contracts issued by the entity as contingent consideration from a business combination

(n) forward purchase contracts for the reporting entity's shares that require physical settlement accounted for under paragraphs 21 and 22 of SFAS 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

A57 The above list is not exhaustive. Not only is it a long list, but there are also at least a few sentences of explanation of each item, and in some cases, the explanation takes several paragraphs.

A58 IAS 39 includes in its scope most derivative contracts that are financial instruments and some derivative contracts that are not financial instruments. However, some financial instruments that meet the definition of a derivative are excluded. These include:

(a) 'regular way' purchases or sales of financial assets

(b) some loan commitments

(c) some financial guarantee contracts

(d) some contracts for contingent consideration in a business combination

(e) some contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date

(f) financial instruments under share-based payment transactions to which IFRS 2 *Share-based Payment* applies.

A59 It should be clear that exceptions add to the difficulty in applying IAS 39 and SFAS 133. It is likely that not all users are aware that some of these items are excluded, which could result in misinterpretations of information given in financial statements. Consequently, the boards could reduce the complexity of current standards by eliminating some or all of the exceptions.

A60 The boards have not made any decision on this issue.

A principle-based scope with fewer adjustments

A61 It is clear that using a definition of a financial instrument to set the initial scope results in many subsequent adjustments. Moreover, scope exceptions add complexity to a financial instruments standard.

A62 Therefore, a principle-based scope would reduce complexity associated with scope adjustments. One possibility is to define the scope with reference to probable outcomes instead of contractually required outcomes. Part of the definition of a financial instrument refers to requirements to deliver or exchange financial instruments. It might be possible to describe a class of contracts for which it is highly probable that the outcome will be delivery or exchange of cash, a contract that requires delivery of cash, or a highly liquid contract that can be readily converted to known amounts of cash. Such an approach would cover many of the non-financial contracts included in IAS 39 or SFAS 133. In other words, the number of adjustments to the scope could be reduced and the corresponding complexity associated with the scope exclusions could also be reduced.

A63 Both boards have discussed that possibility briefly. However, the implications of such a description have not been investigated in detail.

Appendix B
Measurement issues to be resolved

B1 This appendix discusses measurement issues that the boards may need to resolve before they could require the general fair value measurement of financial instruments. Tentative decisions of the IASB are included on some issues. Those tentative decisions do not represent official views of the IASB because they have not been subject to formal vote by written ballot. They might change as a result of future deliberations.

The meaning of fair value

B2 The FASB has issued SFAS 157, which establishes general principles for determining the fair value of all types of assets and liabilities. It defines fair value as an exit price and addresses many but not all measurement issues specific to financial instruments.

B3 The IASB's definition of fair value for financial instruments in IAS 32 is similar to that in SFAS 157. However, there are some differences. Those differences must be resolved if the two boards are to issue a common standard requiring the fair value measurement of financial instruments. To that end, in November 2006 the IASB published a discussion paper on fair value measurements that used SFAS 157 as the starting point for its deliberations. The IASB has recently started its redeliberations.

B4 Assuming that this issue is resolved, the boards expect to make decisions about how to measure the following types of financial instruments:

(a) financial instruments with options that are priced in market transactions as assets to the writer (see examples set out in paragraph B5); and

(b) contractual and non-contractual guarantees by third parties to the holder of a debt instrument in the financial statements of the debtor.

Financial instruments with options that are priced in market transactions as assets to the writer

B5 Some types of contracts that are written options or have embedded written options are known to be priced in market transactions as assets. Common examples are credit card contracts and other loan

commitments.* All such instruments of which the boards are aware arise from instruments originated in principal-to-principal transactions between a financial institution or similar entity and a retail customer (consumer). Some, such as credit card contracts, are usually not recognised except in business combinations or unless they create a loss that is required to be recognised.

B6 Those types of customer contracts permit a customer (option holder) to engage in transactions that create profits (or gains) to the issuer of the instrument (option writer). Theories behind share option pricing models predict that the customer would not exercise an option unless exercise would be a detriment to the writer. However, customers do exercise their options. Huge volumes of credit card transactions occur every day, nearly all of which contribute to the profits of the card issuer. Customers may enter into such transactions for many reasons, some of which are purely economic and many of which are related to convenience or security.

B7 Transactions involving portfolios of credit card contracts occur on occasion, and invariably the entity assuming the obligation under the options pays the entity being relieved of the obligation. Similarly, in business combinations and other transactions entities assuming mortgage loan commitments assign positive values to them and entities assuming deposit liabilities assign values below the face value. These transactions provide evidence that an asset exists for credit card contracts and mortgage loan commitments. Likewise, these transactions provide evidence that the fair value of the deposit liability might be below its face value.

B8 Credit card contracts and loan commitments are written options held by the cardholder or potential borrower. Card issuers and lenders typically do not recognise those options as assets or liabilities. One possible reason is that there is little or no likelihood of loss and no guarantee of gain. If the cardholder or holder of the loan commitment exercises its option, the card issuer or lender pays cash in exchange for a financial instrument—a credit card receivable (the balance on the card) or a loan receivable. (That credit card or loan receivable is recognised by both parties and is not the issue under discussion here.) Therefore, the options qualify as financial instruments under each board's current definition.

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* Some such loan commitments are commonly referred to as interest rate lock commitments.

B9 In addition, most accountants expect written options to be liabilities. Pricing models used to price share options and similar options never result in asset values. However, as market transactions indicate, portfolios of written options in credit card contracts and loan commitments are assets. Consequently, the boards will need to make a decision on how to recognise them.

B10 Demand deposit liabilities of financial institutions create a liability to the depositor for the amount on deposit. Measurement of that liability raises issues because although depositors can withdraw funds immediately, most do not. Therefore, if the deposit pays no interest or pays interest at a level below comparable deposits that cannot be withdrawn on demand, the financial institution has an inexpensive source of funds until they are withdrawn. (The cost of servicing the deposits would also be a factor in estimating fair value and may offset part of the effect of the interest rate.)

B11 The demand deposit issue that is analogous to credit card contracts and loan commitments is not the amount on deposit but the underlying deposit agreement that permits the depositor to deposit money at any time.

B12 That right to make a deposit can be described as a call option to purchase a liability instrument from the depository institution. (Depositing the money creates a liability owed by the depository institution to the customer.)

B13 That underlying agreement creates a relationship with the depositor that has a positive value in business combinations, sales of branches, and transfers of deposit portfolios. The positive value is less than the negative value of the outstanding deposits so a deposit portfolio is a net liability, but noticeably smaller than face value.

B14 The two reasons why the transfer price for a demand deposit portfolio is less than face value are the low interest rate and the expectation of deposits that will bear low interest rates. The deposit itself is a financial instrument under each board's definition. However, the status of the underlying deposit agreement is less certain. A depository institution has incentives to accept deposits unless it suspects illegal activity or unless the deposit would cause it not to meet regulatory requirements. Therefore, it is not certain that the deposit agreement requires the depository institution to accept cash in exchange for a deposit liability, and such a requirement is a necessary part of the definition of a financial instrument.

B15 Some view a deposit agreement as nothing more than an offer to do business with anyone who chooses to do so. Others point out that a bank will not and cannot accept deposits without doing the necessary paperwork that sets out the terms under which it will accept deposits and return the funds to the depositor.

B16 The boards could decide to exclude credit card contracts, loan commitments, demand deposit agreements, and similar financial instruments from the scope of a financial instruments standard. Such items have characteristics that are not normally regarded as associated with financial instruments. There is a precedent for that type of exception: investments in subsidiaries are excluded because they have characteristics that are different from other financial instruments.

B17 If the boards decide to include those contracts in the scope of a fair value measurement requirement, they will have to decide how to recognise the positive value (asset or reduced net liability). Past discussions have identified two views:

(a) the positive value is inseparable from and inherently a part of the option or embedded option value.

(b) the positive value is a separate intangible customer relationship asset.

B18 The issues related to credit card contracts and demand deposit liabilities are described in more detail in the FASB Preliminary Views *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*, which was published in 1999.

Accounting by a debtor for contractual guarantees by third parties to the holder of the debt instrument

B19 When a contractual guarantee has been issued to the holder of the debt instrument by someone other than the debtor ('third-party guaranteed debt'), measurement by the holder is fairly clear. The holder's asset is the instrument, including the guarantee, unless the guarantee is a separate contract between the holder and the guarantor. In that case, as a practical matter, the holder might still recognise one asset that combines the value of the receivable and the guarantee. However, in concept there are two sets of future cash flows—one from the debtor and one from the guarantor that only occurs if the debtor does not pay. That distinction is unlikely to be important to a user of financial information.

B20 The fair value to the debtor of its own debt is less obvious and is a more difficult question than whether two cash flow streams are combined. There are two possibilities:

(a) the guarantee is a contract between the guarantor and the debt holder that does not affect the obligation of the debtor, in which case the fair value of the debtor's liability is not affected by the guarantee.

(b) the fair value of the debtor's liability is increased by the guarantee and the guarantee is an asset to the debtor.

B21 The two possibilities can be illustrated with an example comparing three obligations from the same debtor—a collateralised liability, an uncollateralised liability and a third-party contractually guaranteed liability. The contractually guaranteed liability assumes that the debtor purchases the guarantee and then transfers the guarantee to the creditor when the liability is issued. In each situation, the debtor has an obligation to repay CU105 in one year.

Example

	Collateralised	Uncollateralised	Guaranteed
Repayment amount in 1 year (CU)	105	105	105
Interest rate	5%	8%	5%
Proceeds from loan (CU)	100	97.22	100
Cost of guarantee (CU)	–	–	2.78
Net proceeds (CU)	100	97.22	97.22
Cost of funding (CU)	5	7.78	7.78
Cost of funding (%)	5%	8%	8%

B22 The collateralised obligation is straightforward. By collateralising the liability and increasing the probability that the asset holder will receive full settlement at the contracted time, the entity can raise CU100 today at a cost of 5 per cent.

B23 The same debtor could raise CU97.22 on an uncollateralised loan at a cost of 8 per cent.

B24 The debtor also could raise CU100 by issuing a liability guaranteed by a third party with a high credit rating. The debtor would pay CU2.78 to the guarantor for providing the guarantee, which results in net proceeds of CU97.22—the same as from an uncollateralised liability.* In this example, if the guarantee amount is paid to the holder of the debt instrument, the obligation of the debtor is not eliminated. Instead, the guarantor will become the creditor and the debtor will be obliged to repay the guarantor.

B25 Both the uncollateralised liability and the guaranteed liability require a cash outflow of CU105 in one year. Also, in both cases the probability that the debtor will be able to pay (the probability-weighted cash outflow) is the same. That supports the view that the third-party contractual guarantee has no effect on the debtor's expected cash outflows, and that both liabilities have the same fair value to the debtor. Any future payments by the guarantor will benefit the debt holder but will not affect the debtor.

B26 However, the terms of the guarantee could state that payment by the guarantor to the debt holder releases the debtor from its obligation. If that were the case, the guarantee would affect the fair value of the liability to the debtor. If the debtor experiences financial difficulty, the guarantor will step into the debtor's position and settle the debt. That guarantee represents an asset to the debtor because it provides cash to settle the debtor's liability. In that case, the fair value of the liability to the debtor would the same as the asset value to the debt holder. However, guarantees that release the debtor from its obligation are likely to be rare because of the moral hazard involved.

B27 The tentative decision of the IASB is that if the guarantee is a contract between the guarantor and the debt holder and does not affect the obligation of the debtor, the fair value of the debtor's liability is not affected by the guarantee.

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* This example assumes that markets are perfectly efficient. In reality the cost of purchasing the guarantee could be different from the benefits of the coupon differential between a guaranteed and uncollateralised liability. If this was the case, then under this approach a gain or loss would be recognised in relation to the guarantee by the debtor.

Accounting by a debtor for a non-contractual guarantee to the holder of the debt instrument

B28 Some liabilities are guaranteed by a government or government agency. Those guarantees often occur in regulated financial services markets for retail depositors. Such insurance is statutory and not contractual. Therefore, it is not a financial instrument because it is not a contract or an ownership interest.

B29 The issue of how a debtor should recognise liabilities that are statutorily guaranteed raises questions about the interaction between the law and the rights and obligations that form a contract. Deposit insurance provided by a government agency covers all liabilities that have specific characteristics (typically retail deposits up to a specified size). In exchange for the guarantee, the depository institutions must submit to regulatory oversight.

B30 However, rather than simply paying out the guarantee if the depository institution fails, the regulator can decide to intervene to ensure that insured liabilities are paid. The regulator may take over the institution or arrange a take-over or an assumption of the guaranteed liabilities, which effectively means that the insured liabilities are partially or wholly satisfied by the entity itself. Alternatively, the regulator may guarantee the value of the assets of the deposit-taking entity that is in trouble.

B31 Therefore, there is an argument that the fair values of statutorily insured liabilities are affected by the regulatory environment as much as or more than the guarantee itself. Market participants (both the holders of the regulated entities liability and institutions assuming insured liabilities) consider the effect of the regulatory environment in pricing the liabilities.

B32 The tentative decision of the IASB is that the effect of the regulatory environment should be included in the measurement of the fair value of a non-contractual guarantee.

Appendix C
Overview of relevant IASB and joint IASB - FASB projects

Distinction between equity and non-equity instruments

C1 The objective of this project is to improve financial reporting for financial instruments by developing an improved distinction (compared with today) between equity instruments and liability and asset instruments (non-equity instruments).

C2 In 2006 the IASB and the FASB published an MoU, affirming their commitment to convergence. One of the goals for 2008 set out in the MoU is to issue one or more due process documents relating to a proposed standard on the distinction between liabilities and equity.

C3 The IASB and FASB are conducting this project under a modified joint approach. The FASB has taken the lead for the research stage. In November 2007 the FASB published a Preliminary Views document *Financial Instruments with Characteristics of Equity*. That document describes three approaches to distinguish equity instruments and non-equity instruments—basic ownership, ownership-settlement and reassessed expected outcomes.

C4 The IASB did not participate in the development of the FASB preliminary views document. The IASB has not deliberated any of the three approaches, or any other approaches.

C5 In February 2008 the IASB published a discussion paper comprising an Invitation to Comment and the FASB Preliminary Views document.

C6 The liabilities and equity project is on the IASB's research agenda. The IASB plans to consider a proposal to add the project on to its active agenda during the comment period for the discussion paper.

Derecognition

C7 In 2005 the IASB and FASB established three long-term objectives to simplify and improve financial reporting requirements for financial instruments, if technical and practical hurdles can be overcome. One of the objectives is to develop a better way of accounting for the derecognition of financial instruments.

C8 Consequently, the IASB and FASB directed the staff to begin a research project to develop an approach to derecognition with an initial focus on financial instruments. The IASB and FASB also directed the staff to consider as part of the research project the feasibility of developing a broader derecognition standard that would apply to all types of assets.

C9 The preliminary conclusions of the staff research are that an entity should derecognise a financial asset when the entity ceases to have the power to enforce the promise in the contract that gave rise to the financial asset. Similarly, an entity should derecognise a financial liability when the entity ceases to have the obligation to honour the promise in the contract that gave rise to the financial liability.

C10 The staff further propose that for presentation purposes a recognised financial asset and a recognised financial liability should be presented together in the financial statements (referred to as 'linked presentation') if either the entity is unconditionally obliged to pay benefits to settle the obligation when the asset generates benefits, or the entity is unconditionally entitled to the right to receive benefits from the asset when the financial liability is settled.

C11 In the staff approach, derecognition of financial instruments is based on the entity no longer being able to enforce the rights and obligations in the contract. Linked presentation informs users of financial statements how the economic benefits of recognised financial assets and liabilities are linked.

C12 A paper is expected to be published in the first half of 2008. That publication is consistent with the commitment set out in the MoU.

Financial statement presentation

C13 The aim of this joint project between the IASB and FASB is to establish a common, high quality standard for presentation of information in the financial statements, including the classification and display of line items and the aggregation of line items into subtotals and totals. The boards are conducting this project in three phases.

C14 Phase A defines what constitutes a complete set of financial statements and deals with requirements to present comparative information. In March 2006 the IASB published its phase A exposure draft of proposed Amendments to IAS 1 *Presentation of Financial Statements*. In September 2007 the IASB issued a revised version of IAS 1 that made it largely consistent with SFAS 130 *Reporting Comprehensive Income*. The FASB did not

publish a separate exposure draft on phase A and intends to expose its phase A proposals along with its phase B proposals.

C15 Phase B addresses the more fundamental issues for presentation of information on the face of financial statements:

(a) developing principles for aggregating and disaggregating information in each financial statement.

(b) defining the totals and subtotals to be reported in each financial statement (that might include categories such as business and financing).

(c) deciding whether components of other comprehensive income should be recycled/reclassified to earnings and, if so, the characteristics of the transactions and events that should be recycled and when recycling should occur.

(d) considering SFAS 95 *Statement of Cash Flows* and IAS 7 *Statement of Cash Flows*, including whether to require the use of the direct or indirect method.

C16 The boards plan to publish a discussion paper on phase B later in 2008.

C17 Phase C addresses presentation and display of interim financial information in US GAAP. The IASB may reconsider the requirements in IAS 34 *Interim Financial Reporting*.

Fair value measurement

C18 IFRSs require some assets, liabilities and equity instruments to be measured at fair value. However, guidance on measuring fair value has been added to IFRSs piecemeal over many years and is not always consistent among IFRSs.

C19 In November 2006 the IASB published a discussion paper containing the unmodified text of SFAS 157 along with the IASB's preliminary views on the main issues in SFAS 157.

C20 The objectives of the IASB's project on fair value measurement are:

(a) to establish a single source of guidance for fair value measurements required or permitted by existing IFRSs;

(b) to clarify the definition of fair value and to ensure consistency in the related guidance; and

(c) to enhance disclosures about fair value to enable users of financial statements to assess the extent to which fair value is used to measure assets, liabilities and equity instruments, and to provide them with information about the inputs used to estimate fair values.

C21 The comment deadline for the IASB's discussion paper on fair value measurement was May 2007. Responses to the discussion paper will assist the IASB in developing an exposure draft of an IFRS on fair value measurement. The IASB aims to publish the exposure draft in 2009.

Appendix D
Overview of FASB project on hedge accounting

D1 In May 2007 the FASB took onto its agenda a project to simplify accounting for hedging activities. The objective of the project is to amend SFAS 133, so as to achieve the following:

(a) resolve practical issues that have arisen under SFAS 133.

(b) simplify accounting for hedging activities.

(c) improve the financial reporting of hedging activities to make the accounting model and the associated disclosures easier to understand for financial statement users.

(d) address differences in the accounting for derivative instruments and hedged items or transactions.

D2 The hedge accounting approach would establish a fair value methodology to hedge accounting. The approach would eliminate many elements that exist under the current hedge accounting model, including bifurcation by risk, the 'shortcut' method, critical terms match, and the requirement to assess effectiveness quantitatively in order to qualify for hedge accounting.

D3 The items and transactions currently eligible for special hedge accounting would continue to be eligible under this approach. However, hedges of individual risks in a hedged item or transaction would generally not be permitted. Except in the situations discussed in paragraph D4, the hedged risk must be the risk of all changes in fair value of the hedged item or all changes in the hedged cash flows.

D4 There are two exceptions to the requirement that the hedged risk must be the risk of all changes in fair value in the hedged item—hedges of foreign currency risk and for hedges of interest rate risk in an entity's own debt. Entities would be permitted to designate just foreign currency risk as the hedged risk in any hedged item subject to foreign currency risk. Entities would also be permitted to designate interest rate risk as the hedged risk in its own fixed or variable rate debt, but that exception would apply only at initial recognition of the debt.

D5 Formal, contemporaneous documentation of the hedging instrument, and hedged item or forecast transaction would be required along with a qualitative evaluation of the nature of the risk that the entity is attempting to hedge. The qualitative evaluation would demonstrate that (a) an economic relationship exists between the hedging instrument and hedged item or forecast transaction, and (b) the derivative should be expected to reasonably offset changes in fair value or the variability in the hedged cash flows attributable to all risks. In some situations, a quantitative analysis may be more effective in demonstrating the relationship between the derivative instrument and the hedged risk.

D6 After inception, an entity would need to reassess effectiveness if circumstances indicate that the hedging relationship is no longer reasonably effective. These circumstances would depend on the nature of the hedged item or transaction and hedging instrument. The ability to discontinue hedge accounting by simply removing the designation of the hedging relationship would not be permitted.

D7 In December 2007 the FASB directed the staff to begin drafting an exposure draft for vote by the FASB.

Appendix E
Questions for respondents

Section 1 Problems related to measurement

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 IASB respond to assertions that the current requirements are too complex?

Section 2 Intermediate approaches to measurement and related problems

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(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 2.2?

(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 2.2?

(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 2.2?

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

  (i) Which method(s) should the IASB consider, and why?

  (ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the 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 IASB 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?

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

Section 3 A long-term solution—a single measurement method for all types of financial instruments

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Question 9

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

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of 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 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

Question 11

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

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

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

