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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **November 2008, London**

Project: **Financial Instruments**

Subject: **Agenda proposal (Agenda paper 10)**

INTRODUCTION

1. This paper discusses a proposal to add to the IASB's active agenda a project on recognition and measurement of financial instruments. The project 'Financial Instruments: A Replacement of IAS 39 *Financial Instruments: Recognition and Measurement*' is on the IASB's research agenda.

2. This paper:

   a) summarises the background of the project to replace IAS 39

   b) discusses whether the project meets the IASB's agenda criteria

   c) provides a staff recommendation

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

BACKGROUND OF THE PROJECT TO REPLACE IAS 39

3. IAS 39 sets out requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

4. IAS 39 was originally issued by the Board's predecessor body, the International Accounting Standards Committee (IASC). A revised IAS 39 was issued in December 2003 as part of the 'Improvements' project. However, that project did not entail addressing the fundamental basis of IAS 39.

5. For some time the Board has acknowledged the need to improve the reporting of financial instruments and to reduce the complexity of that reporting. IAS 39 has been amended several times since 2003 for various reasons, but the Board has not reconsidered the fundamental requirements of IAS 39.

Work performed to date

6. The research project referred to in paragraph 1 of this paper is included in the Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006-2008*. One of the goals for 2008 set out in that MoU was 'to have issued one or more due process documents relating to the accounting for financial instruments' (the project is also included in the updated MoU).

7. In accordance with the 2008 goal, the IASB published the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* in March 2008. The FASB also published an Invitation to Comment, which included the IASB's Discussion Paper.

8. The Discussion Paper set out several possible approaches for improving and simplifying the accounting for financial instruments. The discussion paper focussed

on measurement and hedge accounting. Over 160 comment letters have been received to date, and at the joint IASB-FASB meeting in October 2008 the staff presented a summary of the comments received (the Observer Notes from that meeting are included in appendix one for reference).

9. The IASB added a project on derecognition to its active agenda in July 2008. This proposed project would address other aspects of reporting for financial instruments.

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

10. As part of our commitment to work in an internationally coordinated manner to consider accounting issues emerging from the global crisis the IASB and the FASB (the Boards) decided at the joint meeting in October 2008 to establish an advisory group comprised of senior leaders with broad international experience with financial markets.

11. The advisory group will be asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The group will be asked to identify any accounting issues that require urgent and immediate attention of the boards as well as issues for longer-term consideration.

12. In developing their approaches on issues resulting from the discussions the boards will follow appropriate due process. In the interest of transparency, the advisory group will meet in public session with webcasting facilities available to all interested parties.

13. While the advisory group is being established, the boards will also organise three roundtables—one each in Asia, Europe and North America. The purpose of these public roundtables is to gather input on reporting issues emanating from the current global financial crisis—including responses by governments, regulators and others. This should enable the boards to act rapidly and the advisory group, once established,

to advance its deliberations efficiently. The first roundtable will be held in London on 14 November 2008.

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

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

Agenda decision by the FASB

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

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

IASB'S AGENDA CRITERIA

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

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

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

    a) international relevance

    b) pervasiveness

    c) urgency

    d) consequences of not adding the project to the agenda.

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

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

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

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

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

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

Criterion 2: Existing guidance available

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

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

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

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

Criterion 3: The possibility of increasing convergence

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

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

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

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

Criterion 4: The quality of the standards to be developed

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

    a) availability of alternative solutions

    b) cost/benefit considerations

c) feasibility.

34. The IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments* includes a number of alternatives to improving the reporting for financial instruments, including introducing a general fair value measurement requirement. Others have made alternative suggestions.

35. The costs of implementing new requirements will depend on any change made, and this will be an issue the Board will need to consider in deciding how to proceed. It is also important to note that such costs apply to all constituents. One thing is clear - that respondents to the discussion paper do not want a series of changes.

36. The benefits of improving and simplifying the requirements for financial instruments could be significant to both users and preparers. As with costs, this is an important consideration for the Board in deciding how to proceed.

37. In the light of the discussions of alternative solutions and other discussions that have already taken place the staff is confident that developing solutions within a reasonable period of time is feasible. The staff thinks that the challenge lies in the diverging views among constituents about the preferable way of improving financial reporting and reducing complexity. The additional challenge is for the Board to balance the need for any short-term improvements to current requirements with the development of solutions aimed at providing greater transparency and reduced complexity.

38. The staff thinks that there are identified feasible alternative solutions that will improve financial reporting. Hence, the staff thinks that the proposed project meets Criterion 4.

Criterion 5: Resource constraints

39. Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:

a) availability of expertise outside the IASB

b) amount of additional research required

c) availability of resources.

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

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

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

STAFF RECOMMENDATION

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

INPUT FROM THE STANDARDS ADVISORY COUNCIL (SAC)

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

QUESTION FOR THE BOARD

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

Appendix 1

Comment Letter Analysis for IASB DP: Reducing Complexity in Reporting Financial Instruments

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Purpose OF THIS Memorandum

1. At the October 21, 2008 joint FASB and IASB education session, the staff will present to the Boards a brief summary of the comment letters received in response to the IASB's Discussion Paper (DP), *Reducing Complexity in Reporting Financial Instruments*. As of October 1, 2008, the Boards received 157 comment letters. The following table summarizes the constituent profile by type and geographical region:

Type	Number
Public Accounting	27
Preparers	82
Users	9
Others*	39
TOTAL	157
Geographical region	**Number**
Africa	5
Asia-Pacific	26
Europe	59
International	36
Middle East	1
North America	29
South America	1
TOTAL	157

* Others include academics, individuals, associations, standard setters and regulators.

2. The staff has not completed its full analysis of the comment letters received to date. However, the staff would like to present the Boards with a condensed summary of responses to key topics identified by the project team thus far in its

comment letter review. Those key topics are (a) the need for a significant change to the current requirements for reporting financial instruments, (b) approaches for addressing complexity issues—including Intermediate Approaches 1 and 2, simplifying hedge accounting requirements (Intermediate Approach 3) and the approach requiring fair value for all financial instruments, and (c) other issues/concerns.

3. For the purposes of this condensed analysis, preparer and auditor comments have been analyzed as a whole and contrasted with user comments as the preparer and auditor responses are generally consistent.

SUMMARY COMMENT LETTER ANALYSIS

A: The need for a significant change to the current requirements for reporting financial instruments

4. Preparers/Auditors: The majority of these constituents believe there is a need for a significant change to the current requirements for reporting financial instruments. Those constituents stated that the current requirements are too complex, do not fit their business models, and should be more principles-based. Some constituents, however, do not agree that a significant change in current reporting requirements is needed. Some of these constituents support a simplified mixed-attribute model, while others argue that financial instruments themselves are inherently complex and that oversimplification would not be a fair representation of the complexity of those instruments.

5. Users: Users stated that there is a need for a significant change to the current requirements for reporting financial instruments, as the current mixed-attribute model is not only confusing for users but creates structuring opportunities for preparers to achieve particular accounting effects.

B: Approaches for addressing complexity issues

Intermediate Approaches 1 and 2 vs. long-term full fair-value method

6. Preparers/Auditors: The majority of these constituents do not support a long-term solution requiring fair value for financial instruments. Many constituents also do not support the intermediate approaches to address the complexity issues. They believe the benefits of those approaches would not outweigh the costs given that those approaches could be replaced. Others support some of the intermediate approaches as a way to simplify current reporting complexity, especially for hedge accounting.

7. Some preparers and auditors agree that reducing measurement categories for financial instruments and eliminating restrictions on the existing measurement categories for financial instruments (Approach 1) would reduce complexity. However, how that should be achieved differed among those constituents. Some of those constituents suggested the Held-To-Maturity (HTM) category should be eliminated. Assets previously categorized under HTM should be moved to either Loans and Receivables or Available-for-Sale (AFS), while others suggested a "Trading" versus "Nontrading" concept.

8. The majority of preparers and auditors do not support replacing existing measurement requirements with a fair value measurement principle with optional exceptions (Approach 2). They believe Approach 2 would add more complexity without apparent benefits.

9. As indicated above, the majority of preparers and auditors do not support requiring fair value for all financial instruments. Those constituents stated that it is not appropriate for financial instruments not held for trading purposes or not managed on a fair-value basis to be measured at fair value. They also stated that it is difficult to value financial instruments that are not actively traded. In addition, they also believe that moving to a full fair-value method would add artificial volatility to earnings.

10. Users: Users generally support the long-term solution of requiring fair value for all financial instruments and did not express strong support for intermediate Approach 1 or Approach 2. However, some users would support elimination of the HTM category and/or support a requirement for all financial instruments to be measured at fair value with certain exceptions, presuming that those exceptions would limit the ability of management intent to determine the measurement basis.

Reducing hedging-related complexities (Intermediate Approach 3)

11. Preparers/Auditors: The majority of preparers and auditors stated that hedge accounting should not be eliminated and partial hedges should be permitted because they believe such accounting better reflects the reporting entities' risk management strategies. However, many of those constituents would support replacing fair value hedge accounting with a model that permits recognition outside of earnings gains and losses on hedging instruments (similar to cash flow hedge accounting).

12. Preparers and auditors also suggested the following for simplifying existing hedge accounting requirements: remove retrospective effectiveness testing with recognition of all ineffectiveness in earnings, retain only qualitative prospective effectiveness testing, and simplify documentation requirements.

13. Users: Many users expressed support for the Boards working together on a project to simplify the accounting for hedging activities, provided that the simplification reduced the complexity underlying interpretation. Most users also support the elimination of the ability to hedge individual risks as proposed in the FASB ED on simplifying hedge accounting. Those users stated that the changes proposed in the FASB ED would more comprehensively reflect risk exposures.

14. Some users expressed a strong preference for an interim approach that would eliminate hedging altogether. Some of this group of users do not favor the Boards spending any time on changes to hedge accounting if that would result in

sacrificing the timely resolution of more critical issues in other projects. These users do not believe that modifications to the current hedge accounting model would provide any benefit for users. Other users expressed concern that changes that simplified the ability to qualify for hedge accounting might further entrench hedge accounting and make the longer term goal of fair value for financial instruments more difficult to achieve.

C: Other issues/concerns

15. Preparers/Auditors: Many preparers and auditors stated that the Boards need to properly define fair value and complete the Fair Value Measurement project before proposing an approach that would require fair value for all financial instruments. In addition, they stated that it is also important for the Boards to complete the Financial Statement Presentation project because it relates to how gains and losses would be disclosed if such an approach were adopted.

16. Users: All users stated the importance of a comprehensive framework for presentation and disclosure of financial instruments in relation to a consistent framework for recognition and measurement. Some users stated that completion of the financial statement presentation project, completion of a comprehensive disclosure framework, and adoption of a fair value measurement framework under IFRS should be prerequisites to requiring fair value for all financial instruments. They stated that these items are critical to ensure that users are provided with the clearest, most complete and up-to-date information about fair values.

Appendix 2

International Accounting Standards Board®

Press Release

20 October 2008

IASB and FASB Commit to a Global Approach to Enhance Market Confidence

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have announced further details on their joint approach to dealing with reporting issues arising from the global financial crisis. The boards reiterated the importance of working cooperatively and in an internationally coordinated manner to consider accounting issues emerging from the global crisis. The boards also emphasised the role of high quality financial reporting in helping enhance confidence in the financial markets by responding in a timely manner that improves transparency and provides greater global consistency in financial reporting.

Building on their announcement of Thursday 16 October regarding the establishment of a joint advisory group, the boards agreed to the following measures:

- Rapid appointment of a high-level advisory group: **The boards agreed that the advisory group shall be comprised of senior leaders with broad international experience with financial markets. The boards will task this high-level advisory group with considering how improvements in financial reporting could help enhance investor confidence in financial markets. The group also will be charged with identifying the accounting issues requiring urgent and immediate attention of the boards as well as issues for longer-term consideration. The high-level advisory group will also draw upon work already underway in a number of jurisdictions on accounting and the credit crisis. In the interest of transparency, the advisory group will meet in public session with webcasting facilities available to all interested parties.**

  The boards will seek to identify external chairs and members of the group as soon as possible in order for the advisory group to begin its work expeditiously.

- Public roundtables in Asia, Europe, and North America: **In the coming weeks, while the advisory group is being established, the IASB and the FASB will organise three roundtables—one each in Asia, Europe, and North America. The purpose of these public roundtables is to gather input on reporting issues emanating from the current global financial crisis—including responses by governments, regulators and others. This should enable the boards to act rapidly and the advisory group, once established, to advance its deliberations efficiently. The first roundtable will be held in Europe.**

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

In announcing these initiatives, Sir David Tweedie, chairman of the IASB, said:

> **The FASB and the IASB recognise that the urgency of the credit crisis requires unprecedented action, and we at the IASB are committed to act where necessary. It is also essential that any further steps taken should improve confidence in the markets and be done so in such a way that takes account of the broad interests at stake. The establishment of this high-level advisory group and the holding of public roundtables should ensure that both boards together reach common high-quality solutions that help return confidence to the martketplace.**

Robert Herz, chairman of the FASB, said:

> **We expect this new global group to generate valuable short and longer-term input for both boards to consider. In the short-term, we welcome advice about**

common issues affecting the international markets and how a coordinated response from the boards could enhance confidence in the markets. Just as important, we look forward to further exploration of how to increase the transparency of reported financial information to investors.

END

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Notes for editors

About the IASB

The IASB was established in 2001 and is the standard-setting body of the International Accounting Standards Committee (IASC) Foundation, an independent private sector, not-for profit organisation. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that provide high quality transparent and comparable information in general purpose financial statements. In pursuit of this objective the IASB conducts extensive public consultations and seeks the co-operation of international and national bodies around the world. Its 14 members (12 of whom are full-time) are drawn from nine countries and have a variety of professional backgrounds. They are appointed by and accountable to the Trustees of the IASC Foundation, who are required to select the best available combination of technical expertise and diversity of international business and market experience.

About the Financial Accounting Standards Board

Since 1973, the US Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information. For more information about the FASB, visit its Website at www.fasb.org.