Financial Accounting Standards Board

International Accounting Standards Board

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting: 24 March 2009, London

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

Subject: **Comment Letter Analysis for IASB and FASB Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (Agenda paper 6A)**

OVERVIEW

1. In March 2008, the International Accounting Standards Board (IASB) issued for public comment a discussion paper, *Reducing Complexity in Reporting Financial Instruments*. The Financial Accounting Standards Board (FASB) issued this discussion paper as part of an Invitation to Comment (ITC) to its constituents. The comment period for the discussion paper ended on September 19, 2008.

2. At the October 2008 joint IASB/FASB meeting, the IASB and FASB staff presented a high-level summary of the comment letters received as of October 1, 2008 (IASB agenda paper 8). That summary was not a full analysis of all comment letters received. However, it provided the Boards with a condensed

summary of responses to key topics identified by the project team. IASB agenda paper 8 is attached as Appendix A.

3. The staff has since completed a full analysis of all comment letters received to date. The purpose of this comment letter summary is to:

   a. update the boards on any additional issues raised by respondents that the project team considers important.

   b. expand on some issues discussed in IASB agenda paper 8.

4. The staff also plans to consider the feedback received through the comment letters as it develops analysis related to the Financial Instruments – Recognition and Measurement project.

5. As of February 6, 2009, comment letters were received from 162 respondents. Below is a detailed summary of respondents by type and geographic region.

Respondent Profile

Type	**Number**
Academics	4
Accountancy Bodies	24
Accounting Firms	6
Corporate Treasurers	5
Financial Institutions	24
Individuals	5
Industry Groups	19
International Bodies	5
Preparers:	
Representative Bodies	10
Companies	22
Professional Bodies	4
Public Sector	5
Regulators	7
Standard Setters	14
Users:	
Representative Bodies	4
Companies	4
TOTAL	**162**

Geographic region	Number
Africa	5
Asia-Pacific	27
Europe	62
International	36
Middle East	1
North America	30
South America	1
TOTAL	**162**

6. The following issues are discussed in more detail:

   a. Amending current requirements for reporting financial instruments

   b. Fair value measurement for all financial instruments

   c. Hedge accounting complexities

   d. Other concerns.

COMMENT LETTER ANALYSIS – ADDITIONAL ISSUES RAISED

7. Most respondents agreed that current reporting requirements for financial instruments, including derivatives, are complex and require significant change. These respondents suggested that the Boards jointly take a fresh look at all financial instruments accounting and reporting requirements in a long-term project. Some respondents are concerned that intermediate changes may not be consistent with long-term goals, causing more complexity.

8. Many respondents suggested that the Boards consider the outcome of other projects such as financial presentation, conceptual framework, and fair value measurement prior to considering amendments to current accounting and reporting requirements for financial instruments. In addition, respondents recommended that the Boards work on a comprehensive disclosures package for financial statements.

Amending current requirements for reporting financial instruments

9. Most preparers and auditors did not support the long-term solution of fair value measurement for all financial instruments. These respondents believe the current

mixed-attribute model better reflects the business purposes served by each financial instrument type.

10. The respondents that favored amending current requirements for reporting financial instruments suggested the following improvements:

    a. Some respondents noted that many entities do not use the held-to-maturity category. These respondents suggested relaxing tainting rules for this category could reduce complexity. Others suggested eliminating the held-to-maturity category in its entirety.

    b. Some respondents suggested disaggregating gains and losses from trading instruments. Some respondents suggested that gains and losses on available-for-sale instruments should be further disaggregated by equity and debt instruments because most equities are actively traded and more volatile.

    c. Some respondents commented that the Boards should require more robust disclosures about financial instruments while other respondents stated that the current required disclosures are excessive and burdensome. Respondents agreed that disclosures should clarify the business purpose of a particular financial instrument.

    d. Many respondents suggested that the number of financial instrument classifications be reduced. A popular suggestion was to have only two categories of financial instruments: “Trading” (measured at fair value through profit or loss) and “Non-trading” (measured at amortized cost).

Fair value measurement for all financial instruments

11. Most users favored the long-term solution of fair value measurement for all financial instruments. They indicated that measuring financial instruments at fair value is more relevant than other measurements (such as amortized cost) in helping to assess the effect of current economic events on an entity. These respondents asserted that one measurement attribute for all financial instruments

promotes consistency in valuation, presentation, and disclosure and usefulness of financial statements.

12. Some respondents debated whether the financial statements should reflect management's strategies or market opportunities. Some respondents believe that fair value (an exit price notion) represents market opportunities and active trading may not be the business purpose of a particular financial instrument held. These respondents believe that financial statements should reflect the business purpose of each financial instrument category. They suggested that measurement should be an accounting policy decision made by management and explained thoroughly in the notes to the financial statements.

13. Some preparers believe that amortized cost is the best reflection of future cash flows for certain financial instruments (especially for loans) and should be the other measurement attribute considered as part of the long-term measurement solution for financial instruments.

14. Many preparers state that fair value is unreliable when markets are illiquid or not fully developed (such as in developing countries) and could have serious implications on dividends, taxes, and other cash flow items.

15. A number of respondents, including those that were generally supportive of the broad application of fair value for financial instruments, cited concerns about the use of fair value when fair value cannot be reliably determined.

16. Some respondents suggested that the Boards provide scope exceptions for the following financial instruments if the Boards decide to require fair value measurement for all financial instruments:

    a. Financial instruments for which there is no quoted market price such as:

        1) Financial instruments that do not trade in an active market

        2) Financial instruments that are private or illiquid making the fair value difficult to estimate (for example, Level 3 financial instruments pursuant to FASB Statement No. 157, *Fair Value*

Measurements). Many preparers believe that the fair value estimate for an illiquid financial instrument may not be a faithful representation of the value of the underlying cash flows if the entity intends to hold the financial instrument long-term.

b. Financial liabilities such as borrowings entered into to generate funds for the entity and not for trading purposes. Many respondents are concerned about recording the effects of own-credit risk on fair value of financial liabilities.

c. Financial instruments with fixed or slightly variable cash flows.

Hedge accounting complexities

17. The majority of respondents did not support eliminating hedge accounting or partial hedges. However, the small number of respondents that supported eliminating hedge accounting believe that current hedge accounting:

    a. is not principle-based.

    b. increases complexity and opportunities for error.

    c. is subject to manipulation (i.e. it is not objective and hence might be impossible to distinguish between genuine hedging and speculative position taking).

18. Some respondents did not support any of the methods to replace fair value hedge accounting set out in the discussion paper. These respondents think that all of the methods introduce new complexities. In addition, many respondents suggested that the Boards review complexities related to recognition and measurement of financial instruments prior to considering amendments to fair value hedge accounting. In general, respondents that supported replacing fair value hedge accounting also supported measuring all financial instruments at fair value, citing that fair value hedge accounting would no longer be necessary if all financial instruments were measured at fair value.

19. Of the three methods set out in the discussion paper to replace fair value hedge accounting, most respondents preferred the method to permit recognition outside earnings of gains and losses on financial instruments designated as hedging instruments (similar to cash flow hedge accounting). Respondents supported this method because:

   a. it aligns cash flow hedge accounting and fair value hedge accounting, hence reducing complexity

   b. it results in more transparent information with all effects of risk management activities in other comprehensive income (OCI)

   c. it reduces the need to adjust the carrying amount of the hedged item

   However, some respondents believe that this method introduces more artificial mismatches and volatility in OCI and is still complex as there is a need to track adjustments in equity to ensure that recycling occurs at the right time. Some respondents highlighted that this method relies on the Financial Statement Presentation and disclosures projects. These respondents suggested that separate disclosures in OCI would be useful.

20. There was limited support for the method to substitute a fair value option for instruments that would otherwise be hedged items. Respondents noted that the fair value option:

   a. is irrevocable after initial recognition and hence lacks the flexibility needed to reflect risk management strategies.

   b. is not applicable to non-financial instruments.

   c. must apply to the entire financial instrument and hence prohibits partial hedges.

   Some respondents suggested allowing for a more flexible fair value option (i.e. possibility to deselect the fair value option after initial recognition). A number of respondents suggested that the IASB remove restrictions to the application of the fair value option.

21. Overall, respondents did not support the method to permit recognition outside earnings of gains and losses on hedged items. Respondents believe that this method:

    a. results in a fundamental change to the existing hedge accounting model and requires significant systems changes.

    b. requires revaluation of the hedged item which is complex and counterintuitive.

    c. relates to fair value as a primary basis for measuring all financial instruments (respondents believe such a basis is premature).

22. Most respondents proposed simplifying the existing hedge accounting requirements. They had the following suggestions in addition to those described in Appendix A:

    a. develop a principle-based approach to hedge accounting.

    b. reduce current anti-abuse rules.

    c. eliminate the arbitrary 80%-125% threshold.

    d. enhance disclosures relating to hedge accounting (i.e. clear disclosure of offsetting amounts and presenting gains and losses as separate assets or liabilities on the statement of financial position).

    e. replace the highly effective requirement with a reasonably effective requirement while requiring all ineffectiveness to go through earnings.

    f. eliminate basis adjustment options.

23. Some respondents suggested extending hedge accounting to allow for:

    a. hedges of net positions.

    b. partial hedges of non-financial instruments.

c. deferral of time value when hedging with options using the hypothetical derivative method.

d. hedges of exposure to the sub-LIBOR interest rate.

24. In addition to the IASB's discussion paper, in June 2008, the FASB issued the Exposure Draft, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*. The exposure draft proposed amendments intended to simplify hedge accounting and improve financial reporting. The comment period for that exposure draft ended on August 15, 2008. A comment letter analysis for that exposure draft is posted on the FASB website under the "Accounting for Hedging Activities" project page.

Other concerns

25. Many respondents highlighted other issues related to financial instruments for the Boards to consider. These issues include:

a. reversals of impairment losses recognized.

b. utilizing an incurred loss or expected loss measurement model.

c. presentation and disclosure requirements for financial statements (including off-balance sheet items).

d. reconsidering the scope of IAS 39.

APPENDIX A

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**21 October 2008, Norwalk**
Project:	**Reducing Complexity in Reporting Financial Instruments**
Subject:	**Comment letter analysis (Agenda paper 8)**

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.