

Can financial instrument accounting be simplified?

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Reducing complexity in reporting financial instruments

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Reducing complexity in reporting financial instruments

- First step towards a new financial instruments standard
- Principles based and less complex than current IAS 39 or US GAAP
- Part of MoU between IASB and FASB
- Comments due 19 September 2008
- Timetable for ED and IFRS/FAS are deliberately unknown
 - IASB/FASB discussion of MoU 21 April “better to do nothing than to continue with a suboptimal solution”

Reducing complexity in reporting financial instruments

Three parts:

Part 1 – Discusses complexity and problems

Part 2 – Possible intermediate approaches

Part 3 – Longer term solution

Part 1: Problèmes created by the many ways to measure financial instruments

Problems highlighted:

- Classification criteria complex and difficult to apply
- No clear requirements for some instruments
- Classification made generally at inception
- Different gains and losses result from different measurement methods
- Two or more measures in the same line in the income statement
- Maintenance and interpretation is time consuming for standard setters

DP conclusion is that measuring all financial instruments the same way would make reported information easier to understand and facilitate comparison between entities and between periods.

Part 1: Problems created by the many ways to measure financial instruments

How using fair value for all types of financial instruments could reduce measurement related complexity

Component of standard	How complexity would be reduced
Classification	Not required
Impairment	Not required
Transfers between categories	Not required
Fair value hedge	Not required for financial instruments; perhaps FVH for non-financial instruments
Cash flow hedge	Retained
Embedded derivatives	Not applicable for financial instruments; may still be required for non-financial instruments

Part 2: Possible intermediate approaches to reducing complexity

Proposed approaches

1. Amending the existing measurement requirements;
2. Replacing the existing measurement requirements with a fair value measurement principle with some optional exceptions; and/or
3. Simplifying hedge accounting requirements.

Part 2: Possible intermediate approaches to reducing complexity

Key criteria for any proposed change (Paragraph 2.2):

- provide more relevant and easily understandable information for users
- consistent with the long term measurement objective of fair value
- not increase complexity
- any improvement and simplification must justify the cost of change.

Part 2: Possible intermediate approaches to reducing complexity

1. Amending the existing measurement requirements

- Eliminate held to maturity category or remove tainting rules
- Eliminate available for sale category
- FVTPL for instruments traded in active markets; others categorised based on existing measurement requirements

Part 2: Possible intermediate approaches to reducing complexity

2. Replacing the existing measurement requirements with a fair value measurement principle with some optional exceptions (1 of 2)

Cost-based method subject to restrictions:

- Equity instruments with readily available market prices and all derivatives – not eligible
- Eligibility based on variability of cash flows – eg highly variable (derivatives) must be FVTPL whereas fixed (debt instruments) might be eligible for cost
- However for fixed with high credit risk then FVTPL if impaired
- Other possible exceptions

Part 2: Possible intermediate approaches to reducing complexity

2. Replacing the existing measurement requirements with a fair value measurement principle with some optional exceptions (2 of 2)

Advantages

- Fair value measurement is consistent with long-term objective
- Clear specified criteria for exceptions.
- Principle would apply to newly created instruments
- Most effective and efficient intermediate step identified
- A general principle is more logical and easier to understand

Disadvantages

- Significant change required in the shorter term
- Optional exceptions might not be easily understandable

Part 2: Possible intermediate approaches to reducing complexity

3. Simplifying hedge accounting requirements

Two general approaches:

- Eliminate and possibly replace
- Maintain and simplify

Part 2: Possible intermediate approaches to reducing complexity

3. Simplifying hedge accounting requirements

Eliminate and possibly replace existing hedge accounting requirements

- Eliminate all hedge accounting
- Replace fair value hedge accounting
 - Fair value option for instruments that would be hedged items
 - Recognition outside profit or loss of gains and losses on hedging instruments
 - Recognition outside profit or loss of gains and losses on financial instruments

Part 2: Possible intermediate approaches to reducing complexity

3. Simplifying hedge accounting requirements

Maintain and simplify the existing hedge accounting requirements

Suggestion	Implication
Designation is irrevocable	Reduces flexibility and is a key advantage over an irrevocable fair value option
Partial hedges is prohibited	Reduces the frequency in which hedge accounting
Eliminate 80-125% retrospective effectiveness test	Increases the number of hedging relationships and provides greater flexibility
'Similar items' test for portfolio hedges is relaxed or removed	Increases the number of hedging relationships as hedge accounting would reflect the way that entities manage economic risk
Reclassification of gains and loss for cash flow hedges is stated at inception of hedge and will be recognised in profit or loss regardless of whether the forecast transaction occurs as planned	Less complex and reduces the need to track individual gains and losses however mistakes in forecasting would cause volatility in profit or loss

Part 3: Longer term solution – all financial instruments at FV

- Why is fair value the only appropriate measure for all types of financial instruments
- Concerns about using fair value to measure financial instruments
- Issues that need to be addressed before full fair value measurement becomes a general requirement

Part 3: Longer term solution – all financial instruments at FV

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

- Cost not relevant for assessing future cash flows (eg derivatives)
- Eliminate any confusion about the measurement
- No requirement for impairment
- Reflects the price that would be received if an entity needed to sell an asset
- Provides information about anticipated future losses
- Provides information about improvements in credit risk
- Entities with comparable credit ratings and obligations will report liabilities at comparable amounts
- Reflects the cash flows that would be paid if liabilities were transferred at the measurement date

Part 3: Longer term solution – all financial instruments at FV

Concerns about using fair value measurement (1 of 2)

- Relevance of a reported change in fair value
 - Volatility in profit or loss arising from market factors beyond management's control
- Why should unrealised gains and losses affect profit or loss
 - Can they be misleading?
 - Information sufficiently objective and reliable?
 - Use of information about gains and losses that may never be realised?
 - Why recognise unrealised gains and losses on financial liabilities when an entity's obligation is unchanged?
 - Why recognise unrealised gains on financial liabilities when an entity's financial position worsens?

Part 3: Longer term solution – all financial instruments at FV

Concerns about using fair value measurement (2 of 2)

- Difficulty and uncertainty in estimating fair values when no market based information is available
 - May require use of valuation and other experts who may not be widely available in some jurisdictions
 - Judgement will be required by preparers in estimating fair values

Part 3: Longer term solution – all financial instruments at FV

Issues that need to be addressed before full fair value measurement becomes a general requirement

- Presentation
- Disclosure
- Measurement
- Scope



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An alternative set of questions

- Where does the complexity come from?
- Is fair value accounting appropriate at all?
- How do illiquid markets impact the debate?
- What's the real problem with hedge accounting?

An alternative set of questions

- If we keep the mixed model, should impairment move to an expected loss rather than an incurred loss model?
- Would applying fair value accounting to all financial instruments merely move the complexity to the income statement?

Questions?

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