International Accounting Standards Board®

FINANCIAL CRISIS ADVISORY GROUP
Public Meeting
Baruch College Newman Conference Center
New York, NY
March 5, 2009
Agenda*

9:15 – 11:45 am (brief break included)	Opening Remarks (by co-chairs) Issues Discussion (led by co-chairs): *Session Objective: To obtain FCAG members' views on the following issues:* Part I: Further Exploring Matters Discussed at February 13th Meeting*:* • Display of through-the-cycle provisioning in general purpose financial statements • Possible approaches to improvement and simplification of accounting and reporting of financial instruments Part II: Fair Value, continued: • Is it appropriate and useful to report gains (or losses) from fair value changes in a reporting entity's own indebtedness? Why or why not? • What additional guidance, if any, is needed in the area of determining fair value?**
11:45 am – 12:30 pm	LUNCH
12:30 – 3:15 pm (brief break included)	Issues Discussion, continued (led by co-chairs): Part III: Off-Balance Sheet Items: • What are the best ways to bring about useful information regarding securitizations and other structured entities?** • Assuming that a consolidation/de-recognition approach is used, what principles should determine whether the assets and liabilities transferred into a securitization or other structured entity are removed (derecognized) from the balance sheet of a sponsoring entity? Part IV: Standard-Setter Governance and Due Process: • How (and by whom) should oversight be exercised over accounting standard-setters on a national (or international) basis in order to ensure appropriate independence, accountability, and transparency in the standard-setting process? • What criteria should accounting standard-setters consider in balancing the need for resolving an "emergency issue" on a timely basis and the need for active engagement from constituents through due process? Discussion of Next Steps (led by co-chairs) Concluding Remarks (by co-chairs)

*Times listed are EST.
**Issues on the agenda of the February 13th meeting for which time did not permit discussion.

INTRODUCTION

After agreeing that equity and debt investors and other resource providers (collectively, investors) constitute the primary audience for general purpose financial statements (financial statements), and that the primary role of financial statements is to present unbiased information to help investors make capital allocation and similar decisions, the Financial Crisis Advisory Group (FCAG) began exploring several financial reporting issues at the February 13 meeting. The FCAG focused on whether it was possible to depict the impact of potential regulatory changes in a transparent, meaningful way to investors, and on whether other improvements and simplifications could be made in the area of accounting and reporting of financial instruments.

At the March 5 meeting, the FCAG will continue exploring:

- Whether general purpose financial statements can display through-the-cycle provisioning that may be mandated by prudential regulators without diminishing transparency of information to investors
- How the IASB and the FASB could improve and simplify the reporting of financial instruments.

The materials for the meeting included separate papers aimed at facilitating that continued discussion. A summary of the provisioning paper, and feedback received from a member of the Basel Committee on Banking Supervision, is included in Appendix A. The paper on improving and simplifying reporting of financial instruments is attached as Appendix B.

This discussion paper provides background information aimed at facilitating discussion of other potential improvements to financial accounting and reporting, and of key standard-setting matters that the Financial Crisis has helped bring to the fore.

This paper has been prepared solely for the purpose of facilitating discussion at the March 5, 2009, meeting of the Financial Crisis Advisory Group. The views contained herein do not represent official positions of the IASB or the FASB. Official positions of the IASB and the FASB are arrived at only after extensive due process and deliberations.

Questions 1 and 2 explore matters on fair value accounting. Question 1 and an attached staff paper look at the controversial question of whether a reporting entity should recognize gains and losses on credit changes in its own indebtedness. Question 2 asks if additional guidance is needed in determining fair value and explores potential tradeoffs in doing so.

Questions 3 and 4 explore aspects of the accounting and reporting of off-balance-sheet activities, an area that a number of FCAG members have cited as far more contributive than fair value (including mark-to-market) accounting to the Financial Crisis. Question 3 explores different means by which useful information could be provided on securitizations and other structured entities. Question 4 explores the complex but important issues surrounding derecognition from sponsoring entity financial statements of the assets and liabilities transferred into securitizations and other structured entities.

Questions 5 and 6 explore vital issues for accounting standard setters, involving governance and due process. Question 5 explores the matter of how best to balance the need for proper oversight of standard setters, such as the FASB and the IASB, with the need for sufficient independence to set standards aimed at providing unbiased, decision-useful information to investors. Question 6 explores a matter that has been especially brought to the fore by the Financial Crisis—how best to balance the need for "emergency" guidance in such times with the need for appropriate due process to ensure high-quality standards and their broad acceptance.

Question 1: Is it appropriate and useful to report gains (or losses) from fair value changes in a reporting entity's own indebtedness? Why or why not?

A number of FCAG members have asked that the FCAG discuss the topic of including gains and losses from fair value changes in a reporting entity's own indebtedness in the entity's profit and loss (earnings). This topic also was considered in the U.S. Securities and Exchange Commission's (SEC) recent fair value study. The SEC's *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* (Mark-to-Market Report) recommends that the "FASB should assess whether the incorporation of changes in credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is provided."

The question of whether current measurements (including fair value) of liabilities should incorporate the credit standing of the liability is one of the most controversial topics in accounting, engendering spirited discussion between those for and against inclusion. Some of the key arguments for and against are as follows:

Arguments in Favor of Incorporating Credit Standing

1. ***Consistency with initial measurement.*** There is no reason why the initial measurement of some liabilities should include the effects of credit standing and subsequent measurement should not.

2. ***Wealth transfer ("share the pain").*** Gain by a borrower from a decline in its credit standing can be seen as an allocation of the impact of a deteriorating financial condition (of which the credit decline is indicative) between the equity owners and the lender, who might suffer a loss when the credit risk of an instrument increases.

3. ***Symmetry.*** Generally, when circumstances change that result in one entity (Lender) incurring a loss, it might be expected that the other party (Borrower) will have a gain.

4. ***Accounting mismatch.*** If the fair value measurement of liabilities does not incorporate changes in credit spreads, but the measurement of assets carried at fair value does, there is an accounting mismatch and the amounts of profit or loss or other comprehensive income will be distorted by the mismatch.

Arguments against Incorporating Credit Standing

5. ***Counterintuitive results.*** It is counterintuitive when an entity reports a gain from a deterioration of its own financial condition (of which the credit decline is indicative).

6. ***Realization.*** Generally, an entity can realize a gain on an asset with little difficulty because an asset can be easily transferred. This is not true of liabilities because they are seldom transferred or transferable. Generally, gains on liabilities can only be realized by entities that buy back their own debt or have trading liabilities.

7. ***Accounting mismatch.*** Including changes in an entity's credit standing is likely to increase the mismatch between assets and liabilities. A decline in an entity's credit standing usually signals a decline in the value of assets that may not be measured on a current basis (like fixed assets and goodwill), unrecognized intangible assets, and confidence in the entity's management. Since changes in those items are not recognized in financial statements[1], changes in credit standing should be similarly excluded.

8. ***Decision usefulness.*** Many respondents to IASB and FASB documents have indicated that they do not find remeasurements that incorporate changes in credit

[1] In the case of fixed assets or goodwill, some changes may be recognized through impairment charges, though not necessarily in the same timeframe.

standing to be decision useful because information about an entity's ability to repay its debts is already available in the financial statements and annual reports. Because entities do not routinely transfer liabilities, information about hypothetical settlement with an entity of comparable credit standing does not enhance the ability to make those judgments.

With regard to incorporating a reporting entity's own credit standing in the current value (including fair value) measurement of a liability, which set of arguments (in favor or against) do you find more compelling, and why? Does your answer depend on the type of financial liability (for example, derivative versus debt)? Why or why not?

Question 2: What additional guidance, if any, is needed in the area of determining fair value?

FASB Statement No. 157, *Fair Value Measurements*, defines fair value as follows:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

An orderly transaction excludes forced sales and liquidations.

In its fair value measurement guidance project, the IASB is considering the appropriateness of the guidance in Statement 157, but is currently expected to issue final guidance that will contain a largely similar current exit price approach to fair value.

While there are many different views concerning the appropriateness of fair value for various types of financial instruments under various scenarios, a number of constituents have expressed a desire for (a) additional application guidance for identifying illiquid or inactive markets and for determining the impact of liquidity on fair value and (b) additional disclosures on how entities have determined fair value in such circumstances. Recommendations in this area come from such otherwise divergently-viewed constituents, such as Professor Stephen Ryan, the G-30, and the SEC, in their respective papers/reports.

The IASB recently issued guidance developed by an expert panel that identified issues relating to the difficulties of measuring fair value when markets are illiquid. The guidance focused on the information that can be used when markets are illiquid and emphasized the judgment needed to arrive at the fair value estimate. It also identified disclosure practices that would provide greater transparency about the use of fair value estimates in financial statements. Other efforts in this area by the IASB and the FASB were described by Gavin Francis and Russ Golden at the January 20 meeting.

Another area for which additional guidance has been sought by constituents is contractual restrictions on transfer of liabilities. Most indebtedness can only be settled, not transferred to third parties. The FASB is currently addressing this matter with proposed FASB Staff Position (FSP) FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*, which is being redeliberated and is expected to be issued in March 2009.

The SEC's Mark-to-Market Report also calls for additional consideration by the FASB of a number of other fair value implementation matters. The FASB has vetted these matters with its Valuation Resource Group, and recently added short-term projects to consider providing additional application guidance on:

- Determining when a market for an asset or a liability is active or inactive
- Determining when a transaction is distressed
- Applying fair value to interests in alternative investments, such as hedge funds and private equity funds.

The FASB also added a short-term project to consider requiring additional disclosures on such matters as sensitivities of fair value measurements to key inputs and transfers of items between the fair value measurement levels.

The IASB is monitoring the progress of the FASB's short-term application and disclosure projects.

Some believe that additional guidance is needed. Others are concerned that more guidance will lead to rules and limit the use of judgment. What additional guidance, if any, do you believe is needed in the area of determining fair value, and why? Do you believe that providing more guidance will limit the use of judgment?

Question 3: What are the best ways to bring about useful information regarding securitizations and other structured entities?

This question on securitizations and other structured entities focuses primarily on informational display issues. Question 4 explores one of these approaches—consolidation/derecognition—in more depth, especially focusing on the issues surrounding derecognition of transferred assets.

Securitization is the process by which financial assets are transformed into securities. Under current accounting literature, many securitizations are accounted for as sales with recognition of the related gain or loss and the assets being removed from the balance sheet. If an entity transfers financial assets, surrenders control of those assets to a successor entity, and has no continuing involvement with those assets, accounting for the transaction as a sale and derecognizing the assets and recognizing the related gain or loss is not controversial. However, accounting for transfers of financial assets has been controversial and inconsistent in circumstances in which an entity transfers only a partial interest in a financial asset or has some other continuing involvement with the transferred asset or the transferee. In many securitization transactions, the transferring entity retains substantial risks and benefits related to the assets being transferred.

An entity that transfers securitized assets has many motivations for doing so, including lower capital requirements if transfers are accounted for as sales, risk transference (including credit, liquidity, and prepayment risk), lower funding costs, liquidity, and realization of profit with the associated sale. Other structured non-consolidated entities are designed by an entity to affect a specific transaction or transactions. Generally, the motivation for creating these entities is similar to those identified for securitizations above.

There are three primary ways that have been identified to provide useful information for users of financial statements, including:

Consolidation and Derecognition—Many people believe that more information about securitizations and other structured entities should be on the consolidated balance sheet of the sponsoring entity. All of the related assets and liabilities would be recognized on the face of the balance sheet with all other assets and liabilities of the consolidated entity, either commingled or displayed separately. Many people believe that derecognition of financial assets should not be permitted if the entity that is transferring the asset has any continuing involvement in the assets in the form of risk retention. Others, however, believe that financial assets should be divided into components, and that the component being transferred should be derecognized even if the entity retains risk related to that component.

Linked Presentation—The principle behind linked presentation is to present on the face of the balance sheet the linkage between certain assets and liabilities of an entity that result from consolidation of a specific entity or group of entities. In particular, when the consolidated assets of the specific entity or group of entities are segregated or pledged for the repayment of the specific consolidated liabilities of the aforementioned entity or groups of entities (and those assets are not available for the benefit of general creditors and investors of the consolidated entity), it is important to clearly identify these assets and liabilities on the face of the balance sheet as being linked. Proponents of this approach believe that presenting assets and liabilities as linked on the face of the balance sheet provides financial statement users with clear information regarding the assets recognized by the consolidated entity, which are designed for repayment of specific liabilities. There are, however, a number of scope and implementation issues that would need to be resolved before mandating such an approach.

Disclosure—The third method involves enhancing current disclosure to provide additional information to financial statement users. For example, the principles of the additional disclosures related to securitizations and other structured entities would be to provide more detail on the following:

- The entity's involvement with the securitizations and other structured entities
- The nature of, and changes in, the risks associated with the entity's involvement with the securitization and/or other structured entity
- The nature of how the entity's involvement affects the entity's financial position, financial performance, and cash flows.

Which of these three methods would provide the most useful information in a cost-beneficial manner and why? Are there any other methods that you would suggest?

Question 4: Assuming that a consolidation/derecognition approach is used, what principles should determine whether the assets and liabilities transferred into a securitization or other structured entity are removed (derecognized) from the balance sheet of a sponsoring entity?

For a sponsoring entity, a securitization transaction typically poses two accounting issues:

- Do the financial assets transferred into the securitization vehicle qualify for derecognition from the entity's balance sheet?

- Does the entity consolidate the vehicle?

Some believe that these two issues (derecognition and consolidation) are linked and that arguably the same or similar criteria for assessing them should be used. Others contend that these two issues really are separate—the first one focuses on specific (individual) assets while the second one concentrates on an entity (the securitization vehicle) and, thus, the assessment criteria might be different.

A related issue is the order of the assessment. Should derecognition be assessed before consolidation or the other way around? Does it matter, and, if so, why? Some argue that the logical approach is to first identify the assets and liabilities of the vehicle and then to assess who consolidates that entity. They argue that this order must be followed because the consolidation decision hinges on the assets and liabilities in the securitization vehicle, and depends on whether those assets and/or liabilities qualified for derecognition from the sponsoring entity's balance sheet in the first place. Others disagree with this view because it provides for opportunities to structure a transaction to achieve derecognition of financial assets from the sponsoring entity, but in which the sponsoring entity continues to have significant exposure to the risks and rewards of the assets after the transfer.

Both the consolidation and derecognition questions relate to how continuing involvement in (a) another entity and/or (b) transferred financial assets should be accounted for to provide useful information to investors and other financial statement users.

To focus the discussion, the remainder of this section of the discussion paper considers a key question about derecognition of financial assets:

> *What should be the principles that require an entity to derecognize financial assets that it transferred to another entity?*

In general, derecognising a financial asset is not contentious when the contractual right that gave rise to the asset has expired or has been satisfied or cancelled.

However, derecognition of a financial asset is contentious when:

- The contractual right that gave rise to the asset still exists
- But the holder of that right has entered into a contract that purports to transfer the benefits arising from that right to another entity
- The transferring entity continues to be involved with the right so transferred (for example, through a subordinated interest, an option, a forward, a swap, etc.).

In such types of transfers, the transferring entity bears some or all of the downside risks or retains some or all upside potential of the transferred asset as a result of its involvement. The entity receiving the assets (or the investors in the securitisation vehicle that received the assets) may often be entitled only to a risk-free or investment-grade rate of return.

Therefore, the principal issue that arises for a transfer of a financial asset in which the transferring entity continues to be involved in the asset after the transfer is whether the previous recognition of the asset should affect whether the entity can derecognize the asset. Stated differently, *should the conditions for derecognition of a financial asset be more restrictive than those for recognition of that asset in the first place?*

In that regard, two broad but divergent views exist:

> '*Components (inventory)' approach*—Each entity considers the rights and obligations it has after the transfer and accounts for those consistently, regardless of the way in which those rights were acquired in the past. The asset that the transferor recognized before the transfer (and that was the subject of the transfer) does *not* factor into the derecognition assessment. The basis for this approach is that economically similar transactions should be accounted for similarly and it should not matter which transactions an entity undertook to get to the position at which it is at a given reporting date.
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> *'History matters' approach (sometimes labeled 'risks and rewards' approach*—Assets are only derecognized if some form of 'derecognition event' occurs. Under different variations of this approach, the derecognition event could be based on the transference of substantially all risks and rewards associated with the asset or the transference of control of the asset. However, the principle is the same; assets are 'sticky' and previous ownership of the asset matters in assessing which party should recognize the asset.

Consider an example in which an entity ('A') transfers a portfolio of receivables to another entity ('B'). As part of the transfer arrangement, A agrees to guarantee any losses that B may incur if the debtors underlying the receivables were to default.

The 'components' approach would lead to A derecognizing the receivables portfolio and recognizing the guarantee as a new asset. The outcome would be consistent with that for the scenario in which A provides a similar guarantee without having owned (recognized) the asset.

The 'history matters' approach may, as a result of A's continued exposure to the credit risk of the receivable portfolio, lead to A recording the transfer as a secured borrowing. (A would recognize the proceeds from the transfer as a liability and continue to recognize the portfolio.) The outcome under the 'history matters' approach may, therefore, be different from that for the scenario in which A provided a stand-alone guarantee without having owned the asset before the transfer, even though A is in an economically identical position after the transfer.

Consider another example in which an entity transfers a portfolio of loans to a securitization vehicle in exchange for cash and a beneficial interest in the vehicle. The interest entitles the entity to 10 percent of the cash flow from the assets it transferred into the vehicle; however, the interest also obligates the entity to absorb the first 10 percent of losses incurred on those assets. The entity also is the servicer of the assets.

The ‘components’ approach would lead to the entity derecognizing the loan portfolio and recognizing the subordinated beneficial interest as a new asset.

The ‘history matters’ approach may result (because of the entity’s retention of some of the credit risk of the loan portfolio) in the entity recording the transfer as a partial derecognition to the extent of the entity’s continuing involvement in the loan portfolio, or entirely as a secured borrowing.

Some other issues that are more or less significant depending on whether one takes the ‘components’ view or the ‘history matters’ view to derecognition of financial asset are:

> *Measurement*—How should any part of (or interest in) a financial asset retained by the transferring entity be measured at the date of and subsequent to the transfer? Should the basis be the same as the one the entity applied to the asset before the transfer? If not, should the basis be determined depending on how management classifies that part on its balance sheet?
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> *Mirror image accounting*—Should the derecognition outcome for the transferor determine the transferee’s accounting?
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> *Linked presentation (discussed under Question 3)* —In a transfer that does not qualify for derecognition, should the resulting liability be linked to the financial assets for presentation purposes? If so, should the scope of the linked presentation be limited to failed sales for which the transferee assumed the non-performance risk of the ‘transferred’ assets? Should linked presentation be done on the face of or in the notes to the financial statements?
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> *Disclosures (also discussed under Question 3)* —What should the disclosure objectives and requirements be for transfers that qualify for derecognition, but for which the transferring entity remains involved in the transferred assets? What should the disclosure objectives and requirements be for transfers that do *not* qualify for derecognition?

What factors should determine whether an entity derecognizes a financial asset, if that entity has a continuing involvement in the performance of that asset? Why, and how do those factors provide useful information to users of financial statements?

Question 5: How (and by whom) should oversight be exercised over accounting standard setters on a national (or international) basis to ensure appropriate independence, accountability, and transparency of the standard-setting process?

Independent, private sector organizations—the Financial Accounting Foundation (FAF) and the International Accounting Standards Committee Foundation (IASCF)—provide similar oversight functions to the FASB and the IASB, respectively. Each organization has a Board of Trustees that is broadly responsible for the governance and oversight, including funding.

One of the principal duties of the FAF and IASCF is to oversee the effectiveness and efficiency of the standard-setting process. The FAF and IASCF Trustees have recently enhanced their oversight in several ways. For example:

- The FAF Trustees are overseeing the implementation of a formal process by which the standard-setting Boards (FASB and the Governmental Accounting Standards Board [GASB]) will retrospectively evaluate the effectiveness of new standards. The FAF Trustees also have formed a standing Trustee advisory committee on standard-setting process oversight, which will establish and administer processes for the Trustees' ongoing oversight of the adequacy and transparency of the FASB and the GASB due process procedures.

- The IASCF Trustees approved a framework to guide and evaluate the effectiveness of their oversight function and, as part of that function, are required to review their Constitution every five years. The Trustees' compliance with their oversight framework is overseen by the Trustee's Due Process Oversight Committee, and the summaries of the Trustees' progress measured against this framework are publicly available. The IASCF also has post-implementation reviews and feedback statements in place.

Another principal duty of the FAF and the IASCF is to ensure the independence of the FASB and the IASB—an objective that is imperative for both standard setters. The capital markets and government are comprised of many participants with competing demands, requirements, and proprietary interests. As independent entities without a political or commercial stake in a particular outcome, the standard-setting Boards provide objectivity, neutrality, and integrity to the financial reporting system. Independence is fundamental to the standard-setting Boards' activities because their work is intended to provide investors and other users of financial reports with decision-useful information that represents the underlying economic transactions and realities. The FAF's and the IASCF's role is to protect the independence and integrity of the standard-setting process; therefore, they are not involved in technical matters relating to financial reporting standards, nor do they participate in the Boards' deliberations or promulgation of standards.

National securities regulators or other publicly accountable authorities also have various forms of oversight over accounting standard setters. For example:

> National accounting standard setters traditionally have been accountable to a national securities regulator or other government authority. In the United States, the Financial Accounting Foundation ("FAF"), the parent of the FASB, is overseen by the [U.S. Securities and Exchange] Commission. The IASC Foundation has not historically had a similar link with any national securities regulators.[2]

The IASCF Trustees created a direct link to public authorities that seeks to replicate, on an international basis, the link between accounting standard setters and those public authorities. That link was created through the establishment of a newly created Monitoring Board that will comprise the relevant leaders from the International Organization of Securities Commissions, the European Commission, the Japan Financial Services Agency, and the U.S. SEC. The responsibilities of the Monitoring Board are:

- To participate in the process for appointing Trustees and to approve the appointment of Trustees according to the guidelines set out in the IASCF Constitution.
- To review and provide advice to the Trustees on their fulfillment of the responsibilities set out in IASCF Constitution. The Trustees will provide an annual written report to the Monitoring Board.
- To meet with the Trustees or a subgroup of the Trustees at least once annually, and more frequently as appropriate. The Monitoring Board has the authority to request meetings with the Trustees or separately with the Chairman of the Trustees (with the Chairman of the IASB as appropriate) about any area of work of either the Trustees or the IASB. These meetings may include discussion of, and any IASCF or IASB proposed resolution of, issues that the Monitoring Board has referred for timely consideration by the IASCF or the IASB.

[2] U.S. Securities and Exchange Commission (SEC) Proposed Rule, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers.*

Underpinning both the FASB's and the IASB's structures is a principle that accounting standards should be developed by independent organizations that follow a transparent and open due process that considers the views of all stakeholders. That principle means that while regulators or governments have oversight, they rely on the expertise and process of accounting standard setters. In contrast, in some countries, the national securities regulators or government actively establishes or changes financial reporting requirements.

How should independent standard setting be defined? How should the oversight function help ensure both the independence and accountability of standard setting?

Question 6: What criteria should accounting standard setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process?

The credibility of accounting standards greatly depends on both (a) the robust and transparent public processes followed by the standard setter and (b) the timeliness and relevancy of those standards to the needs of investors.

The FASB and the IASB engage in an open due process to encourage active and collaborative involvement from all interested parties. There are a number of different "channels" for interested party observation and participation, including holding Board meetings that are open to the public (in person and over the Internet), broadly publicizing the decisions reached by the Boards, issuing Exposure Drafts for all proposed standards, providing the opportunity for public comment, and holding public roundtable discussions. As part of its normal due process, the FASB typically provides comment periods that are between 15–180 days. Determining the appropriate comment period length requires judgment and includes consideration of factors such as the time of year and other outstanding proposals or initiatives, the complexity of the proposal, the types of entities likely to be affected by the proposal, and the urgency of FASB action. Similarly, the IASB typically provides comment periods that are 120 days for major projects, but could be less depending upon the urgency and complexity of projects.

Currently, the FASB exposes both proposed major changes, as well as its application and implementation guidance (for example, draft consensuses from the FASB's Emerging Issues Task Force [EITF], interpretations, and so forth). However, throughout much of the FASB's existence, several different pieces of authoritative guidance previously were not subject to formal public exposure. In particular,

- In the early days, FASB interpretations did not require public exposure, but instead were circulated to a small group outside the FASB, such as their advisory council members.
- FASB Technical Bulletins, which are no longer issued, also were not subject to formal due process.

- Consensuses of the EITF were not subject to public exposure until a couple of years ago; moreover, they were often effective on the date issued.

The IASB currently publishes its proposals on all projects, as well as draft Interpretations from its International Financial Reporting Interpretations Committee.

In the fall of 2008, both Boards and their Trustees recognized the urgency of the situation facing the world's financial markets and the potential need for an accelerated response to the credit crisis. As a result of that recognition:

> The IASCF gave the IASB approval for its planned approach to accelerate its response to the credit crisis. Their October 9, 2008, press release, *Trustees Support IASB's Accelerated Steps on the Credit Crisis,* states:
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> > Under this approach, the IASB will seek appropriate language to eliminate any differences in how International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) address the issue of reclassification of financial instruments. The Trustees support the IASB's intention to complete this work by the end of next week.
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> > The Trustees, as the IASB's oversight body, have agreed that the IASB can suspend its normal due process. This will permit any IASB decision on reclassification made next week to take effect for the third quarter.
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> The FASB temporarily modified their Rules of Procedure to allow for a shortened period for public exposure of documents, which is one part of their due process. In the FASB's authorization of limited and temporary modifications to standard-setting processes, they observed that:
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> > When markets are operating efficiently, the competing forces between robust due process and timely pronouncement of FASB statements, concepts, and staff positions are well balanced. During such times, FASB follows specific minimum (and sometimes extended) due process timelines and procedures for public participation and comment in the standard setting processes. However, in times of grave economic conditions when market turbulence is so pervasive and ubiquitous that financial and capital markets are incapable of operating efficiently, a temporary rebalancing of such competing forces may be necessary and be in the best interest of investors and the financial and capital markets if the immediacy of new accounting standards or guidance is necessary or appropriate to facilitate the restoration of efficiently operating financial and capital markets.

Two recent examples that have been challenges in balancing the need for urgent responses were the IASB's amendments to permit reclassification of financial instruments and the FASB's amendments to the impairment guidance for certain beneficial interests.

On October 13, 2008, the IASB amended IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosures*, in *Reclassification of Financial Assets*. Paragraph BC104E of the Amendment states:

> The Board normally publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, given the requests to address this issue urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to proceed directly to issuing the amendments. In taking this exceptional step the Board noted that the amendments to IAS 39 relaxed the existing requirements to provide short-term relief for some entities. The Board also noted that the amendments were a short-term response to the requests and therefore the Board decided to restrict the scope of the amendments.

The Trustees supported the IASB's request to waive due process in this exceptional circumstance because of the risk that potential carve-outs implemented would reduce comparability and lead to greater regulatory arbitrage opportunities. It was noted at the time that there was no guidance on emergency procedures.

On January 12, 2009, the FASB issued FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*. The comment period for the proposal was less than 15 days; however, paragraph 6 of that FSP describes other aspects of the FASB's due process leading up to the FSP's issuance.

> The Board obtained input from a range of constituents, including investors, preparers, auditors, regulators, and others, on financial reporting issues encountered during the credit crisis, including input on impairments of securities. That input came from (a) observing the SEC's fair value roundtable discussions (and considering the resulting *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting,* which was issued on December 30, 2008), (b) participating in the joint FASB and IASB roundtables on the global financial crisis, and (c) engaging in discussions with other constituents such as the Investors Technical Advisory Committee, the Center for Audit Quality, the American Council of Life Insurers, individual investors, and the SEC. These forums each raised issues with the current guidance on other-than-temporary impairments. In December 2008, the Board issued

proposed FSP, *Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue 99-20*. Approximately 300 organizations and individuals responded to the proposed FSP, including investors, preparers, auditors, regulators, and others.

Would it ever be appropriate for the Boards to limit the extent of public exposure, perhaps by circulating the document to selected persons or groups, as the FASB did in its earlier days? Why (or why not) and are there criteria or characteristics that define when it would be appropriate?

Appendix A

DISPLAY OF THROUGH-THE-CYCLE LOAN PROVISIONS IN GENERAL PURPOSE FINANCIAL STATEMENTS

At the February 13, 2009, meeting, FCAG members discussed various approaches to loan provisioning for regulatory and financial reporting purposes. The conversation focused especially on “dynamic” or through-the-cycle provisioning. During the discussion, a summary of which can be found at http://www.fasb.org/fcag/fcag_mtg_minutes.shtml, there appeared to be a consensus on the following key principles:

- It is not the primary responsibility of accounting standard setters to support financial stability, but rather to require companies to reflect economic reality
- Financial statements should be transparent and any changes in accounting should make the financial statements more transparent
- There is support for prudential regulators requiring ‘through the cycle’ provisions by banks and other regulated financial institutions as long as this practice does not detract from the integrity and transparency of the financial statements.

To facilitate continuation of that discussion, the project staff and co-chairs prepared a paper that discusses how it may be possible to reconcile regulatory needs and accounting needs. The paper lays out a proposed approach, acceptable within the current accounting framework, concerning how differences between provisions required for regulatory purposes, to the extent they differ from those acceptable for accounting purposes, could be displayed in a way that does not hinder, and can even augment, transparency of information for investors and other resource providers who use the financial statements. For example, an ‘economic cycle’ reserve that may be aimed by regulators at ensuring adequate capital for bad times by limiting stock buy-backs or distributions during good times, could be created as an allocation from retained earnings, with appropriate disclosure:

Example: disclosure on the face of the balance sheet

	2012	2011	2010
Equity			
Ordinary shares	100	100	100
Share premium	1000	1000	1000
Economic cycle reserve	220	110	250
Total non-distributable capital and reserves	1,320	1,210	1,350
Retained earnings	600	550	450
Total distributable reserves	600	550	500
Total owners equity	**1,920**	**1,760**	**1,850**

Example presentation in the statement of equity

Year ended 31 December 2012

	Retained earnings	Economic cycle reserve
Opening position at 1 January 2011	**450**	**250**
Comprehensive income for the year ended 31 December 2011	(40)	
Transfer from economic cycle reserve	140	(140)
Closing position at 31 December 2011	**550**	**110**
Comprehensive income for the year ended 31 December 2012	160	
Transfer to economic cycle reserve	(110)	110
Closing position at 31 December 2012	**600**	**220**

Example: footnote explaining the economic cycle provision

The prudential regulator has made an annual assessment of the potential effect of a reasonable possible adverse change in the economic environment and has required us to set aside CU220 (2011: CU110) as a non-distributable economic cycle reserve. This provision may only be distributed with the prior approval of the banking supervisor.

The prudential regulator's assessment is that asset prices have grown significantly above their long term trend during the current year and that a reasonably possible adverse change in economic conditions would have a correspondingly greater adverse impact on the bank's business prospects and would trigger an increased level of loan loss provisions were such circumstances to arise. Accordingly, the prudential regulator has required us to increase the amount of the economic cycle reserve.

The paper also shows a variation of this approach involving a separate 'Appropriation of Comprehensive Income' statement.

The project team shared a draft of the paper with the FCAG's official observer from the Basel Committee on Banking Supervision. In her response, the observer expressed concern about relegating such reserves to equity allocations outside of profit and loss (earnings). She is concerned that the appropriation-of-equity approach would not be sufficiently transparent and is "not really operational since most of management incentives are built into [profit or loss]." Accordingly, she indicates that central bankers and regulators would prefer that accounting standard setters change the accounting standards/framework to enable such reserve build-up and use to flow through profit or loss.

The FCAG members and official observers will use both the paper and the response as the basis for their discussion at the March 5 meeting.

Appendix B

IMPROVING AND SIMPLIFYING THE REPORTING OF FINANCIAL INSTRUMENTS

INTRODUCTION

This paper discusses some of the problems associated with the accounting for financial instruments today, and the issues arising from different possible ways to measure financial instruments. This paper includes two questions.

Objectives of the joint IASB and FASB financial instruments project

Today there are many different ways of measuring and accounting for financial instruments. For example, under IAS 39 there are at least 20 ways in which final classification is determined taking into account measurement choices (including accounting for impairment). Such choices create significant complexity for users of financial statements, and impair usefulness and comparability of the information. The IASB and FASB have a joint project on their agenda to address recognition and measurement of financial instruments.

One possible objective for the project might be a significant improvement in the usefulness, understandability and comparability of information provided to users of financial statements.

Question 1: What should be the objectives of the project? How should different objectives be weighted?

Different Measurement Models (Fair Value[3], Other Remeasurement Approaches using Discounted Cash Flows, Amortized Cost)

Many think that measuring all financial instruments at fair value would more appropriately reflect the underlying economics of an entity's business than other measurement models. Those people think that not measuring all financial instruments at fair value leads users of financial statements, specifically investors, to make irrational judgments based on insufficient or an inaccurate understanding of an entity's economic condition.

Those people also think that using fair value as the only measurement method reduces the overall complexity of accounting for financial instruments, and increases the understandability of information provided. In addition, no rules for impairment or reclassifications of financial assets are needed. Those people also believe that measuring complex financial instruments traded in illiquid markets at fair value, while difficult, is not a new challenge, as the most complex financial instruments (e.g., derivatives) are currently measured using fair value.

Other people think that requiring financial instruments to be reported at fair value may not reflect the entity's use of the instrument and remeasuring fair value each reporting period creates "noise" in financial statements that may lead to instability in the market place. Those people also think that recognizing all instruments at fair value may be costly without providing significant benefits to users of financial statements. They also have concerns about the reliability of fair value measurements when they are not based on observable market data. In their view, the significant judgments required in determining many fair values undermine comparability (that is, fair value may result in only a perceived comparability, but not actual comparability).

[3] The term fair value is an exit price notion.

Those people think that other measurement models, such as other remeasurement approaches using discounted cash flows or amortized cost may provide more useful information to users of financial statements.

However, as with fair value, there are numerous issues that need to be addressed with those other measurement models. For example, issues that would need to be addressed with an amortized cost model include when and how to measure impairment of financial assets, classification and reclassification, tainting, implications of hedging and potentially the fair value option. Issues that would need to be addressed with other remeasurement approaches using discounted cash flows would include, among other things, what discount rate should be used and how risk and uncertainty would be included in the calculation.

Question 2: What criteria or characteristics should be used to determine how to measure financial instruments? How should the different criteria or characteristics be weighted?

For example, criteria or characteristics for determining how to measure financial instruments may include the following:

1. Characteristics related to the financial instrument:
    - variability of future cash flows (for example, fixed future cash flows vs. highly variable future cash flows)
    - does the entity has the ability to impact the timing of cash flows either received or paid on the instrument
2. Characteristics related to management's intended use of the asset or the entity itself:
    - if the entity intends to actively market and trade the security
    - ability and intent to hold to maturity
    - intent to match financial assets and financial liabilities
3. Other:
    - market liquidity (e.g. traded in an active market)

- difficulty in valuing the instrument
- comparability between entities in different industries