July 2009

Exposure Draft

# Snapshot:
# Financial Instruments: Classification and Measurement

This snapshot is a brief introduction to a proposed IFRS on the classification and measurement of financial instruments. It provides an overview of the proposals published for public comment by the International Accounting Standards Board (IASB).

The proposals form part of the IASB's response to the global financial crisis and are consistent with recommendations made by the G20, the Financial Stability Board and others.

| | |
|---|---|
| Project objectives: | To improve the ability of users of financial statements to assess the amounts, timing and uncertainty of future cash flows by replacing the many financial instrument classification categories and associated impairment methods in IAS 39 *Financial Instruments: Recognition and Measurement*. |
| Project stage: | To give priority to the most urgent issues the project has three main phases – classification and measurement, impairment methodology and hedge accounting. This exposure draft (ED) contains proposals on the first phase – classification and measurement. |
| Comment deadline: | The ED is open for public comment until 14 September 2009. |



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## Continued

**Next steps:** The IASB is undertaking an extensive outreach programme to seek views on these proposals. In addition, in June 2009 the IASB published a discussion paper seeking comments on own credit risk in liability measurement. Responses to that paper will be relevant to the ED on classification and measurement.

Upon completion of these consultations, the IASB will re-deliberate the proposals and expects to issue the new requirements on classification and measurement in time for early (voluntary) adoption in 2009 year-end financial statements.

An ED containing proposals on the impairment methodology is expected to be published in October 2009. Associated with this, in June 2009 the IASB published a Request for Information on the practical feasibility of an expected cash flow approach to impairment.

An ED containing proposals to improve and simplify hedge accounting is expected to be published in December 2009.

# How is the IASB undertaking the project to replace IAS 39?

In order to respond quickly to concerns raised by the financial crisis and to give interested parties maximum opportunity to comment on the proposals in accordance with the IASB's due process, the IASB has divided the project to replace IAS 39 into three main phases: classification and measurement, impairment methodology and hedge accounting.

| Project phase | Exposure draft | Finalisation |
|---|---|---|
| 1. Classification and measurement | July 2009 | In time for 2009 year-end financial statements – but no mandatory application before 2012 |
| 2. Impairment | October 2009 | In 2010 |
| 3. Hedge accounting | December 2009 | In 2010 |

Mandatory effective date not before 1/1/2012

## Classification and measurement requirements are the foundation of any accounting standard

The financial crisis has accentuated concerns about the complexity of the accounting for financial instruments. Today there are many different classification categories and associated impairment methods. For example, concern has been expressed about the difference in the magnitude of impairment losses recognised for debt instruments with similar cash flow profiles depending on how they are classified.

The IASB believes that the most effective way to address such issues and improve the ability of users of financial statements to understand the information presented is to replace existing classification categories.

The classification and measurement requirements will form the basis for subsequent proposals on the impairment methodology and hedge accounting.

## Removing inconsistencies in the accounting for financial instruments between IFRSs and US GAAP

Removing inconsistencies in accounting for financial instruments would enable comparisons to be made more easily between entities applying IFRSs and those using US GAAP.

The US Financial Accounting Standards Board (FASB) is still developing its proposals. It is not uncommon for the boards to deliberate separately on joint projects and then subsequently to reconcile any differences in their technical decisions. The IASB will expose for comment FASB proposals, if they are materially different from IASB proposals.

However, the IASB and the FASB are committed to working together to develop a comprehensive standard to improve the reporting of financial instruments.

# What is the IASB proposing?

## Classification determines how financial instruments are accounted for.

### Two measurement bases

The ED proposes two measurement categories: amortised cost and fair value.

The classification approach to determine which financial assets or financial liabilities would be accounted for at amortised cost uses two criteria that the Board believes will ensure that amortised cost provides decision-useful information about the amounts, timing and uncertainty of future cash flows:

- Does the financial instrument have basic loan features?

  Basic loan features are contractual terms that give rise to cash flows that are payments of principal and interest on the principal outstanding.

- Is the instrument managed on a contractual yield basis?

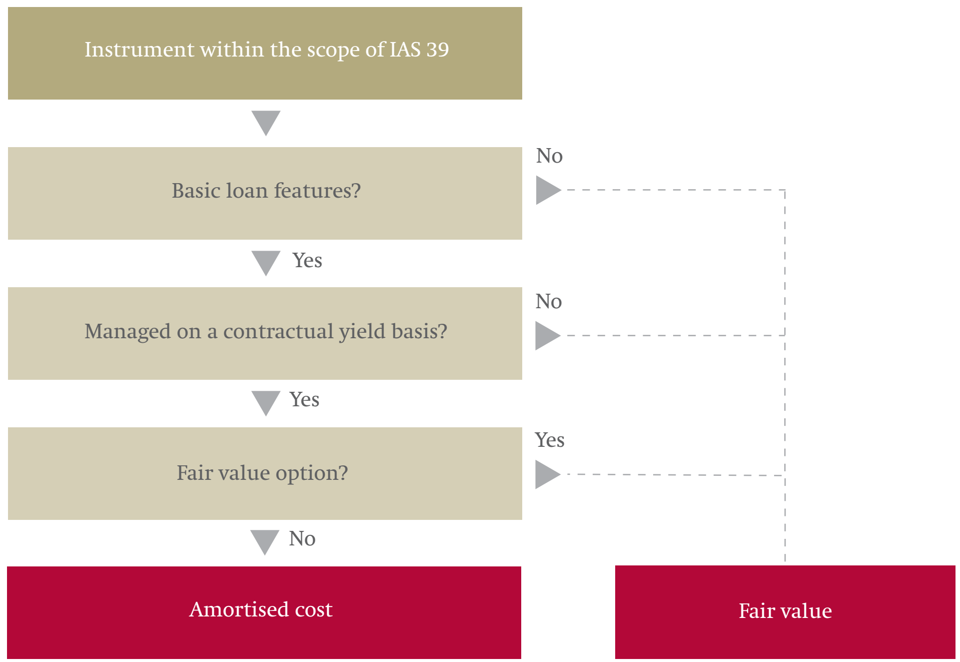
  Instruments are managed on a contractual yield basis if the business model is to pay and receive the contractual cash flows that are generated when held or issued.

Financial assets measured at amortised cost would not be subject to the tainting rules that exist in IAS 39, and would be subject to a single impairment model.

### Fair value option

The ED proposes a fair value option for financial instruments otherwise measured at amortised cost. A financial instrument would be eligible to be measured at fair value through profit or loss if such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

**Process for determining measurement**



## Simplified accounting for 'embedded derivatives'

Derivative features that are embedded in a non-derivative instrument ('the host') are a major source of complexity today.

The ED proposes that one classification approach should be used for all types of financial instruments, including those that contain embedded derivative features.

## All equity investments measured at fair value

Because equity investments do not have contractual cash flows the ED proposes that all equity investments should be measured at fair value.

Under the proposals, no impairment of equity investments would be necessary.

> The ED proposes that one classification approach should be used for all types of financial instruments.

IAS 39 contains an exemption from fair valuing investments in equity instruments (and some related derivatives) if they are unquoted and their fair value cannot be determined reliably. IAS 39 requires such investments to be assessed for impairment, using a fair value-based approach.

The ED proposes eliminating this exemption.

## Alternative presentation of fair value changes for some equity investments

The ED provides for a presentation alternative for gains or losses on investments in some equity instruments (for example, strategic equity investments). This option would be available at initial recognition and would be irrevocable. If the option was used all gains or losses (including dividends) on the instrument would be recognised in other comprehensive income. No recycling of gains and losses to profit or loss would be allowed, and hence no impairment requirements are necessary.

## Transition

The ED proposes to require retrospective application of the new guidance to facilitate comparability. Retrospective application restates all information in the IFRS financial statements as if the new guidance had always been applied. Some transition relief is proposed to address possible implementation problems.

Entities would have to apply the new classification model to their existing instruments.

For example, for financial instruments with basic loan features that were previously measured at fair value the information provided would have to be restated to reflect an amortised cost measurement (including any impairment based on incurred losses).

## Effective date

The IASB will set the effective date once it finalises the standard. However, in order to enable entities to adopt at the same time all the requirements that result from the different phases of the project to replace IAS 39 the Board expects that the (mandatory) effective date for all the phases will not be before 1 January 2012. Any final requirements arising from the classification and measurement phase would be available for early (voluntary) adoption in 2009 year-end financial statements.

# What is the impact of the proposed classification approach?

The proposed classification approach is intended to improve the ability of users of financial statements to understand and use the financial information presented, and to eliminate the complexity that is created by the many classification categories and associated impairment methods in IAS 39.

IAS 39 has many classification categories with different associated impairment methods. This is a major source of complexity and has raised many concerns, especially during the financial crisis.

The major impact that the proposals would have are:

**Two measurement categories:**

- The IAS 39 classification categories would be replaced with two measurement categories – fair value and amortised cost.

**Characteristics of instrument drive measurement:**

- Debt instruments (including debt instruments that are in security form and quoted in a market) that are today classified as 'available for sale' and measured at fair value could be measured using amortised cost, if the criteria are met.

**Elimination of tainting rules:**

- The 'tainting' requirements in IAS 39 for held-to-maturity assets would be eliminated. Separate presentation of gains and losses arising on the derecognition of items measured at amortised cost before maturity would enable users to understand the effects of such transactions within the context of a business model based on the payment or receipt of contractual cash flows.

**One impairment method:**

- One impairment method would be applied to all financial assets measured at amortised cost – a major simplification compared with today's requirements, which require different impairment approaches for available-for-sale debt instruments, equity investments and for assets measured using amortised cost.

**Single classification approach:**

- One classification approach would be used for all types of financial instruments. This would include financial contracts that have derivative features embedded. This would significantly reduce complexity.

**All equity investments at fair value:**

- All equity instruments would be measured at fair value and there would be an option to present gains or losses for some equity investments in other comprehensive income. There would be no impairment requirements for such circumstances.

# How can I comment on the ED?

The ED includes questions on the proposals. Respondents are invited to comment on any or all of those questions and to comment on any other issue that the Board should consider in finalising the proposals. The IASB's redeliberations of the proposals will take place in public meetings as announced on the IASB website.

The deadline for comments on the ED is 14 September 2009. To view the ED and submit your comments, visit www.iasb.org.

More information about measures undertaken by the IASB in response to the G20 conclusions and the recommendations of the Financial Stability Board is available on www.iasb.org/financial+crisis.

To stay up to date with the latest developments of the project to replace IAS 39 sign up for email alerts via the project homepage on www.iasb.org.

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