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Exposure Draft ED/2009/7

Financial Instruments: Classification and Measurement

Comments to be received by 14 September 2009



International
Accounting Standards
Board®

Exposure Draft

**FINANCIAL INSTRUMENTS:
CLASSIFICATION AND
MEASUREMENT**

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This exposure draft *Financial Instruments: Classification and Measurement* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklets) should be submitted in writing so as to be received by **14 September 2009**. Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

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Introduction and invitation to comment

Reasons for publishing the exposure draft

- IN1 IAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The International Accounting Standards Board inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.
- IN2 Many users of financial statements and other interested parties have told the Board that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged the Board to develop a new standard of financial reporting for financial instruments that is principle-based and less complex. Although the Board has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.
- IN3 Since 2005, the Board and the US Financial Accounting Standards Board (FASB) have had a long-term objective to improve and simplify the reporting for financial instruments. In March 2008 the boards published a discussion paper *Reducing Complexity in Reporting Financial Instruments*. That paper discussed the main causes of complexity in reporting financial instruments and possible intermediate and long-term approaches to improving financial reporting and reducing complexity. The boards received 162 comment letters. In the discussions leading to the exposure draft *Financial Instruments: Classification and Measurement*, the Board considered relevant recommendations and suggestions about classification and measurement from those comment letters.
- IN4 In October 2008, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis, the boards set up a Financial Crisis Advisory Group (FCAG). The FCAG was asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The FCAG expects to publish a report in the third quarter of 2009. However, the exposure draft reflects its discussions to date. The exposure draft also draws on input that the Board obtained from discussions with interested parties, in particular, from three public round tables held to discuss reporting issues that arose from the financial crisis.

- IN5 In April 2009, in response to the input received as a result of their work responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the boards announced an accelerated timetable for replacing their respective financial instruments standards.

The IASB's approach to replacing IAS 39

- IN6 The Board noted requests from interested parties that the accounting for financial instruments should be improved quickly. The G20 leaders recommended that the Board take action by the end of 2009 to improve and simplify the accounting requirements for financial instruments. To achieve this, the Board divided its project to replace IAS 39 into three phases. As the Board completes each phase, it will delete the relevant portions of IAS 39 and, along with its current project on the derecognition of financial instruments, create an IFRS that will eventually replace IAS 39. The Board published an exposure draft on derecognition in March 2009.
- IN7 This exposure draft proposes requirements for the classification and measurement of financial assets and financial liabilities. The Board decided to address those aspects first because they form the foundation of a standard on reporting financial instruments. Moreover, many of the concerns that have been expressed during the financial crisis arise from the classification and measurement requirements of IAS 39.
- IN8 In its deliberations leading to the exposure draft, the Board discussed alternative approaches for improving the reporting for financial instruments. The exposure draft discusses one alternative approach (and possible variants of that approach) and asks respondents for comments.

Presentation of the contents of this exposure draft

- IN9 The proposals in this exposure draft would necessitate extensive consequential amendments to IAS 39 and other IFRSs and to the guidance on those IFRSs. For the convenience of readers, all of those proposed amendments are set out in a separate booklet.

Next steps

- IN10 The Board plans to develop an IFRS from the proposals in this exposure draft to be available for early adoption in time for 2009 year-end financial statements. The Board also expects to publish exposure drafts in the

fourth quarter of 2009 on impairment of financial assets and hedge accounting. The Board will review the effective date of the proposals from the three exposure drafts in due course, but expects that the new requirements will not be mandatorily effective before January 2012, although early application of any finalised requirements on impairment and hedge accounting may also be permitted.

- IN11 The Board and the FASB are committed to working together to develop a comprehensive standard to improve the measurement and reporting of financial instruments. The Board has chosen to complete the project in three phases. However, the FASB believes that it will be important to its constituents to be able to comment on a proposed standard including classification, measurement and impairment at the same time. It is not uncommon for the boards to deliberate separately on joint projects and then subsequently to reconcile any differences in their technical decisions. At the time this exposure draft was published, the FASB had not deliberated what the basic classification model for financial instruments should be but planned to do so shortly.

Other relevant IASB activities

Credit risk in liability measurement

- IN12 In June 2009 the IASB published a discussion paper on the role of credit risk in liability measurement (commonly referred to as 'own credit risk'), together with a staff paper that described the most common arguments for and against including credit risk in measuring liabilities. The Board acknowledged that the issue of whether profit or loss resulting from changes in 'own credit risk' should be recognised when a financial liability is measured at fair value has generated more comment and controversy than any other issue about the use of fair value, especially during the recent financial crisis. The discussion paper asks whether current measurements of liabilities (including fair value) should incorporate the probability that an entity will fail to perform as required and, if not, what the alternatives are.
- IN13 The discussion paper seeks comment on three possible approaches to liability measurement set out in the staff paper. Those approaches identify possible ways to measure liabilities while excluding own credit risk, as follows:
- (a) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about

default. Any difference between the resulting amount and cash proceeds (if any) should be charged to profit or loss immediately.

- (b) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to equity and amortised over the life of the liability.
- (c) Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk. Subsequent current measurements should incorporate changes in market interest rates. Changes arising from the entity's credit quality or the price of its credit should be excluded from the market interest rates. This would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.

IN14 The discussion paper is open for comment until 1 September 2009 and can be accessed free of charge on eIFRS or on the 'Open to comment' section on the IASB's website (www.iasb.org). The Board believes that responses to the discussion paper will be relevant to this project and intends to consider them along with the responses to this exposure draft when it reconsiders and finalises the proposals in this exposure draft.

Summary of the proposals and invitation to comment

The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated
- (b) indicate the specific paragraph or paragraphs to which the comments relate
- (c) contain a clear rationale
- (d) describe any alternatives the Board should consider.

The Board is not seeking comments on aspects of IAS 39 not addressed in this exposure draft.

Comments should be submitted in writing so as to be received no later than **14 September 2009**.

Classification approach (paragraphs 3–5)

The exposure draft proposes two primary measurement categories for financial instruments. A financial asset or financial liability would be measured at amortised cost if two conditions are met:

- the instrument has basic loan features, and
- the instrument is managed on a contractual yield basis.

A financial asset or financial liability that does not meet both conditions would be measured at fair value.

The proposed approach would reduce the complexity that results from the many categories and related impairment methods in IAS 39. The proposed approach would also simplify accounting requirements by eliminating the ‘tainting’ provision in IAS 39, ie the exposure draft contains no proposal to prohibit an entity from measuring a financial asset at amortised cost if the entity has previously sold other financial assets measured at amortised cost before maturity. However, an entity would be required to separately present in the statement of comprehensive income gains or losses arising from the derecognition of a financial asset or financial liability measured at amortised cost and provide additional disclosures.

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has ‘basic loan features’ and ‘is managed on a contractual yield basis’? If not, why? What additional guidance would you propose and why?

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

- (a) what alternative conditions would you propose? Why are those conditions more appropriate?

- (b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?
- (c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

Embedded derivatives (paragraphs 6–8)

The exposure draft proposes that a hybrid contract with a host that is within the scope of the proposed IFRS ('financial host') is classified in its entirety in accordance with the proposed classification approach.

Many consider the accounting requirements in IAS 39 for embedded derivatives complex and rule-based. The exposure draft would simplify those accounting requirements by proposing a single classification approach for all financial instruments including hybrid contracts with financial hosts.

The exposure draft also addresses investments in contractually subordinated interests (ie tranches). The exposure draft proposes to apply the classification criteria to such investments by requiring that any tranche that provides credit protection to other tranches on the basis of any possible outcome (rather than a probability-weighted outcome) must be measured at fair value because provision of such credit protection is a form of leverage and not a basic loan feature.

Question 4

- (a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

- (b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

Fair value option (paragraph 9)

The exposure draft retains the fair value option in IAS 39 that permits an entity to elect at initial recognition to measure any financial asset or financial liability within the scope of the exposure draft 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').

IAS 39 also permits designation of financial assets and financial liabilities at fair value through profit or loss:

- when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel; or
- for some contracts that contain one or more embedded derivatives.

Under the proposed approach, these eligibility conditions are not needed. The proposals would require financial instruments that do not have basic loan features or are not managed on a contractual yield basis to be measured at fair value and would eliminate the requirement to identify and account for embedded derivatives separately.

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

Reclassification (paragraph 10)

The exposure draft proposes to prohibit reclassification of financial assets and financial liabilities between the amortised cost and fair value categories.

This proposal would improve comparability and eliminate the need for complex reclassification requirements.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

Investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured

IAS 39 requires all investments in equity instruments (and derivatives on those equity instruments) to be measured at fair value, unless they do not have a quoted market price in an active market and their fair value cannot be reliably measured (and, in the case of derivatives, are settled by delivery of those equity instruments). Such instruments are measured at cost.

Moreover, IAS 39 requires the holder to monitor such investments for impairment and recognise a loss if one has been incurred. That requirement has been criticised because it is based on a calculation that is similar to fair value. Some have told the Board that the impairment calculation is not more reliable or less costly than measuring the equity investment at fair value.

The Board recognises that measuring all investments in equity instruments (and derivatives on those equity instruments) at fair value would impose additional costs on preparers. In the Board's view, these costs are justified by improved decision-useful information about equity investments for users of financial statements. Measuring all investments in equity instruments in the same way would also simplify the accounting requirements and improve comparability. Therefore, the exposure draft proposes that all investments in equity instruments (and derivatives on those equity instruments) should be measured at fair value. The Board notes that the relative costs and benefits may vary depending on the size of the entity and the significance of equity investments to its financial position and performance.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Investments in equity instruments that are measured at fair value through other comprehensive income (paragraphs 21 and 22)

An investment in equity instruments does not meet the conditions to be measured at amortised cost because it does not have basic loan features.

The Board has been told that some equity instruments are purchased for strategic purposes and are not held with the primary objective of realising a profit from increases in the value of the instrument and dividends. Therefore, the exposure draft proposes to permit an entity, on initial recognition of investments in equity instruments that are not held for trading but are held for purposes other than realising direct investment gains, to make an irrevocable election to present changes in the fair value of those investments in other comprehensive income. Dividends on such investments would also be presented in other comprehensive income. There would be no transfers from other comprehensive income to profit or loss ('recycling') and hence no impairment requirements.

This proposal is intended to assist users of financial statements to identify separately the gains and losses on equity instruments that are held for purposes other than realising direct investment gains and to assess the implications of such fair value changes accordingly.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

- (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?
- (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Effective date and transition (paragraphs 23–33)

The Board will review the effective date in due course, but expects that the new requirements will not be mandatorily effective before January 2012. The Board expects to permit early application of any finalised requirements.

The exposure draft proposes to amend IFRS 7 *Financial Instruments: Disclosures* to require additional disclosures if an entity decides to adopt the proposed IFRS before its mandated effective date.

The exposure draft also proposes specific requirements in paragraphs 24–33 for transition to the proposed IFRS.

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

An alternative approach

In its deliberations leading to the exposure draft, the Board discussed alternative approaches to classification and measurement.

One alternative approach was that financial assets that meet the two conditions specified in this exposure draft (ie they have basic loan features and are managed on a contractual yield basis) and meet the definition of loans and receivables in

IAS 39 would be measured at amortised cost in the statement of financial position. All other financial assets would be measured at fair value in the statement of financial position, including assets that meet the conditions specified in this exposure draft to be measured at amortised cost. The fair value changes of such financial assets for each period would be disaggregated, and presented as follows:

- (a) changes in recognised value determined on an amortised cost basis (including impairments determined using the incurred loss impairment requirements in IAS 39) would be presented in profit or loss; and
- (b) any difference between the amortised cost measure in (a) and the fair value change for the period would be presented in other comprehensive income (OCI).

There would be no recycling between OCI and profit or loss. Any reversals of impairment losses would be recognised in profit or loss.

Some Board members think that this approach might provide decision-useful information to users of financial statements because fair value information is provided in the statement of financial position and changes in fair values are disaggregated (in profit or loss and OCI).

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

- (a) in the statement of financial position?
- (b) in the statement of comprehensive income?

If so, why?

Possible variants of this alternative approach were also discussed.

One variant would be to present both (a) and (b) in profit or loss, but separately.

Another variant would be to measure all financial instruments (including financial assets that meet the two conditions specified in the exposure draft and meet the definition of loans and receivables in IAS 39) at fair value in the statement of financial position. All financial instruments (including financial liabilities) with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as described in (a) and (b).

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

[Draft] International Financial Reporting Standard X *Financial Instruments: Classification and Measurement* ([draft] IFRS X) is set out in paragraphs 1–33 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold** type state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X Financial Instruments: Classification and Measurement

Objective

- 1 The objective of this [draft] IFRS is to establish principles for the classification and measurement of *financial assets* and *financial liabilities* that will present relevant and decision-useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows. The principles in this [draft] IFRS complement the principles for recognising, presenting and providing disclosures about financial assets and financial liabilities in IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*.

Scope

- 2 This [draft] IFRS shall be applied to all items within the scope of IAS 39.

Classification approach

Two categories of financial assets and financial liabilities

- 3 **On initial recognition, an entity shall classify financial assets and financial liabilities as subsequently measured at either *amortised cost* or *fair value* in accordance with paragraphs 4 and 5.**
- 4 **A financial asset or financial liability shall (unless paragraph 9 applies) be measured at amortised cost if both of the following conditions are met:**
- (a) the instrument has only basic loan features, and
 - (b) the instrument is managed on a contractual yield basis.
- Paragraphs B1–B13 provide guidance on these conditions.**
- 5 **A financial asset or financial liability that does not meet the conditions in paragraph 4 shall be measured at fair value. Changes in fair value shall be presented in profit or loss or other comprehensive income in accordance with paragraphs 19, 21 and 22.**

Embedded derivatives

- 6 An embedded *derivative* is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to the cash flows of a stand-alone derivative. If a derivative is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, that derivative is not an embedded derivative, but a separate financial instrument.
- 7 **If the host is not within the scope of this [draft] IFRS, an entity shall apply the requirements in paragraphs 10–13 and AG28-AG33 of IAS 39 to determine whether an embedded derivative must be separated from the host. If an embedded derivative must be separated from the host, the entity shall account for the derivative in accordance with paragraphs 3–5. The entity shall account for the host in accordance with other appropriate IFRSs.**
- 8 An entity shall apply the requirements in paragraphs 3–5 to all other hybrid contracts.

Option to designate a financial asset or financial liability at fair value through profit or loss

- 9 At initial recognition, an entity may designate a financial asset or financial liability that would otherwise be measured subsequently at amortised cost, as 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’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

Reclassification

- 10 An entity shall not reclassify a financial asset or financial liability between the fair value and amortised cost categories.

Measurement

Initial measurement of financial assets and financial liabilities

- 11 At initial recognition, an entity shall measure a financial asset or financial liability at its fair value (see paragraphs 48-49 and AG69-AG82 of IAS 39) plus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs*.

Subsequent measurement of financial assets and financial liabilities

Financial assets

- 12 After initial recognition, an entity shall measure financial assets at fair value (see paragraphs 48-49 and AG69-AG82 of IAS 39) or amortised cost in accordance with paragraphs 3-9.
- 13 An entity shall apply the impairment requirements in paragraphs 58-65 and AG84-AG93 of IAS 39 to all financial assets measured at amortised cost.
- 14 An entity shall apply the hedge accounting requirements in paragraphs 89-102 of IAS 39 to financial assets that are designated as *hedged items* (see paragraphs 78-84 and AG98-AG101 of IAS 39).

Financial liabilities

- 15 After initial recognition, an entity shall measure financial liabilities at fair value (see paragraphs 48-49 and AG69-AG82 of IAS 39) or amortised cost in accordance with paragraphs 3-9 except for:
- (a) those that arise when a transfer of a financial asset does not qualify for *derecognition* or when the continuing involvement approach applies, which shall be measured in accordance with paragraphs 29 and 31 of IAS 39.
 - (b) a *financial guarantee contract* as defined in paragraph 9 of IAS 39 (unless (a) applies), which shall be measured in accordance with paragraphs 16 and 17.
 - (c) a commitment to provide a loan at below-market interest rates, which shall be measured in accordance with paragraphs 16 and 17.

- 16** A financial guarantee contract or a commitment to provide a loan at a below-market interest rate shall be measured at fair value through profit or loss if either of the following criteria is met:
- (a) it is designated at fair value through profit or loss in accordance with paragraph 9; or
 - (b) it is held for trading.
- 17** A financial guarantee contract or a commitment to provide a loan at a below-market interest rate that does not meet either of the criteria in paragraph 16 shall be measured at the higher of:
- (a) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and
 - (b) the amount initially recognised (see paragraph 11) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.
- 18** An entity shall apply the hedge accounting requirements in paragraphs 89–102 of IAS 39 to financial liabilities that are designated as hedged items (see paragraphs 78–84 and AG98–AG101 of IAS 39).

Gains and losses

- 19** A gain or loss on a financial asset or financial liability that is measured at fair value and is not part of a hedging relationship (see paragraphs 89–102 of IAS 39) shall be presented in profit or loss unless the financial asset is an investment in an *equity instrument* and the entity elects to present gains and losses on that investment in other comprehensive income in accordance with paragraph 21.
- 20** A gain or loss on a financial asset or financial liability that is measured at amortised cost shall be recognised in profit or loss when the financial asset or financial liability is derecognised and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 78–84 and AG98–AG101 of IAS 39) the gain or loss shall be recognised in accordance with paragraphs 89–102 of IAS 39.

Investments in equity instruments

- 21** At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of investments in equity instruments within the scope of this [draft] IFRS that are not held for trading.

- 22 If an entity makes that election, it shall recognise in other comprehensive income dividends from those investments when the entity's right to receive payment is established.

Effective date and transition

Effective date

- 23 An entity shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies this [draft] IFRS in its financial statements for a period before [date to be inserted after exposure], it shall disclose that fact and at the same time apply the amendments set out in Appendix C.

Transition

- 24 An entity shall apply this [draft] IFRS retrospectively, subject to the transitional provisions in paragraphs 25–33, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. For the purposes of the transitional provisions in paragraphs 25–33, the date of initial application is the date when an entity first applies the requirements in this [draft] IFRS.
- 25 An entity shall assess whether a financial asset or financial liability meets the condition in paragraph 4(b) on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.
- 26 If a hybrid contract is required to be measured at fair value in accordance with paragraph 5 but the fair value of the hybrid contract had not been determined in comparative periods, the entity shall measure the hybrid contract in the comparative periods using the sum of the fair value of the components (ie the host and the embedded derivative) at the end of each comparative period presented. At the date of initial application, the entity shall measure the hybrid contract in its entirety at fair value. Any difference between that measurement at the date of initial application and the sum of the fair values of the components at the date of initial application shall be recognised in the opening retained earnings of the reporting period of initial application if this [draft] IFRS is applied initially at the beginning of a reporting period and in profit or loss if this [draft] IFRS is applied initially during a reporting period.

- 27 An entity may designate a financial asset or financial liability as at fair value through profit or loss in accordance with paragraph 9. Such designation shall be made on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.
- 28 An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 21. Such designation shall be made on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.
- 29 An entity may revoke its previous designation of a financial asset or financial liability as at fair value through profit or loss in accordance with paragraph 9 on the basis of the facts and circumstances that existed at the date of initial application (and shall revoke its designation if the eligibility criterion in paragraph 9 is not met). That classification shall be applied retrospectively.
- 30 If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39, the entity shall determine the amortised cost of the financial instrument or any impairment on a financial asset in each period presented on the basis of the fair value of the financial instrument at the end of each comparative period. If an impairment loss is recognised using that approach or if it is impracticable for the entity to apply the effective interest method, the fair value of the financial instrument at the date of initial application shall be the new amortised cost of that instrument at the date of initial application of this [draft] IFRS.
- 31 If an entity previously accounted for an investment in an unquoted equity instrument (or a derivative that is linked to and must be settled by delivery of such unquoted equity instruments) in accordance with paragraphs 46(c), 47(a) and 66 of IAS 39, that instrument shall be measured at fair value at the date of initial application. Any difference shall be recognised in the opening retained earnings of the reporting period of initial application.
- 32 Any hedge relationship accounted for in accordance with paragraphs 85–101 of IAS 39 that is de-designated as a consequence of the classification approach in this [draft] IFRS shall be accounted for as a discontinuation of hedge accounting in accordance with paragraphs 91 and 101 of IAS 39 from the date of initial application.
- 33 An entity that prepares interim financial reports in accordance with IAS 34 *Interim Financial Reporting* need not apply the requirements in this [draft] IFRS to prior interim periods if it is impracticable (as defined in IAS 8).

Appendix A Defined terms

This appendix is an integral part of the [draft] IFRS.

The following terms are defined in paragraph 11 of IAS 32 or paragraph 9 of IAS 39 and are used in this [draft] IFRS with the meanings specified in IAS 32 or IAS 39:

- (a) derecognition
- (b) derivative
- (c) equity instrument
- (d) fair value
- (e) financial asset
- (f) financial guarantee contract
- (g) financial instrument
- (h) financial liability
- (i) hedged item
- (j) hedging instrument.

amortised cost The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

effective interest method A method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period using the effective interest rate.

- effective interest rate** The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18), transaction costs and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
- held for trading** A financial asset or financial liability is held for trading if:
- (a) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - (b) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (c) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

transaction costs

Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Appendix B

Application guidance

This appendix is an integral part of the [draft] IFRS.

Classification approach

Two categories of financial assets and financial liabilities

Basic loan features

- B1 Basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding. For the purposes of this [draft] IFRS, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. Contractual terms that change the timing or amount of payments of principal or interest on the principal outstanding are not basic loan features unless they protect the creditor or debtor (see paragraph B3(c)). Other contractual features that result in cash flows that are not payments of principal and interest are not basic loan features.
- B2 An entity shall assess whether a contractual term is a basic loan feature in the currency in which the financial asset or financial liability is denominated (see also paragraph B25).
- B3 The following are examples of basic loan features:
- (a) returns to the holder that are:
 - (i) a fixed amount (eg a zero coupon bond);
 - (ii) a fixed return over the life of the instrument;
 - (iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR) and/or an adjustment of the interest rate in accordance with (c) below; or
 - (iv) some combination of such fixed return and variable return (such as LIBOR plus or minus 50 basis points), including debt instruments issued at a discount or premium and fixed rate debt instruments with one or more interest rate resets at pre-specified rates and pre-specified times. For fixed and

variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.

- (b) a contractual feature that is a combination of a fixed interest return and a variable interest return (as described in (a)). Such a feature may reduce the cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed interest rate becomes variable.
 - (c) contractual provisions that permit the issuer (the debtor) to prepay a debt instrument (eg loans or bonds) or permit the holder (the creditor) to put a debt instrument back to the issuer before maturity and are not contingent on future events. In such a case, the prepayment amount must substantially represent unpaid amounts of principal and interest. For this purpose, terms that protect the lender from credit deterioration of the borrower in cases of defaults, credit downgrades and loan covenant violations, and terms relating to possible future changes in taxation, law and similar factors that protect the lender are not considered to be contingent on future events. Such prepayment provisions may include terms that require the issuer to compensate the holder for the early termination of the instrument.
- B4 The following do not violate the conditions for returns in paragraph B3(a):
- (a) changes in the return to the holder attributable to changes in the timing of cash flows (including related contractual payments that compensate either party for that change in the timing permitted in accordance with paragraph B3(c)).
 - (b) pre-specified resets of interest rates in response to changes in the credit quality of the financial asset or financial liability.
- B5 Other contractual features that result in cash flows that are not payments of principal and interest on the principal outstanding are not basic loan features. An interest rate swap, or a forward contract or option contract to deliver another financial instrument, does not have basic loan features because the contractual cash flows are not payments of principal and interest on the principal outstanding.
- B6 In almost every lending transaction the creditor is ranked relative to an entity's other creditors. An instrument that is subordinated to other instruments may still have basic loan features if the issuer's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the issuer's

bankruptcy. For example, a trade receivable that ranks as a general creditor has basic loan features even if the debtor has issued loans that are collateralised, which in the event of bankruptcy gives that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal.

- B7 In some types of transactions, an entity may prioritise payments to the holders of the financial assets using multiple contractually subordinated interests (ie tranches). Each tranche has a subordination ranking that specifies the order in which any losses that the issuer incurs are allocated to the different tranches. The senior tranche is paid in full before any subordinated tranche is paid.
- B8 Any tranche that provides credit protection to other tranches in any situation does not have basic loan features. The cash flows of the tranche are not principal and interest because its holder is compensated for providing that credit protection.

Managed on a contractual yield basis

- B9 Financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), on the basis of the contractual cash flows that are generated when held or issued (including any adjustment or consideration for prepayment provisions).
- B10 Whether financial instruments are managed on a contractual yield basis does not depend on management's intentions for an individual instrument. It depends on how management manages the instruments, which is unlikely to differ for an individual financial asset or financial liability in isolation. Accordingly, this condition is not an instrument-by-instrument approach to classification. However, an entity may have several units that are managed in different ways. Therefore, classification need not be determined at the reporting entity level. For example, a bank with a broad scope of activities may have an investment banking business managed on one basis and a retail banking business managed on another basis. Instruments held in the investment banking business will most likely be managed differently from those in the retail banking business.
- B11 An entity shall not reclassify a financial asset or financial liability between the fair value and amortised cost categories under any circumstances.

- B12 The following are examples of financial assets or financial liabilities that are managed on a contractual yield basis:
- (a) trade accounts receivable (or payable) that an entity holds to collect (or pay) the cash amounts due.
 - (b) instruments that an entity manages on the basis of contractual payments of principal and interest that are received during the contract term.
 - (c) issued bonds that the entity manages on the basis of contractual interest and principal that it pays to investors under the terms of the contract.
- B13 The following are examples of financial assets or financial liabilities that are not managed on a contractual yield basis:
- (a) a financial asset or financial liability that is held for trading.
 - (b) a financial asset that is acquired at a discount that reflects incurred credit losses.

Option to designate a financial asset or financial liability at fair value through profit or loss

- B14 An entity may designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss only if such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise.
- B15 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in financial statements that provide reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.
- B16 This [draft] IFRS and IAS 39 determine the way that a financial asset or financial liability is measured, how recognised changes in its value are presented and whether hedge accounting may be applied. In some circumstances, those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting

mismatch'). For example, if a financial asset is measured at fair value through profit or loss and a liability the entity considers related is measured at amortised cost (with changes in fair value not recognised), an entity may conclude that its financial statements provide less relevant information than if both the asset and the liability were classified as at fair value through profit or loss.

- B17 An entity may designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9. The following examples are circumstances in which the principle may be met:
- (a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of IFRS 4 *Insurance Contracts*), and financial assets it considers related that would otherwise be measured at amortised cost.
 - (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 of IAS 39 are not met.
 - (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and the risk gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:
 - (i) the entity has financed a portfolio of fixed rate assets with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through profit or loss corrects the inconsistency that could arise from measuring the assets at fair value and the debentures at amortised cost.
 - (ii) the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the

bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring the loans at amortised cost and the bonds at fair value.

- B18 For such examples, the measurement or recognition inconsistency could be eliminated or significantly reduced, and more relevant information produced, if an entity designates, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to take place.
- B19 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and therefore would not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100* and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

* In this [draft] IFRS, monetary amounts are denominated in 'currency units (CU)'.

Measurement

Initial measurement of financial assets and financial liabilities

- B20 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph AG76 of IAS 39). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74–AG79 of IAS 39). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- B21 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest method.

Subsequent measurement of financial assets

- B22 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value decreases below zero, it is a financial liability measured in accordance with paragraphs 15–18.
- B23 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income in accordance with paragraph 21. An entity acquires an asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.

Gains and losses

- B24 Paragraph 21 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of particular investments in equity instruments. Amounts recognised in other comprehensive income are not subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss (including any dividends recognised in accordance with paragraph 22) within equity.
- B25 An entity applies IAS 21 *The Effects of Changes in Foreign Exchange Rates* to financial assets and financial liabilities that are monetary items in accordance with IAS 21 and denominated in a foreign currency. IAS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a *hedging instrument* in either a cash flow hedge (see paragraphs 95–101 of IAS 39) or a hedge of a net investment (see paragraph 102 of IAS 39).
- B26 Paragraph 21 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of particular investments in equity instruments. Those investments are not monetary items. Accordingly, the gain or loss that is presented in other comprehensive income under paragraph 21 includes any related foreign exchange component.
- B27 If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

Defined terms

Effective interest rate

- B28 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market

rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

- B29 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect changes in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- B30 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92 of IAS 39. The adjustment is recognised in profit or loss as income or expense.

Financial assets and financial liabilities held for trading

- B31 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.
- B32 Financial liabilities held for trading include:
- (a) derivative liabilities that are not accounted for as hedging instruments in accordance with IAS 39;

- (b) obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed and does not yet own);
- (c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
- (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Transaction costs

- B33 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

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The exposure draft *Financial Instruments: Classification and Measurement* was approved for publication by thirteen of the fourteen members of the International Accounting Standards Board. Mr Leisenring voted against publication. His alternative view is set out after the Basis for Conclusions.

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