July 2004

EXPOSURE DRAFT OF PROPOSED

Amendments to IAS 39 Financial Instruments: Recognition and Measurement

Transition and Initial Recognition of Financial Assets and Financial Liabilities

Comments to be received by 8 October 2004

International Accounting Standards Board®

Exposure Draft of proposed

AMENDMENTS TO
IAS 39 FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT

TRANSITION AND INITIAL RECOGNITION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Comments to be received by 8 October 2004

This Exposure Draft of proposed Amendments to IAS 39 *Financial Instruments: Recognition 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 in final form as an amendment of IAS 39. Comments on the Exposure Draft and the Basis for Conclusions should be submitted in writing so as to be received by **8 October 2004**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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Background

1. In July 2001, the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002 the Board published its proposed improvements as an Exposure Draft and in December 2003 it issued a revised version of the two Standards.

2. Among the revisions to IAS 39 was expanded guidance on how to measure the fair value of financial instruments. The Board decided to include such guidance to help achieve reliable and comparable estimates when financial instruments are measured at fair value.

3. Specifically, the Board decided to include guidance on when an entity can recognise gains or losses on initial recognition of financial instruments. In the revised version of IAS 39, paragraph AG76 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets. It follows that a 'day 1' gain or loss can be recognised only if evidenced in this way. When developing this requirement, the Board noted that it converged with US GAAP.

4. The transition provisions in the revised IAS 39 and IFRS 1 *First-time Adoption of International Financial Reporting Standards* require retrospective application of the guidance described in paragraph 3.

5. Respondents to the June 2002 Exposure Draft who commented on the proposed transition provisions did not raise any specific concern about the retrospective application of the fair value measurement guidance in IAS 39. However, after the revised IAS 39 was issued, constituents raised the following concerns:

(a) retrospective application of the 'day 1' gain or loss recognition requirements will be difficult and expensive, and may require subjective assumptions about what was observable and what was not. For example, because the average contractual term of the investments could be as long as ten years, it may be difficult to identify all transactions on which 'day 1' profit has been recognised.

(b) retrospective application diverges from the requirements of US GAAP. Very similar requirements in US GAAP are applicable only to transactions entered into after 25 October 2002.

6. The Board is committed to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many entities will adopt IFRSs for the first time. However, because the issue concerns transition and because retrospective application of the requirements in paragraph AG76 can be difficult and give rise to reconciling differences with US GAAP for a number of years, the Board decided, as a special case, to propose an amendment to the transition requirements in the revised IAS 39. This amendment would apply when entities first adopt that Standard. It would allow, but not require, entities to adopt an approach to transition that is easier to implement than that in the revised IAS 39 and also enable entities to eliminate any reconciling differences with US GAAP. More specifically, it decided to give entities a choice of applying the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76 either:

(a) prospectively to transactions entered into after 25 October 2002, or

(b) retrospectively as required by paragraph 104 of IAS 39.

7. The Board also noted that confusion had arisen over how any gain or loss not recognised on 'day 1' should be recognised subsequently. In particular, some suggested that the entire gain or loss might be recognised on 'day 2'. The Board decided to clarify that:

(a) the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements in IAS 39; and

(b) accordingly, a gain or loss should be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

8. The Board also decided not to provide any additional guidance on fair value measurement at this time.

Invitation to Comment

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Question 2

Do the proposals contained in this Exposure Draft appropriately address the concerns set out in paragraph 5 of the Background on this Exposure Draft? If not, why not and how would you address those concerns?

Question 3

Do you have any other comments on the proposals?

Proposed Amendments to IAS 39

In the Standard, [draft] paragraphs 107A and 108A are added. For ease of reference, paragraphs 103 and 104 are reproduced below, although no changes are proposed to them.

Effective Date and Transition

103. An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for annual periods beginning before 1 January 2005 unless it also applies IAS 32 (issued December 2003). If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

104. This Standard shall be applied retrospectively except as specified in paragraphs 105-108. The opening balance of retained earnings for the earliest prior period presented and all other comparative amounts shall be adjusted as if this Standard had always been in use unless restating the information would be impracticable. If restatement is impracticable, the entity shall disclose that fact and indicate the extent to which the information was restated.

107A. Notwithstanding paragraph 104, an entity may apply the requirements in the last sentence of paragraph AG76 prospectively to transactions entered into after 25 October 2002.

108A. An entity shall apply [draft] paragraph AG76A for annual periods beginning on or after 1 January 2005. Earlier application is permitted.

In the Application Guidance [draft] paragraph AG76A is added. For ease of reference, paragraph AG76 is reproduced below, although no change is proposed to it.

Appendix A

Application Guidance

Measurement (paragraphs 43-70)

No Active Market: Valuation Technique

AG76. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

AG76A. The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. Accordingly, a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

Proposed Consequential Amendments to IFRS 1

In the Standard, paragraph 13 is amended (new text is underlined) and [draft] paragraph 25E is added.

13 An entity may elect to use one or more of the following exemptions:

(a) ….

<u>(j)</u> <u>fair value measurement of financial assets or financial liabilities at initial recognition (paragraph 25E).</u>

…

Fair value measurement of financial assets or financial liabilities

25E A first-time adopter may have measured financial assets or financial liabilities at fair value in accordance with previous GAAP. If it determined fair value at initial recognition on a basis that does not comply with the last sentence of paragraph AG76 of IAS 39, it may elect not to apply that sentence to transactions entered into before 25 October 2002.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Background

BC1. The revised IAS 39 paragraph AG76 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets. It follows that a 'day 1' gain or loss can be recognised only if evidenced in this way. When developing this requirement, the Board noted that it converges with US GAAP.

BC2. IAS 39 and IFRS 1 *First-time Adoption of International Financial Reporting Standards* in most cases require retrospective application so that assets and liabilities are measured in the comparative financial statements on the same basis as in the current year financial statements. The Board's view is that retrospective application provides the most comparable information to users of financial statements. In particular, IAS 39 and IFRS 1 require retrospective application of the fair value measurement guidance in IAS 39 paragraph AG76.

The rationale for the proposed amendments

BC3. Respondents to the June 2002 Exposure Draft who commented on the transition provisions did not raise any specific concern on the retrospective application of the fair value measurement guidance in IAS 39. However, after the revised IAS 39 was issued constituents raised the following concerns:

(a) retrospective application of the 'day 1' gain or loss recognition requirements may be difficult and expensive, and may require subjective assumptions about what was observable and what was not. For example, because the average contractual term of the investments could be as long as ten years, it may be difficult to identify all transactions on which 'day 1' profit has been recognised.

(b) retrospective application diverges from US GAAP. Very similar requirements in US GAAP are applicable only to transactions occurring after 25 October 2002.

BC4. The Board considered the following ways to address these concerns:

(a) deem retrospective application of the ‘day 1’ gain or loss recognition requirements in paragraph AG76 to be impracticable.

(b) extend the transition exception for derecognition transactions in IAS 39 to the recognition of ‘day 1’ gains or losses.

(c) permit prospective application of the ‘day 1’ gain or loss recognition requirements in paragraph AG76 to transactions entered into after 25 October 2002.

Deem retrospective application of the ‘day 1’ gain or loss recognition requirements in paragraph AG76 to be impracticable

BC5. The Board considered whether retrospective application could be deemed to be impracticable. IAS 39 exempts retrospective application if such application is impracticable.

BC6. The Board noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines and explains what is impracticable. In particular:

(a) paragraphs 52 and 53 state that retrospective application is impracticable if such an application would require the use of hindsight. In the case of ‘day 1’ gain or loss recognition, hindsight is not required. Entities would not need to re-estimate the fair value of financial instruments. Rather they would recognise them at the transaction price.

(b) paragraph 5 states that retrospective application is impracticable “if the effects of retrospective application … are not determinable”. The Board concluded that whether this test is met is a subjective issue that depends upon entity-specific circumstances (eg what data an entity has) and, hence, will vary from one entity to another. Also, the Board was informed that many of the entities most affected by this issue are large investment banks for whom this test would probably not be met.

BC7. Furthermore, the Board concluded that this approach would provide relief only to existing users of IFRSs. It would not ease the implementation burden for first-time adopters, who cannot claim such an exemption (IFRS 1 does not contain an impracticability exemption). This could lead to incomparability between existing users of IFRSs and first-time adopters.

BC8. Accordingly, the Board decided not to propose this approach.

Extend the transition exception for derecognition transactions in IAS 39 to those involving recognition of 'day 1' gains or losses

BC9. The second approach the Board considered was to extend the transition exception for derecognition transactions in IAS 39 to those involving recognition of 'day 1' gains or losses. Under this exception entities would apply the 'day 1' gain or loss recognition requirements in paragraph AG76 prospectively to transactions occurring after 1 January 2004 or an earlier date of the entity's choosing, provided that the information needed to apply the 'day 1' gain or loss recognition requirements in paragraph AG76 was obtained at the time of initial recognition of the transaction. However, the Board noted that this could result in lack of comparability between entities because different entities could choose different dates from which to apply the guidance in paragraph AG76.

BC10. Therefore the Board decided not to propose this approach.

Permit prospective application of the 'day 1' gain or loss recognition requirements in IAS 39 paragraph AG76 to transactions entered into after 25 October 2002

BC11. Lastly, the Board considered whether to permit prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 to transactions entered into after 25 October 2002. This would enable entities to eliminate any difference with US GAAP, because EITF 02-03 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* requires prospective application from 25 October 2002.

BC12. The Board noted that one of its reasons, as stated in the Basis for Conclusions on IAS 39, for its decision on the recognition of 'day 1' gains or losses was to converge with US GAAP. It achieved such convergence on measurement, but not on transition. The Board observed that as a general principle it requires retrospective application because this provides the most comparable information to users of financial statements. However, it acknowledged that the choice between retrospective and prospective application is influenced by practicality considerations and, in this case, by the desire to converge with US GAAP. Hence, to enable entities to converge completely with US GAAP, the Board decided to permit prospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76 for transactions entered into after 25 October 2002.

BC13. The Board also noted that this approach would be less onerous than full retrospective application. Entities that reconcile their results to US GAAP could comply with this requirement because they would have the relevant data. For entities that do not reconcile to US GAAP, collecting the necessary information for the eighteen months prior to 1 January 2004 will be less onerous than full retrospective application.

BC14. The Board acknowledged that the amendments proposed in this Exposure Draft are likely to be finalised very close to the time when the financial statements to which IAS 39 is first applied are published, and may be finalised after interim financial statements for those periods have been published. As a result, some entities might already have compiled all the data necessary for retrospective application of the 'day 1' gain or loss recognition requirements in paragraph AG76. In view of this, the Board decided that it would also permit entities to apply that requirement with full retrospective effect (as currently required by IAS 39).

BC15. Because the concerns regarding retrospective application of the provisions in paragraph AG76 are equally applicable to first-time adopters, the Board decided to amend IFRS 1 to make the proposals in this Exposure Draft applicable to first-time adopters, as well as existing users of IFRSs.

Other matters considered by the Board

BC16. The Board also noted that confusion had arisen over how any gain or loss not recognised on 'day 1' should be recognised subsequently. In particular, some suggested that the entire gain or loss might be recognised on 'day 2'. The Board decided to clarify that:

(a) the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements in IAS 39; and

(b) accordingly, a gain or loss should be recognised after initial recognition only to the extent it arises from a change in a factor (including time) that market participants would consider in setting a price.

BC17. The Board also decided not to add any additional guidance on fair value measurement at this time. It concluded that because the guidance recently provided on fair value measurement in the revision to IAS 39 is extensive, seemingly minor changes could have unforeseen consequences. It also decided to monitor developments in US GAAP and seek convergence where possible.

