



# **Financial Instruments: Classification and Measurement Exposure Draft ED/2009/7**

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**Public Discussion**

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# Project Overview – Replacement of IAS 39

Project phase	Exposure Draft	Finalisation
1. Classification and Measurement	July 2009	In time for 2009 year end financial statements
2. Impairment	October 2009	In 2010
3. Hedge Accounting	December 2009	In 2010

Mandatory application not before 1 January 2012

In addition separate project '*Derecognition*' (ED/2009/3 issued March 2009)



## ED/2009/7 FI: Classification and Measurement

- Published 14 July 2009
- 60 days commenting period until 14 September 2009
- Objectives of the Exposure Draft:
  - Enhance decision-useful information for users
    - Proposals will make it easier for investors to understand financial statements regarding how financial instruments are classified and measured
    - Proposals will significantly reduce complexity
  - Proposals respond directly to and are consistent with the recommendations and timetable set out by the G20 leaders and other international bodies



## ED/2009/7 - Table of contents

- Only two remaining measurement bases
  - Fair value or
  - Amortised cost
- Simplified accounting for embedded derivatives
- Fair Value Option remaining for accounting mismatch only
- No reclassification
- Equity Instruments
  - Elimination of the cost exemption
  - Optional Fair Value Through OCI
- Effective Date and Transition
- Alternative Approaches



## ED/2009/7 - Measurement Bases Overview

Financial instruments which meet the following criteria:

- Basic loan features **and**
- Managed on a contractual yield basis



**Amortised cost**  
(one impairment model)



Fair Value Option  
for  
accounting mismatch  
(option)

**Reclassification prohibited**

All other instruments:

- Equities
- Derivatives
- some hybrid contracts
- ...



**Fair Value**  
(no impairment)



Equities:  
OCI presentation  
available  
(option)



## ED/2009/7 - Measurement basis amortised cost (1)

### Basic loan features

- Guiding principle: Contractual terms that give rise to payments of principal and interest
  - Interest is consideration for the time value of money and the associated credit risk
  - The ED's application guidance contains examples in B3 and B4 for basic loan features
  - The ranking of an entity's creditors due to commercial law (including bankruptcy law) leads to subordination of financial instruments which is consistent with the notion of a basic loan feature
  - The same applies to credit risk associated with any secured or senior liabilities ranking above general creditors



## ED/2009/7 - Measurement basis amortised cost (2)

- Contractual terms that change the timing or amount of payments of principal or interest as well as other contractual features that result in cash flows that are not payments of principal and interest are not basic loan features
- An interest swap, or a forward contract or option contract to deliver another financial instrument, does not have basic loan features
- If a financial asset is acquired at a discount that reflects incurred credit losses, it does not have basic loan features
- In some types of transactions, an entity may prioritise payments to the holders of the financial assets using multiple contractually subordinated interests (ie tranches). Any tranche that provides credit protection to other tranches in any situation does not have basic loan features. As a result, only the most senior tranche will have basic loan features



## ED/2009/7 - Measurement basis amortised cost (3)

### Managed on a contractual yield basis

- The business model of the respective business unit is to manage financial instruments and evaluate their performance on the basis of the contractual cash flows generated when holding or issuing those instruments
- Not an instrument by instrument approach to classification
- The ED's application guidance contains examples in B12 and B13 of financial instruments that are managed or not managed on a contractual yield basis



## ED/2009/7 - Measurement basis amortised cost (4)

### Elimination of the tainting rules

- ie sale/repurchase of a financial instrument measured at amortised cost before maturity does not result in mandatory reclassification of the remaining instruments in this category
- but gains and losses arising from the derecognition of financial assets and financial liabilities measured at amortised cost shall be presented in a separate line item in the statement of comprehensive income
- Additionally IFRS 7.20A requires to disclose a reconciliation of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets and financial liabilities measured at amortised cost



## ED/2009/7 - Measurement basis amortised cost (5)

### 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?



## ED/2009/7 - Measurement basis amortised cost (6)

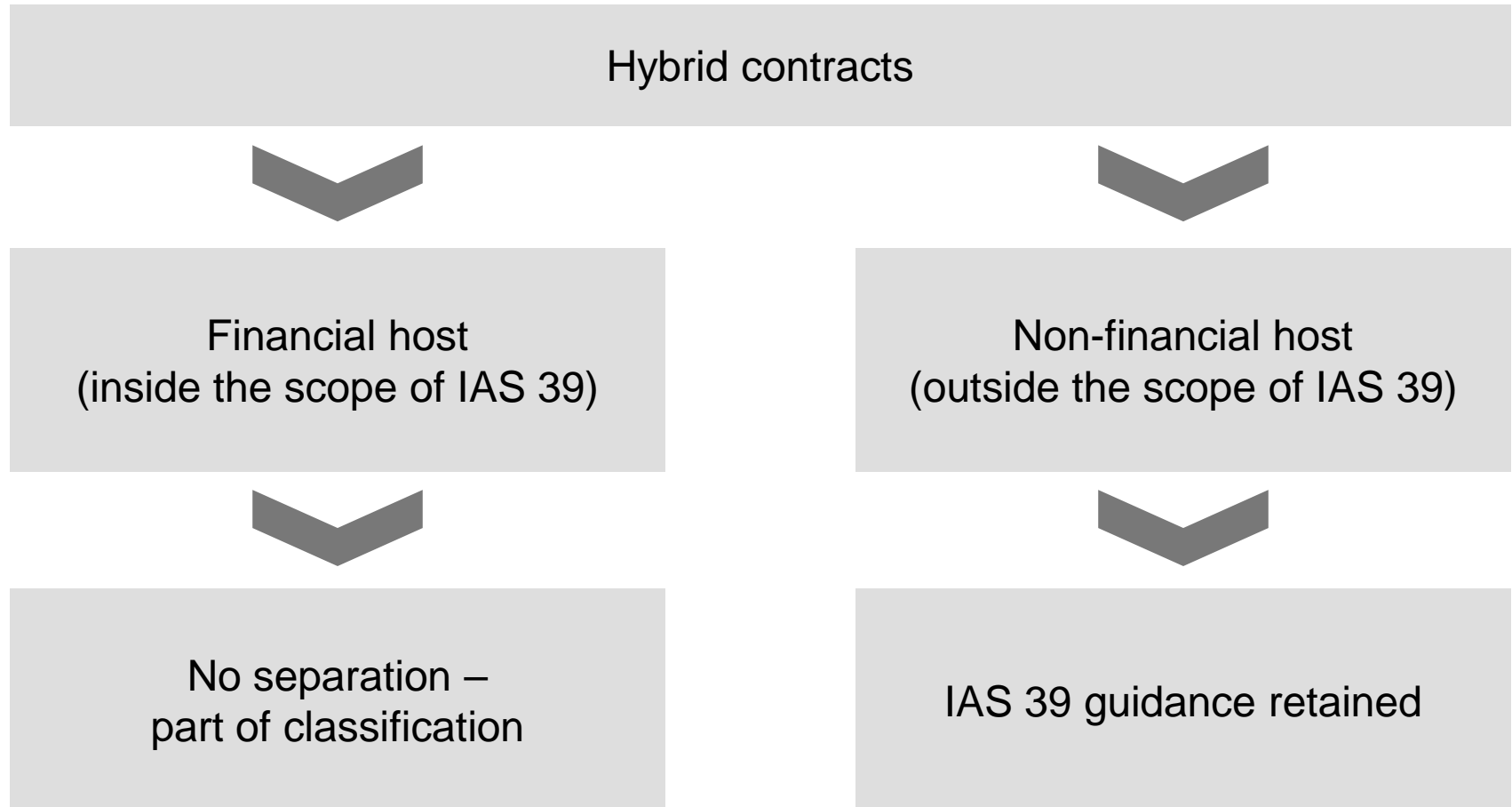
### Question 3

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?



## ED/2009/7 - Embedded derivatives (1)





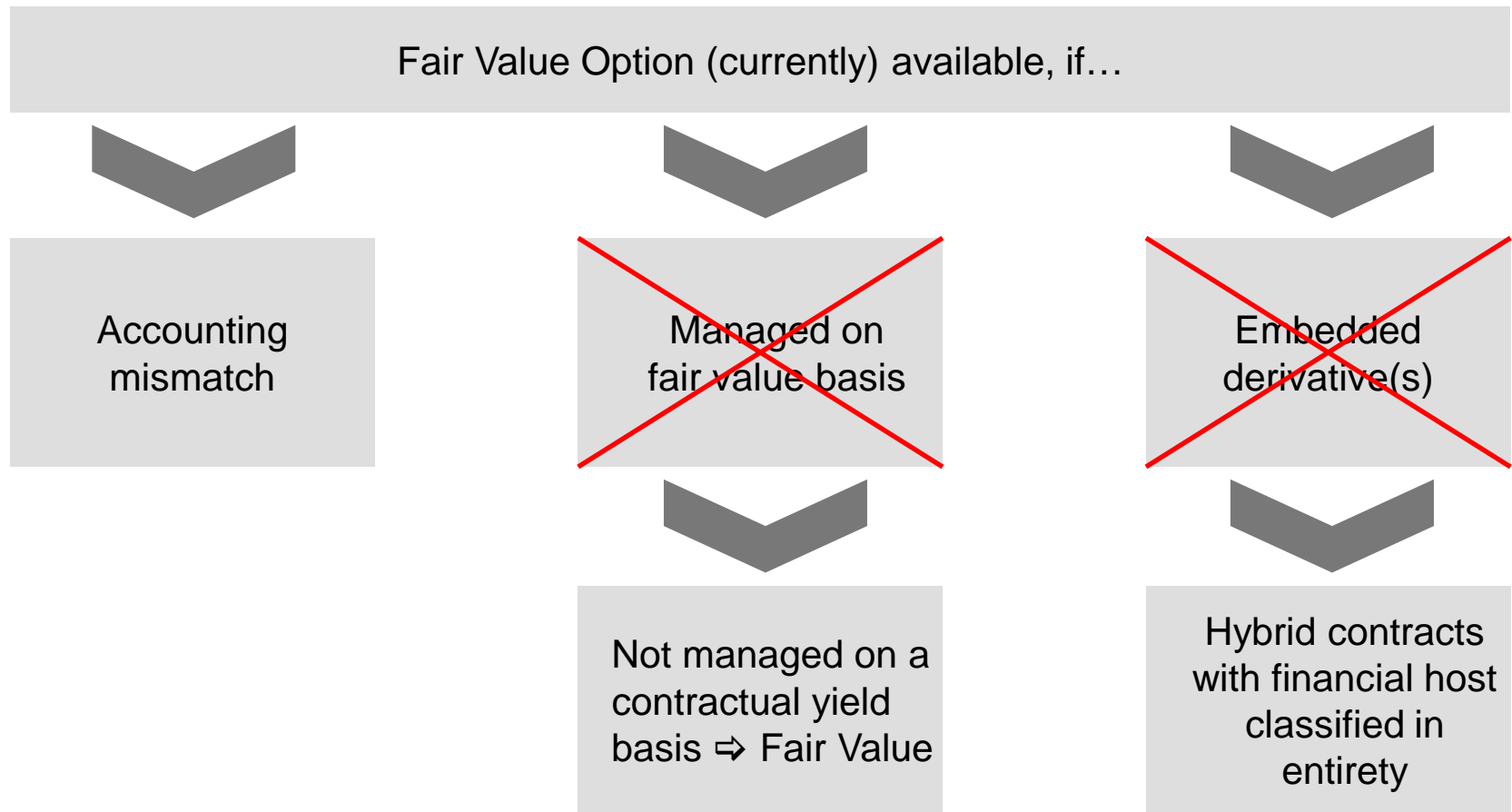
## ED/2009/7 – Embedded derivatives (2)

### 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?



# ED/2009/7 - Fair Value Option (1)





## ED/2009/7 – Fair Value Option (2)

### 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 circumstances should it be allowed and why?



## ED/2009/7 – Reclassification (1)

- The ED prohibits any reclassification of financial assets and financial liabilities between the fair value and amortised cost categories, ‘under any circumstances’ (see ED Appendix B Par. B11)
- This decision is based on the following reasons:
  - The elimination of the held-to-maturity category and the associated tainting provision would render the associated reclassification requirements unnecessary
  - Reclassifications would not make it easier for users to understand the information that financial statements provide about financial instruments
  - Reclassifications would also increase complexity because detailed guidance would be required to specify when reclassifications would be permitted and the subsequent accounting for any reclassified items



## ED/2009/7 – Reclassification (2)

### 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?



## ED/2009/7 - Equity Instruments (1)

- Equity instruments have no contractual cash flows and therefore no basic loan features ⇒ measured at fair value
- Elimination of the cost exemption, because
  - measuring investments in equity instruments at fair value provides the most relevant information to users
  - IAS 39 requires the holder to monitor the investments for impairment and recognise a loss if incurred. That requirement is based on a calculation that is similar to a fair value determination and is no more reliable than measuring the equity investment at fair value
  - removing this exemption would also reduce complexity. A possible increased complexity in determining the fair value of the equity investment would be offset by eliminating the requirement to monitor it for impairment
  - Valuation methodologies for equity investments are well-developed and are often far less complex than those required for other financial instruments that are required to be measured at fair value, including many complex derivative products
  - in many cases reliable valuation models are at hand for which parameters can be set accordingly



## ED/2009/7 – Equity instruments (2)

### 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?



## ED/2009/7 - Equity instruments (3)

- Equity instruments have no contractual cash flows and therefore no basic loan features ⇒ generally measured at fair value
- ED contains an option to present fair value changes in other comprehensive income (OCI)
  - Scope – investments in equity instruments not held for trading (but not for derivatives linked to those investments)
  - Features:
    - option available instrument by instrument
    - no recycling, impairment or change in presentation
    - dividends recognised in OCI



## ED/2009/7 – Equity instruments (4)

### 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 investments 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?



## ED/2009/7 - Effective date

- Effective date has not yet been determined. As all three phases of this project are intended to become mandatory at the same time, it is currently expected that this date will not be before January 2012
- It is planned that the new requirements for classification and measurement of financial instruments will be available for early voluntary application in 2009 year end financial statements



## ED/2009/7 - Transition (1)

- Upon early application an entity shall apply the consequential amendments to IFRS 7 for that earlier period and disclose for each class of financial assets and financial liabilities at the date of initial application:
  - a) the original measurement category and carrying amount determined in accordance with IAS 39;
  - b) the new measurement category and carrying amount determined in accordance with [draft] IFRS X;
  - c) the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that have been reclassified in accordance with paragraph 9 of [draft] IFRS X, and their original measurement basis and presentation method;



## ED/2009/7 - Transition (2)

- d) the amount of any financial assets or financial liabilities that were previously designated as at fair value through profit or loss that are no longer so designated, distinguishing between those that [draft] IFRS X requires to reclassify and those that an entity elects to reclassify.

An entity shall present the above listed quantitative disclosures in tabular format unless another format is more appropriate. In addition, an entity shall disclose qualitative information to enable users to understand:

- a) the reasons for how it applied the classification requirements in [draft] IFRS X for those financial assets or financial liabilities whose classification has changed as a result of applying [draft] IFRS X;
- b) the reasons for any designation or revocation of financial assets or financial liabilities at fair value through profit or loss.



## ED/2009/7 - Transition (3)

- In principle retrospective application of the new guidance
- Transition requirements contain the following relief:
  - An entity shall assess whether financial instruments meet the conditions to be measured at amortised cost on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively;
  - For hybrid contracts bifurcated so far, the entity shall measure the hybrid contract in the comparative periods using the sum of the fair values of its components if the fair value of the hybrid contract had not been determined in comparative periods;
  - Designating or revoking of previous designation of financial instruments as at fair value through profit or loss shall be done on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively;
  - Designating an investment in an equity instrument as at fair value through OCI 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;



## ED/2009/7 - Transition (4)

- If it is impracticable to retrospectively apply the effective interest method, amortised cost of the financial instrument shall be determined on the basis of the fair value at the end of each comparative period;
- Investments in unquoted equity instruments previously accounted for at cost, 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;
- 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;
- An entity that prepares interim financial reports in accordance with IAS 34 need not apply the requirements in this [draft] IFRS to prior interim periods if it is impracticable (as defined in IAS 8).



## ED/2009/7 – Transition (5)

### 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?



## ED/2009/7 – Consequential amendments (1)

- The proposals will result in considerable consequential amendments to other standards and interpretations (this part of the ED alone contains 88 pages)
- The consequential amendments primarily relate to references to the new [draft] IFRS (instead of IAS 39) and changes due to the reduced number of measurement categories for financial instruments
- In addition, prominent changes are introduced into the following standards and interpretations:
  - **IFRS 1:** The assessment whether financial instruments meet the conditions to be measured at amortised cost as well as the designation of financial instruments as at fair value through profit or loss shall be made on the basis of the facts and circumstances that exist at the date of transition to IFRSs. That classification shall be applied retrospectively



## ED/2009/7 – Consequential amendments (2)

- **IFRS 7:** Additional disclosures for equity instruments measured at fair value through OCI (which investments, reasons, fair value of each such investment, disposals). Reconciliation of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial instruments measured at amortised cost
- **IAS 1:** gains/losses arising from the derecognition of financial instruments measured at amortised cost shall be presented in a separate line item in the statement of comprehensive income. Gains/losses (including dividends) from equity instruments measured at fair value through OCI are a component of OCI
- **IAS 39:** extensive changes, several paragraphs are replaced by requirements in the new [draft] IFRS, some remain (for the time being) in IAS 39, the rest are deleted (refer to table in C25 in the ED part draft amendments to other IFRSs and guidance)
- **IFRIC 9:** The Interpretation now only relates to hybrid contracts with non-financial hosts (outside the scope of IAS 39)



## ED/2009/7 - Alternative approach (1)

Starting point is the classification approach contained in the ED. Financial assets that meet the two conditions specified in the ED (ie they have basic loan features and are managed on a contractual yield basis) are subject to an additional test. If those instruments also meet the definition of loans and receivables in IAS 39, they 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 ED 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.



## ED/2009/7 - Alternative approach (2)

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

### 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?



## ED/2009/7 - Variants of the alternative approach (1)

- The **first variant** matches the alternative approach with the exception to present both a) and b) in profit or loss, but separately – as single line items.
- The **second variant** would be to measure all financial instruments (including financial assets that meet the two conditions specified in the ED 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) of the alternative approach.



## ED/2009/7 – Variants of the alternative approach (2)

### 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?



## ED/2009/7 – Points for further discussion

- Are there currently additional accounting areas that require immediate action by the IASB?
- How many entities are planning an early adoption of this standard? Will this result in difficulties regarding data collection?
- Which entities struggle with the proposals in the ED, and why?
- Current practice regarding measuring unquoted equity instruments?
- Tentative decisions of the FASB regarding their new model for financial instruments accounting known?



## ED/2009/7 - The next steps

October 2009:  
IASB publishes ED  
on **impairment of  
financial assets**

During 2010:

IASB to **complete replacement of  
IAS 39** by issuing final guidance on:

- impairment
- derecognition\*
- hedge accounting

Q4/2009:  
IASB to issue **final IFRS  
on classification and  
measurement of  
financial instruments**  
IASB to publish ED on  
**hedge accounting**

1 January 2012:  
Expected **mandatory effective  
date** of successor standard to  
IAS 39

\*separate project



Deutsches Rechnungslegungs Standards Committee e.V.  
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